GLOSSARY

The definitions in this Glossary apply to the Reports of Condition and Income and are not necessarily applicable for other regulatory or legal purposes. Similarly, the accounting discussions in this Glossary are those relevant to the preparation of these reports and are not intended to constitute a comprehensive presentation on bank accounting.

Acceptances: See "bankers acceptances."

Accounting Changes: Changes in accounting principles -- The accounting principles that banks have adopted for the preparation of their Reports of Condition and Income should be changed only in the direction of more preferable accounting practices. If a bank changes from the use of one acceptable accounting principle to one that is more preferable at any time during the calendar year, it must report the income or expense item(s) affected by the change for the entire year on the basis of the newly adopted accounting principle regardless of the date when the change is actually made. However, a change from an accounting principle that is neither accepted nor sanctioned by bank supervisors to one that is acceptable to supervisors is to be reported as a correction of an error as discussed below.

New accounting standards that are adopted by the Financial Accounting Standards Board (or such other body officially designated to establish accounting principles) may apply retroactively and may require or allow a bank to restate prior years' financial statements prepared in accordance with generally accepted accounting principles. Because each Report of Income covers a single discrete period, retroactive restatement of prior years' Reports of Condition and Income is not permitted. However, the effects of restatement should be reported in the Reports of Condition and Income in a manner consistent with a bank's financial statements for the same reporting period prepared in accordance with generally accepted accounting principles. Therefore, if restatement of prior periods is required (or if the bank elects to restate prior periods if restatement is allowed but not required), the effect on the amount of retained earnings at the beginning of the year in which the new standard is first adopted for purposes of the Reports of Condition and Income (net of applicable income taxes, if any) is to be excluded from net income and reported as a direct adjustment to equity capital in Schedule RI-A, item 2, and detailed in Schedule RI-E, item 4.

If a new standard must be applied retroactively but restatement of prior years' financial statements is not allowed (or if the bank elects not to restate prior periods if restatement is allowed but not required), the effect of the retroactive application on retained earnings at the beginning of the year in which the new standard is first adopted for purposes of the Reports of Condition and Income is to be included in net income like the cumulative effect of a change in accounting principle as described above. The amount of this effect (net of applicable income taxes, if any) is to be reported in Schedule RI, item 11, and detailed in Schedule RI-E, item 3.

Changes in accounting estimates -- Accounting and the preparation of financial statements involve the use of estimates. As more current information becomes known, estimates may be changed. In particular, accruals are derived from estimates based on judgments about the outcome of future events and changes in these estimates are an inherent part of accrual accounting.

Reasonable changes in accounting estimates do not require the restatement of amounts of income and expenses and assets, liabilities, and capital reported in previously submitted Reports of Condition and Income. Computation of the cumulative effect of these changes is also not ordinarily necessary. Rather, the effect of such changes is handled on a prospective basis. That is, beginning in the period when an accounting estimate is revised, the related item of income or expense for that period is adjusted accordingly. For example, if the bank's estimate of the remaining useful life of certain bank equipment is increased, the remaining undepreciated cost of the equipment would be spread over its

Accounting Changes (cont.):

revised remaining useful life. Similarly, immaterial accrual adjustments to items of income and expenses, including provisions for loan and lease losses and income taxes, are considered changes in accounting estimates and would be taken into account by adjusting the affected income and expense accounts for the year in which the adjustments were found to be appropriate.

However, large and unusual changes in accounting estimates may be more properly treated as constituting accounting errors, and if so, must be reported accordingly as described below.

Corrections of accounting errors -- A bank may become aware of an error in a Report of Condition or Report of Income after it has been submitted to the appropriate federal bank regulatory agency through either its own or its regulator's discovery of the error. An error in a report for a prior period may result from:

(1) a mathematical mistake;

(2) a mistake in applying accounting principles; or

(3) the improper use of information that existed when the Reports of Condition and Income for prior periods were prepared.

When a bank's primary federal bank regulatory agency determines that the bank's Reports of Condition and Income contain a material accounting error, the bank may be directed to file amended condition and/or income report data for each prior period that was significantly affected by the error. Normally, such refilings will not be retroactively required for a period exceeding five years. If amended reports are not required, the bank should report the effect of such corrections on retained earnings at the beginning of the year, net of applicable income taxes, in Schedule RI-A, item 2, "Restatements due to corrections of material accounting errors and changes in accounting principles," and in Schedule RI-E, item 4. The effect of such corrections on income and expenses since the beginning of the year in which the error is discovered should be reflected in each affected income and expense account on a year-to-date basis in the next quarterly Report of Income to be filed and not as a direct adjustment to retained earnings.

In addition, a change from an accounting principle that is neither accepted nor sanctioned by bank supervisors to one that is acceptable to supervisors is to be reported as a correction of an error. When such a change is implemented, the cumulative effect that applies to prior periods, calculated in the same manner as described above for other changes in accounting principles, should be reported in Schedule RI-A, item 2, "Restatements due to corrections of material accounting errors and changes in accounting principles," and in Schedule RI-E, item 4. In most cases of this kind undertaken voluntarily by the reporting bank in order to adopt more acceptable accounting practices, such a change will not result in a request for amended reports for prior periods unless substantial distortions in the bank's previously reported results are in evidence.

For further information on these three topics, see APB Opinion No. 20, "Accounting Changes," as amended.

Accounting Errors, Corrections of: See "accounting changes."

Accounting Estimates, Changes in: See "accounting changes."

Accounting Principles, Changes in: See "accounting changes."

Acquisition, Development, or Construction (ADC) Arrangements: An ADC arrangement is an arrangement in which a bank provides financing for real estate acquisition, development, or construction purposes and participates in the expected residual profit resulting from the ultimate sale or other use of the property. ADC arrangements should be reported as loans, real estate joint ventures, or direct investments in real estate in accordance with guidance presented by the American Institute of Certified Public Accountants in a Notice to Practitioners issued in February 1986 (or, if appropriate, in notices issued in November 1983 and November 1984).

12 USC 29 limits the authority of national banks to hold real estate. National banks should review real estate ADC arrangements carefully for compliance. State member banks are not authorized to invest in real estate except with the prior approval of the Federal Reserve Board under Federal Reserve Regulation H (12 CFR Part 208).

Agreement Corporation: See "Edge and Agreement corporation."

Allowance for Loan and Lease Losses: Each bank must maintain an allowance for loan and lease losses (allowance) that is adequate to absorb estimated credit losses associated with its loan and lease portfolio, i.e., loans and leases that the bank has intent and ability to hold for the foreseeable future or until maturity or payoff. Each bank should also maintain, as a separate liability account, an allowance sufficient to absorb estimated credit losses associated with off-balance sheet credit instruments such as off-balance sheet loan commitments, standby letters of credit, and guarantees. This separate allowance should be reported in Schedule RC-G, item 3, "Allowance for credit losses on off-balance sheet credit exposures," not as part of the "Allowance for loan and lease losses" in Schedule RC, item 4.c.

With respect to the loan and lease portfolio, the term "estimated credit losses" means an estimate of the current amount of loans and leases that is not likely to be collected; that is, net charge-offs that are likely to be realized for a loan or pool of loans given facts and circumstances as of the evaluation date. These estimated credit losses should meet the criteria for accrual of a loss contingency (i.e., a provision to the allowance) set forth in generally accepted accounting principles (GAAP).

As of the end of each quarter, or more frequently if warranted, the management of each bank must evaluate, subject to examiner review, the collectibility of the loan and lease portfolio, including any recorded accrued and unpaid interest (i.e., not already reversed or charged off), and make appropriate entries to maintain the balance of the allowance for loan and lease losses on the balance sheet at a level adequate to absorb estimated credit losses. Management must maintain reasonable records in support of their evaluations and entries.

Additions to, or reductions of, the allowance account resulting from such evaluations are to be made through charges or credits to the "provision for loan and lease losses" (provision) in the Report of Income. When available information confirms that specific loans and leases, or portions thereof, are uncollectible, these amounts should be promptly charged off against the allowance. All charge-offs of loans and leases shall be charged directly to the allowance and any recoveries on loans or leases previously charged off shall be credited to the allowance. Under no circumstances can loan or lease losses be charged directly to "Retained earnings."

When a bank makes a full or partial direct write-down of a loan or lease that is uncollectible, the bank establishes a new cost basis for the asset. Consequently, once a new cost basis has been established for a loan or lease through a direct write-down, this cost basis may not be "written up" at a later date. Reversing the previous write-down and "re-booking" the charged-off asset after the bank concludes that the prospects for recovering the charge-off have improved, regardless of whether the bank assigns a new account number to the asset or the borrower signs a new note, is not an acceptable accounting practice.

Allowance for Loan and Lease Losses (cont.):

The allowance account must never have a debit balance. If losses charged off exceed the amount of the allowance, a provision sufficient to restore the allowance to an adequate level must be charged to expense on the income statement immediately. A bank shall not increase the allowance account by transferring an amount from undivided profits or any segregation thereof to the allowance for loan and lease losses.

To the extent that a bank's reserve for bad debts for tax purposes is greater than or less than its "allowance for loan and lease losses" on the balance sheet of the Report of Condition, the difference is referred to as a temporary difference. See the Glossary entry for "income taxes" for guidance on how to report the tax effect of such a temporary difference.

Recourse liability accounts that arise from recourse obligations for any transfers of loans that are reported as sales for purposes of these reports should not be included in the allowance for loan and lease losses. These accounts are considered separate and distinct from the allowance account and from the allowance for credit losses on off-balance sheet credit exposures. Recourse liability accounts should be reported in Schedule RC-G, item 4, "Other" liabilities.

For comprehensive guidance on the maintenance of an adequate allowance for loan and lease losses, banks should refer to the Interagency Policy Statement on the Allowance for Loan and Lease Losses dated December 21, 1993. For guidance on the design and implementation of allowance methodologies and supporting documentation practices, banks should refer to the interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Associations, which was published on July 6, 2001. National banks should also refer to the Office of the Comptroller of the Currency's Handbook for National Bank Examiners discussing the allowance for loan and lease losses. Information on the application of FASB Statement No. 114, "Accounting by Creditors for Impairment of a Loan," to the determination of an allowance for loan and losses on those loans covered by that accounting standard is provided in the Glossary entry for "loan impairment."

For information on reporting on foreclosed and repossessed assets, see the Glossary entry for "foreclosed assets."

Applicable Income Taxes: See "income taxes."

Associated Company: See "subsidiaries."

ATS Account: See "deposits."

Bankers Acceptances: A banker's acceptance, for purposes of these reports, is a draft or bill of exchange that has been drawn on and accepted by a banking institution (the "accepting bank") or its agent for payment by that institution at a future date that is specified in the instrument. Funds are advanced to the drawer of the acceptance by the discounting of the accepted draft either by the accepting bank or by others; the accepted draft is negotiable and may be sold and resold subsequent to its original discounting. At the maturity date specified, the holder or owner of the acceptance at that date, who has advanced funds either by initial discount or subsequent purchase, presents the accepted draft to the accepting bank for payment.

The accepting bank has an unconditional obligation to put the holder in funds (to pay the holder the face amount of the draft) on presentation on the specified date. The account party (customer) has an unconditional obligation to put the accepting bank in funds at or before the maturity date specified in the instrument.

Bankers Acceptances (cont.):

The following description covers the treatment in the Report of Condition of (1) acceptances that have been executed by the reporting bank, that is, those drafts that have been drawn on and accepted by it; (2) "participations" in acceptances, that is, "participations" in the accepting bank's obligation to put the holder of the acceptance in funds at maturity, or participations in the accepting bank's risk of loss in the event of default by the account party; and (3) acceptances owned by the reporting bank, that is, those acceptances -- whether executed by the reporting bank or by others -- that the bank has discounted or purchased.

(1) Acceptances executed by the reporting bank -- With the exceptions described below, the accepting bank must report on its balance sheet the full amount of the acceptance in both (1) the liability item, "Bank's liability on acceptances executed and outstanding" (Schedule RC, item 18), reflecting the accepting bank's obligation to put the holder of the acceptance in funds at maturity, and (2) the asset item, "Customers' liability to this bank on acceptances outstanding" (Schedule RC, item 9), reflecting the account party's liability to put the accepting bank in funds at or before maturity.

Exceptions to the mandatory reporting by the accepting bank of the full amount of all outstanding drafts accepted by the reporting bank in both Liability Item 18 and Asset Item 9 on the balance sheet of the Consolidated Report of Condition occur in the following situations:

(a) One exception occurs in situations where the accepting bank acquires -- through initial discounting or subsequent purchase -- and holds its own acceptance (i.e., a draft that it has itself accepted). In this case, the reporting bank's own acceptances that are held by it should not be reported in the acceptance liability and asset items noted above (i.e., "Bank's liability on acceptances executed and outstanding" and "Customers' liability to this bank on acceptances outstanding"). The bank's holdings of its own acceptances should be reported in "Loans and leases held for sale" (Schedule RC, item 4.a), "Loans and leases, net of unearned income" (Schedule RC, item 4.b), or "Trading assets" (Schedule RC, item 5), as appropriate.

(b) Another exception occurs in situations where the account party anticipates its liability to the reporting bank on an acceptance outstanding by making a payment to the bank that reduces the customer's liability in advance of the maturity of the acceptance. In this case, the reporting bank should decrease the asset item "Customers' liability to this bank on acceptances outstanding" (Schedule RC, item 9) by the amount of such prepayment; the prepayment will not affect the liability item "Bank's liability on acceptances executed and outstanding" (Schedule RC, item 18), which would continue to reflect the full amount of the acceptance until the bank has repaid the holder of the acceptance at the maturity date specified in the instrument. If the account party's payment to the accepting bank before the maturity date is not for the purpose of immediate reduction of its indebtedness to the reporting bank or if receipt of the payment does not immediately reduce or extinguish that indebtedness, such advance payment will not reduce item 9 of Schedule RC but should be reflected in the bank's deposit liabilities.

In all situations other than these two exceptions just described, the accepting bank must report the full amount of its acceptances in its liability item, "Bank's liability on acceptances executed and outstanding," and in its asset item, "Customers' liability to this bank on acceptances outstanding." There are no other circumstances in which the accepting bank can report as a balance sheet liability anything less than the full amount of the obligation to put the holder of the acceptance in funds at maturity. Moreover, there are no circumstances in which the reporting bank can net its acceptance assets against its acceptance liabilities.

Bankers Acceptances (cont.):

NOTE: The amount of a reporting member (both national and state) bank's acceptances that are subject to statutory limitations on eligible acceptances as set forth in federal statute 12 USC 372 and in Federal Reserve regulation 12 CFR Part 250 may differ from the required reporting of acceptances on the balance sheet of the Consolidated Report of Condition, as described above. These differences are mainly attributable to ineligible acceptances, to participations in the reporting bank's acceptances conveyed to others, to participations acquired by the reporting bank in other banks' acceptances, and to the effect of the consolidation of subsidiaries in the Report of Condition.

(2) "Participations" in acceptances -- The general requirement for the accepting bank to report on its balance sheet the full amount of the total obligation to put the holder of the acceptance in funds applies also, in particular, to any situation in which the accepting bank enters into any kind of arrangement with others for the purpose of having the latter share, or participate, in the obligation to put the holder of the acceptance in funds at maturity or in the risk of loss in the event of default on the part of the account party.[1] In any such sharing arrangement or participation agreement -- regardless of its form or its contract provisions, regardless of the terminology (e.g., "funded," "risk," "unconditional," or "contingent") used to describe it and the relationships under it, regardless of whether it is described as a participation in the customer's liability or in the accepting bank's obligation or in the risk of default by the account party, and regardless of the system of debits and credits used by the accepting bank to reflect the participation arrangement -- the existence of the participation or other agreement does not reduce the accepting bank's obligation to honor the full amount of the acceptance at maturity nor change the requirement for the accepting bank to report the full amount of the acceptance in the liability and asset items described above.

The existence of such participations is not to be recorded on the balance sheet (Schedule RC) of the accepting bank that conveys shares in its obligation to put the holder of the acceptance in funds or shares in its risk of loss in the event of default on the part of the account party, and similarly is not to be recorded on the balance sheets (Schedule RC) of the other banks that are party to, or acquire, such participations. However, in such cases of agreements to participate, the accepting bank engaging in the participation agreement will report the participation in Schedule RC-L, item 5, "Participations in acceptances conveyed to others by the reporting bank," if it has foreign offices or $100 million or more in total assets. The nonaccepting bank acquiring the participation will report the participation in Schedule RC-R, item 47, “Risk participations in bankers acceptances acquired by the reporting institution.” This same reporting treatment applies to a bank that acquires a participation in an acceptance of another (accepting) bank and subsequently conveys the participation to others and to a bank that acquires such a participation. Moreover, the bank that both acquires and conveys a participation in another bank's acceptance must report the amounts of the participations in both acceptance participation items in Schedule RC-L and Schedule RC-R.

NOTE: The amount of participations in acceptances reported in Schedule RC-L by a member bank may differ from the amount of such participations that enter into the calculation of the bank's acceptances to be counted toward its acceptance limit under federal statute 12 USC 372 and Federal Reserve regulation 12 CFR Part 250. Such differences are mainly attributable to participations in ineligible acceptances, to participations with "noncovered" institutions, and to participations that do not conform to the minimum requirements set forth in 12 CFR Part 250.

[1] This discussion does not deal with participations in holdings of bankers acceptances, which are reportable as loans. Such participations are treated like any participations in loans as described in the Glossary entry for "transfers of financial assets."

Bankers Acceptances (cont.):

(3) Acceptances owned by the reporting bank -- The treatment of acceptances owned or held by the reporting bank (whether acquired by initial discount or subsequent purchase) depends upon whether the acceptances are held for trading, for sale, or in portfolio and upon whether the acceptances held have been accepted by the reporting bank or by other banks.

All acceptances held for trading by the reporting bank (whether acceptances of the reporting bank or of other banks) are to be reported in Schedule RC, item 5, "Trading assets." Banks that must complete Schedule RC-D, Trading Assets and Liabilities, will identify these holdings (in domestic offices) in item 9, "Other trading assets (in domestic offices)." Banks with foreign offices that must complete Schedule RC-D will identify these holdings in foreign offices in item 10, "Trading assets in foreign offices."

The reporting bank's holdings of acceptances other than those held for trading (whether acceptances of the reporting bank or of other banks) are to be reported in Schedule RC, item 4.a, "Loans and leases held for sale," or in item 4.b, "Loans and leases, net of unearned income," as appropriate, and in Schedule RC-C, part I, "Loans and Lease financing receivables."

In Schedule RC-C, part I, the reporting bank's holdings of other banks' acceptances, other than those held for trading, are to be reported in "Loans to depository institutions and acceptances of other banks" (item 2). On the other hand, the bank's holdings of its own acceptances, other than those held for trading, are to be reported in Schedule RC-C, part I, according to the account party of the draft. Thus, holdings of own acceptances for which the account parties are commercial or industrial enterprises are to be reported in Schedule RC-C, part I, in "Commercial and industrial loans" (item 4); holdings of own acceptances for which the account parties are other banks (e.g., in connection with the refinancing of another acceptance or for the financing of dollar exchange) are to be reported in Schedule RC-C, part I, in "Loans to depository institutions and acceptances of other banks" (item 2); and holdings of own acceptances for which the account parties are foreign governments or official institutions (e.g., for the financing of dollar exchange) are to be reported in Schedule RC-C, part I, "Loans to foreign governments and official institutions" (item 7).

The difference in treatment between holdings of own acceptances and holdings of other banks' acceptances reflects the fact that, for other banks' acceptances, the holding bank's immediate claim is on the accepting bank, regardless of the account party or of the purpose of the loan. On the other hand, for its holdings of its own acceptances, the bank's immediate claim is on the account party named in the accepted draft.

If the account party prepays its acceptance liability on an acceptance of the reporting bank that is held by the reporting bank (in the held-for-sale account, in the loan portfolio, or as trading assets) so as to immediately reduce its indebtedness to the reporting bank, the recording of the holding -- in "Commercial and industrial loans," "Loans to depository institutions and acceptances of other banks," or "Trading assets," as appropriate -- is reduced by the prepayment.

Banks, U.S. and Foreign: In the classification of banks as customers of the reporting bank, distinctions are drawn for purposes of the Reports of Condition and Income between "U.S. banks" and "commercial banks in the U.S." and between "foreign banks" and "banks in foreign countries." Some report items call for one set of these categories and other items call for the other set. The distinctions center around the inclusion or exclusion of foreign branches of U.S. banks and U.S. branches and agencies of foreign banks. For purposes of describing the office location of banks as customers of the reporting bank, the term "United States" covers the 50 states of the United States, the District of Columbia, Puerto Rico, and U.S. territories and possessions. (This is in contrast to the usage with respect to the offices of the reporting bank, where offices in Puerto Rico and U.S. territories and possessions and U.S.-domiciled Edge and Agreement subsidiaries and IBFs are included in "foreign" offices.)

Banks, U.S. and Foreign (cont.):

U.S. banks - The term "U.S. banks" covers both the U.S. and foreign branches of banks chartered and headquartered in the U.S. (including U.S.-chartered banks owned by foreigners), but excluding U.S. branches and agencies of foreign banks. On the other hand, the term "banks in the U.S." or "commercial banks in the U.S." (the institutional coverage of which is described in detail later in this entry) covers the U.S. offices of U.S. banks (including their IBFs) and the U.S. branches and agencies of foreign banks, but excludes the foreign branches of U.S. banks.

Foreign banks - Similarly, the term "foreign banks" covers all branches of banks chartered and headquartered in foreign countries (including foreign banks owned by U.S. nationals and institutions), including their U.S.-domiciled branches and agencies, but excluding the foreign branches of U.S. banks. In contrast, the term "banks in foreign countries" covers foreign-domiciled branches of banks, including the foreign branches of U.S. banks, but excluding the U.S. branches and agencies of foreign banks.

The following table summarizes these contrasting categories of banks considered as customers as used in the Reports of Condition and Income ("X" indicates inclusion; no entry indicates exclusion.)

	"U.S. banks"	"Commercial banks in the U.S."	"Foreign banks"	"Banks in foreign countries"
U.S. branches of U.S. banks (including IBFs)	X	X		
Foreign branches of U.S. banks	X			X
Foreign branches of foreign banks			X	X
U.S. branches and agencies of foreign banks		X	X	

Commercial banks in the U.S. -- The detailed institutional composition of "commercial banks in the U.S." includes:

(1) the U.S.-domiciled head offices and branches of:

(a) national banks;
(b) state-chartered commercial banks;
(c) trust companies that perform a commercial banking business;
(d) industrial banks;
(e) private or unincorporated banks;
(f) International Banking Facilities (IBFs) of U.S. banks;
(g) Edge and Agreement corporations; and

(2) the U.S.-domiciled branches and agencies of foreign banks (as defined below).

Banks, U.S. and Foreign (cont.):

This coverage includes the U.S. institutions listed above that are owned by foreigners. Excluded from commercial banks in the U.S. are branches located in foreign countries of U.S. banks.

U.S. savings and loan associations and savings banks are treated as "other depository institutions in the U.S." for purposes of the Reports of Condition and Income.

U.S. branches and agencies of foreign banks -- U.S. branches of foreign banks include any offices or places of business of foreign banks that are located in the United States at which deposits are accepted. U.S. agencies of foreign banks include any offices or places of business of foreign banks that are located in the United States at which credit balances are maintained incidental to or arising out of the exercise of banking powers but at which deposits may not be accepted from citizens or residents of the United States.

For purposes of the Reports of Condition and Income, the term "U.S. branches and agencies of foreign banks" covers:

(1) the U.S. branches and agencies of foreign banks;
(2) the U.S. branches and agencies of foreign official banking institutions, including central banks, nationalized banks, and other banking institutions owned by foreign governments; and
(3) investment companies that are chartered under Article XII of the New York State banking law and that are majority-owned by one or more foreign banks.

Banks in foreign countries - The institutional composition of "banks in foreign countries" includes:

(1) the foreign-domiciled head offices and branches of:
  (a) foreign commercial banks (including foreign-domiciled banking subsidiaries of U.S. banks and Edge and Agreement corporations);
  (b) foreign savings banks or discount houses;
  (c) nationalized banks not functioning either as central banks, as foreign development banks, or as banks of issue;
  (d) other similar foreign institutions that accept short-term deposits; and

(2) the foreign-domiciled branches of U.S. banks.

See also "International Banking Facility (IBF)."

Banks in Foreign Countries: See "banks, U.S. and foreign."

Bill-of-Lading Draft: See "commodity or bill-of-lading draft."

Borrowings and Deposits in Foreign Offices: Borrowings in foreign offices include assets rediscounted with central banks, certain participations sold in loans and securities, government fundings of loans, borrowings from the Export-Import Bank, and rediscounted trade acceptances. Federal funds sold and repurchase agreements in foreign offices should be reported in accordance with the Glossary entries for "federal funds transactions" and "repurchase/resale agreements." Liability accounts such as accruals and allocated capital shall not be reported as borrowings. Deposits consist of such other short-term and long-term liabilities issued or undertaken as a means of obtaining funds to be used in the banking business and include those liabilities generally characterized as placements and takings, call money, and deposit substitutes.

Brokered Deposits: Brokered deposits represent funds which the reporting bank obtains, directly or indirectly, by or through any deposit broker for deposit into one or more deposit accounts. Thus, brokered deposits include both those in which the entire beneficial interest in a given bank deposit account or instrument is held by a single depositor and those in which the deposit broker sells participations in a given bank deposit account or instrument to one or more investors.

Fully insured brokered deposits are brokered deposits that are issued in denominations of $100,000 or less or that are issued in denominations greater than $100,000 and participated out by the deposit broker in shares of $100,000 or less.

For purposes of these reports, the term deposit broker includes:

(1) any person engaged in the business of placing deposits, or facilitating the placement of deposits, of third parties with insured depository institutions or the business of placing deposits with insured depository institutions for the purpose of selling interests in those deposits to third parties, and
(2) an agent or trustee who establishes a deposit account to facilitate a business arrangement with an insured depository institution to use the proceeds of the account to fund a prearranged loan.

The term deposit broker does not include:

(1) an insured depository institution, with respect to funds placed with that depository institution;
(2) an employee of an insured depository institution, with respect to funds placed with the employing depository institution;
(3) a trust department of an insured depository institution, if the trust in question has not been established for the primary purpose of placing funds with insured depository institutions;
(4) the trustee of a pension or other employee benefit plan, with respect to funds of the plan;
(5) a person acting as a plan administrator or an investment adviser in connection with a pension plan or other employee benefit plan provided that that person is performing managerial functions with respect to the plan;
(6) the trustee of a testamentary account;
(7) the trustee of an irrevocable trust (other than a trustee who establishes a deposit account to facilitate a business arrangement with an insured depository institution to use the proceeds of the account to fund a prearranged loan), as long as the trust in question has not been established for the primary purpose of placing funds with insured depository institutions;
(8) a trustee or custodian of a pension or profit-sharing plan qualified under Section 401(d) or 430(a) of the Internal Revenue Code of 1986; or
(9) an agent or nominee whose primary purpose is not the placement of funds with depository institutions. (For purposes of applying this ninth exclusion from the definition of deposit broker, "primary purpose" does not mean "primary activity," but should be construed as "primary intent.")

Notwithstanding these nine exclusions, the term deposit broker (as amended on September 23, 1994, by the Riegle Community Development and Regulatory Improvement Act of 1994) includes any insured depository institution that is not well capitalized (as defined in Section 38 of the Federal Deposit Insurance Act, Prompt Corrective Action), and any employee of such institution, which engages, directly or indirectly, in the solicitation of deposits by offering rates of interest which are significantly higher than the prevailing rates of interest on deposits offered by other insured depository institutions in such depository institution's normal market area.[1] For purposes of these reports, only those deposits accepted, renewed, or rolled over on or after June 16, 1992, in connection with this form of deposit solicitation are to be reported as brokered deposits. For further information, see Section 337.6(b) of the FDIC's Rules and Regulations.

[1] Any deposit accepted, renewed, or rolled over by a well capitalized institution before September 23, 1994, in connection with this form of deposit solicitation should continue to be reported as a brokered deposit as long as the deposit remains outstanding under the terms in effect before September 23, 1994. Notwithstanding the amendment to the "deposit broker" definition, all institutions that obtain deposits, directly or indirectly, by or through any other deposit broker must report such funds as brokered deposits in the Report of Condition.

Brokered Deposits (cont.):

In addition, deposit instruments of the reporting bank that are sold to brokers, dealers, or underwriters (including both bank affiliates of the reporting bank and nonbank subsidiaries of the reporting bank's parent holding company) who then reoffer and/or resell these deposit instruments to one or more investors, regardless of the minimum denomination which the investor must purchase, are considered brokered deposits.

In some cases, brokered deposits are issued in the name of the depositor whose funds have been placed in a bank by a deposit broker. In other cases, a bank's deposit account records may indicate that the funds have been deposited in the name of a third party custodian for the benefit of others (e.g., "XYZ Corporation as custodian for the benefit of others," or "Custodial account of XYZ Corporation"). Unless the custodian meets one of the specific exemptions from the "deposit broker" definition in Section 29 of the Federal Deposit Insurance Act and this Glossary entry, these custodial accounts should be reported as brokered deposits in Schedule RC-E, Deposit Liabilities.

A deposit listing service whose only function is to provide information on the availability and terms of accounts is not facilitating the placement of deposits and therefore is not a deposit broker per se. However, if a deposit broker uses a deposit listing service to identify an institution offering a high rate on deposits and then places its customers' funds at that institution, the deposits would be brokered deposits and the institution should report them as such in Schedule RC-E. The designation of these deposits as brokered deposits is based not on the broker's use of the listing service but on the placement of the deposits in the institution by the deposit broker.

Broker's Security Draft: A broker's security draft is a draft with securities or title to securities attached that is drawn to obtain payment for the securities. This draft is sent to a bank for collection with instructions to release the securities only on payment of the draft.

Business Combinations: The accounting and reporting standards for business combinations are set forth in FASB Statement No. 141, "Business Combinations." Statement No. 141 requires that all business combinations *initiated* after June 30, 2001, must be accounted for using the purchase method. The use of the pooling-of-interests method to account for business combinations *initiated* after June 30, 2001, is prohibited. However, for combinations between two or more mutual institutions, Statement No.141 will not take effect until interpretive guidance related to the application of the purchase method to those transactions is issued. Business combinations initiated before July 1, 2001, were accounted for using one of two methods, the pooling-of-interests method or the purchase method. A business combination involving the exchange of voting common stock between unrelated stock institutions and meeting all 12 of the conditions specified in APB Opinion No. 16, "Business Combinations," was accounted for using the pooling-of-interests method; all other unrelated party business combinations were accounted for using the purchase method.

Pooling-of-interests method – Under the pooling-of-interests method, the assets, liabilities, and capital of the bank and the business being acquired are added together on a line-by-line basis without any adjustments for fair market value. The historical cost-based amount (cost adjusted for amortization of premiums and discounts or depreciation) of each asset, liability, and capital account of the acquiring bank is added to the corresponding account of the business being acquired to arrive at the balance sheet for the combined bank. However, the capital stock outstanding of the combined bank must be equal to the number of shares issued and outstanding (including the shares issued in connection with the acquisition) multiplied by par or stated value.

If the sum of the capital stock accounts of the entities being combined does not equal this amount (and it rarely, if ever, will), adjustment is required. If the sum of the capital stock accounts is less than the number of shares outstanding of the combined bank multiplied by par or stated value, "Surplus," Schedule RC, item 25, must be debited for the amount of the difference and "Common stock," Schedule RC, item 24, is credited. If the surplus account is insufficient to absorb such an adjustment

Business Combinations (cont.):

the remainder must be debited to "Retained earnings," Schedule RC, item 26.a. If the sum of the capital stock accounts is more than the amount of the outstanding stock of the combined bank, "Surplus" must be credited and "Common stock" debited.

Any adjustments necessary to conform the accounting methods of the acquired entity to those of the reporting bank must be made, net of related tax effects, to "Retained earnings."

For the year in which a pooling of interests occurs, income and expenses must be reported as though the companies had combined at the beginning of the year. The portion of the adjustment necessary to conform the accounting methods applicable to the current period must also be allocated to income and expenses for the period.

Purchase method – In general, under the purchase method an acquiring entity must allocate the cost of an acquired entity to the assets acquired and liabilities assumed based on their estimated fair values at the date of acquisition. Any cash payments, the fair values of securities or other assets distributed as consideration, and the fair values of liabilities incurred by an acquiring entity must be used to measure the cost of an acquired entity. The cost of an acquired entity also includes the direct costs of the business combination. Costs of registering and issuing equity securities must be recognized as a reduction of the otherwise determinable fair value of the securities. However, indirect and general expenses related to business combinations must be expensed as incurred.

Statement No. 141 provides general guidance for assigning amounts to assets acquired and liabilities assumed. Acquired assets may be tangible (such as securities or fixed assets) or intangible (as discussed in the following paragraph). An acquiring entity must not recognize the goodwill, if any, or the deferred income taxes recorded by an acquired entity before its acquisition. However, a deferred tax liability or asset must be recognized for differences between the assigned values and the tax bases of the recognized assets acquired and liabilities assumed in a business combination in accordance with FASB Statement No. 109, "Accounting for Income Taxes." (For further information, see the Glossary entry for "income taxes.")

Under Statement No. 141, an intangible asset must be recognized as an asset apart from goodwill if it arises from contractual or other legal rights (regardless of transferability or separability). Otherwise, an intangible asset must be recognized as an asset apart from goodwill only if it is separable, that is, it is capable of being separated or divided from the acquired entity and sold, transferred, licensed, rented or exchanged either individually or in combination with a related contract, asset, or liability. Examples of intangible assets that must be recognized as an asset apart from goodwill are core deposit intangibles, purchase credit card relationships, servicing assets, favorable leasehold rights, trademarks, tradenames, Internet domain names, and noncompetition agreements. These intangible assets, as well as any unidentifiable intangible assets recorded in accordance with FASB Statement No. 72, must be reported in Schedule RC, item 10.b, "Other intangible assets," and in Schedule RC-M, item 2.

The excess of the cost of an acquired entity over the net of the amounts assigned to assets acquired and liabilities must be recognized as goodwill, which is reported in Schedule RC, item 10.a. An acquired intangible asset that does not meet the criteria described in the preceding paragraph must be included in the amount recognized as goodwill. After initial recognition, goodwill must be accounted for in accordance with FASB Statement No. 142, "Goodwill and Other Intangible Assets," and the instructions for Schedule RI, item 7.c.(1), "Goodwill impairment losses."

In contrast, if the sum of the amounts assigned to assets acquired and liabilities assumed exceeds the cost of the acquired entity, that excess must be allocated as a pro rata reduction of the amounts that otherwise would have been assigned to all of the acquired assets except financial assets (other than investments accounted for by the equity method), assets to be disposed of by sale (such as foreclosed real estate), deferred tax assets, prepaid assets relating to pension or other postretirement benefit

Business Combinations (cont.):

plans, and any other current assets.[1] If any excess remains after reducing to zero the amounts that otherwise would have been assigned to those assets, that remaining excess shall be recognized as an extraordinary gain, generally in the period in which the business combination is completed, and reported in Schedule RI, item 11, "Extraordinary items and other adjustments, net of income taxes."

Under the purchase method, the historical equity capital balances of the acquired business are *not* to be carried forward to the balance sheet of the combined bank. The operating results of the acquired bank or business are to be included in the income and expenses of the reporting bank only from the date of acquisition.

Push down accounting -- Push down accounting is the establishment of a new accounting basis for a bank in its separate financial statements as a result of a substantive change in control. Under push down accounting, when a bank is acquired, yet retains its separate corporate existence, the assets and liabilities of the acquired bank are restated to their fair values as of the acquisition date. These values, including any goodwill, are reflected in the separate financial statements of the acquired bank as well as in any consolidated financial statements of the bank's parent.

Push down accounting is required for purposes of the Reports of Condition and Income if a direct or indirect change in control of at least 95 percent of the voting stock of the bank has occurred, and the bank does not have an outstanding issue of publicly traded debt or preferred stock. Push down accounting also is required if the bank's separate financial statements are presented on a push down basis in reports filed with the Securities and Exchange Commission. Push down accounting may also be used when a direct or indirect change in control of at least 80 percent, but less than 95 percent, of the voting stock of the bank has occurred.

In all cases, the bank's primary federal supervisory authority reserves the right to determine whether or not a bank must use push down accounting for purposes of the Reports of Condition and Income.

When push down accounting is used by a bank in the preparation of its Reports of Condition and Income, both of the following conditions should be met:

(1) An arm's-length purchase acquisition resulting in a substantive change in control of at least 80 percent must have occurred, and

(2) The push down adjusting entries must have eliminated the retained earnings account (therefore, the entire retained earnings of the bank before the acquisition will not be available for the payment of dividends after the acquisition).

In the Reports of Condition and Income for the remainder of the year in which the acquisition occurs, a bank shall report the initial increase or decrease in its equity capital that results from the application of push down accounting in item 7, "Changes incident to business combinations, net," of Schedule RI-A, Changes in Equity Capital. In addition, when push down accounting is used, no income or expense for the period of the calendar year prior to the acquisition date should be included in subsequent Reports of Income.

Reorganization -- A combination of two or more entities involving related parties is considered a reorganization and not a business combination. For example, two subsidiary banks of a bank holding company may combine into one bank, which is a change in legal organization but not a change in the entity. The assets and liabilities transferred in the combination are accounted for at historical cost in a manner similar to that described above under "pooling-of-interests method."

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[1] Prior to the allocation of the excess, the acquiring entity must reassess whether all acquired assets and assumed liabilities have been identified and recognized and perform remeasurements to verify that the consideration paid, assets acquired, and liabilities assumed have been properly valued.

Business Combinations (cont.):

A bank holding company's investment in a bank or other business that was acquired in a purchase business combination may differ from the book value of the net assets in that bank's or business's financial statements because push down accounting was not applied. This situation will generally exist with respect to acquisitions that occurred prior to the September 30, 1989, effective date of the push down accounting instructions set forth above in this Glossary entry.

A bank holding company may transfer its ownership interest in an acquired bank or other business to another one of its subsidiary banks subsequent to its acquisition of the bank or other business. When this occurs, the financial statements of the surviving bank must be adjusted, as set forth in FASB Emerging Issues Task Force Issue No. 90-5, to reflect the assets and liabilities of the acquired bank or other business at the historical cost included in the holding company's financial statements. The necessity and extent of such adjustments should be determined in consultation with the bank's primary federal supervisory authority.

For further information on the accounting for business combinations, see FASB Statement No. 141 and FASB Statement No. 72, "Accounting for Certain Acquisitions of Banking or Thrift Institutions."

Call Option: See "derivative contracts."

Capitalization of Interest Costs: Interest costs associated with the construction of a building shall, if material, be capitalized as part of the cost of the building. Such interest costs include both the actual interest incurred when the construction funds are borrowed and the interest costs imputed to internal financing of a construction project.

The interest rate utilized to capitalize interest on internally financed projects in a reporting period shall be the rate(s) applicable to the bank's borrowings outstanding during the period. For this purpose, a bank's borrowings include interest-bearing deposits and other interest-bearing liabilities.

The interest capitalized shall not exceed the total amount of interest cost incurred by the bank during the reporting period.

For further information, see FASB Statement No. 34, "Capitalization of Interest Costs," as amended.

Carrybacks and Carryforwards: See "income taxes."

Cash Management Arrangements: A cash management arrangement is a group of related transaction accounts of a single type maintained in the same right and capacity by a customer (a single legal entity), whereby the customer and the financial institution understand that payments from one account will be honored so long as a net credit balance exists in the group of related transaction accounts taken as a whole. Such accounts function as, and will be regarded for reporting and deposit insurance assessment purposes as, one account rather than separate accounts, provided adequate documentation of the arrangement is maintained as discussed below. (Note: For reporting and deposit insurance assessment purposes, transaction accounts of affiliates and subsidiaries of a parent company that are separate legal entities may not be offset because accounts of separate legal entities are not permitted within a bona fide cash management arrangement.)

"Transaction accounts of a single type" means demand deposit accounts or NOW accounts, but not a combination thereof. For purposes of cash management arrangements, the terms "right" and "capacity" relate to the form of legal ownership such as being held in an agency or trust capacity, as a joint tenant, or as an individual. "Single legal entity" means a natural person, partnership, corporation, trust, or estate.

Cash Management Arrangements (cont.):

The reporting bank must maintain readily available records that will allow for the verification of cash management arrangements. Such documentation must provide account numbers, account titles, ownership of accounts, and the terms and conditions surrounding the management of the accounts, and must also clearly show that both the customer and the reporting bank have agreed to such terms and conditions. These terms and conditions must clearly indicate the understanding that payments from one account will be honored as long as a net credit balance exists within the group of related transaction accounts taken as a whole and maintained in the same right and capacity. A written cash management agreement, signed by both the customer (a single legal entity) and the reporting bank, accurately maintained and incorporating the above information, will be acceptable evidence of a bona fide cash management arrangement. In addition, the reporting bank must maintain readily available records that will allow for the verification of account balances within cash management arrangements.

See "deposits" for the definitions of transaction account, demand deposit, and NOW account. See also "overdraft."

Certificate of Deposit: See "deposits."

Changes in Accounting Estimates: See "accounting changes."

Changes in Accounting Principles: See "accounting changes."

Clearing Accounts: See "suspense accounts."

Commercial Banks in the U.S.: See "banks, U.S. and foreign."

Commercial Letter of Credit: See "letter of credit."

Commercial Paper: Commercial paper consists of short-term negotiable promissory notes issued in the United States by commercial businesses, including finance companies and banks. Commercial paper usually matures in 270 days or less and is not collateralized. Commercial paper may be backed by a standby letter of credit from a bank, as in the case of documented discounted notes. Holdings of commercial paper are to be reported as "securities" in Schedule RC-B, normally in item 6, "Other debt securities," unless held for trading and therefore reportable in Schedule RC, item 5, "Trading assets."

Commodity or Bill-of-Lading Draft: A commodity or bill-of-lading draft is a draft that is issued in connection with the shipment of goods. If the commodity or bill-of-lading draft becomes payable only when the shipment of goods against which it is payable arrives, it is an arrival draft. Arrival drafts are usually forwarded by the shipper to the collecting depository institution with instructions to release the shipping documents (e.g., bill of lading) conveying title to the goods only upon payment of the draft. Payment, however, cannot be demanded until the goods have arrived at the drawee's destination. Arrival drafts provide a means of insuring payment of shipped goods at the time that the goods are released.

Common Stock of Unconsolidated Subsidiaries, Investments in: See “equity method of accounting” and "subsidiaries."

Continuing Contract: See "federal funds transactions."

Corporate Joint Venture: See "subsidiaries."

Corrections of Accounting Errors: See "accounting changes."

Coupon Stripping, Treasury Receipts, and STRIPS: Coupon stripping occurs when a security holder physically detaches unmatured coupons from the principal portion of a security and sells either the detached coupons or the ex-coupon security separately. (Such transactions are generally considered by federal bank supervisory agencies to represent "improper investment practices" for banks.) In accounting for such transactions, the carrying amount of the security must be allocated between the ex-coupon security and the detached coupons based on their relative fair values at the date of the sale in accordance with FASB Statement No. 140. (See the Glossary entry for "transfers of financial assets.")

Detached U.S. Government security coupons and ex-coupon U.S. Government securities that are held for purposes other than trading, whether resulting from the coupon stripping activities of the reporting bank or from its purchase of stripped securities, shall be reported as "Other domestic debt securities" in Schedule RC-B, item 6.a. The amount of any discount or premium relating to the detached coupons or ex-coupon securities must be amortized. (See the Glossary entry for "premiums and discounts.")

A variation of coupon stripping has been developed by several securities firms which have marketed instruments with such names as CATS (Certificates of Accrual on Treasury Securities), TIGR (Treasury Investment Growth Receipts), COUGAR (Certificates on Government Receipts), LION (Lehman Investment Opportunity Notes), and ETR (East Treasury Receipts). A securities dealer purchases U.S. Treasury securities, delivers them to a trustee, and sells receipts representing the rights to future interest and/or principal payments on the U.S. Treasury securities held by the trustee. Such Treasury receipts are not an obligation of the U.S. Government and, when held for purposes other than trading, shall be reported as "Other domestic debt securities" in Schedule RC-B, item 6.a. The discount on these Treasury receipts must be accreted.

Coupon Stripping, Treasury Receipts, and STRIPS (cont.):
Under a program called Separate Trading of Registered Interest and Principal of Securities (STRIPS), the U.S. Treasury has issued certain long-term note and bond issues that are maintained in the book-entry system operated by the Federal Reserve Banks in a manner that permits separate trading and ownership of the interest and principal payments on these issues. Even after the interest or principal portions of U.S. Treasury STRIPS have been separately traded, they remain obligations of the U.S. Government. STRIPS held for purposes other than trading shall be reported as U.S. Treasury securities in Schedule RC-B, item 1. The discount on separately traded portions of STRIPS must be accreted.

Detached coupons, ex-coupon securities, Treasury receipts, and U.S. Treasury STRIPS held for trading purposes shall be reported at fair value in Schedule RC, item 5.

Custody Account: A custody account is one in which securities or other assets are held by a bank on behalf of a customer under a safekeeping arrangement. Assets held in such capacity are not to be reported in the balance sheet of the reporting bank nor are such accounts to be reflected as a liability. Assets of the reporting bank held in custody accounts at other banks are to be reported on the reporting bank's balance sheet in the appropriate asset categories as if held in the physical custody of the reporting bank.

Dealer Reserve Account: A dealer reserve account arises when a bank purchases at full face value a dealer's installment note receivables, but credits less than the full face value directly to the dealer's account. The remaining amount is credited to a separate dealer reserve account. That account is held by the bank as collateral for the installment notes and, for reporting purposes, is treated as a deposit in the appropriate items of Schedule RC-E. The bank will subsequently disburse to the dealer predetermined portions of the reserve as the purchased notes are paid in a timely manner.

For example, if a bank purchases $100,000 in notes from a dealer for the full face amount ($100,000) and pays to the dealer $90,000 in cash or credits to his/her deposit account, the remaining $10,000, which is held as collateral security, would be credited to the dealer reserve account.

See also "deposits."

Deferred Income Taxes: See "income taxes."

Demand Deposits: See "deposits."

Depository Institutions in the U.S.: Depository institutions in the U.S. consist of:

(1) U.S. branches and agencies of foreign banks;

(2) U.S.-domiciled head offices and branches of U.S. banks, i.e.,
   - (a) national banks,
   - (b) state-chartered commercial banks,
   - (c) trust companies that perform a commercial banking business,
   - (d) industrial banks,
   - (e) private or unincorporated banks,
   - (f) Edge and Agreement corporations, and
   - (g) International Banking Facilities (IBFs) of U.S. banks; and

Depository Institutions in the U.S. (cont.):

(3) U.S.-domiciled head offices and branches of other depository institutions in the U.S., i.e.,
- (a) mutual or stock savings banks,
- (b) savings or building and loan associations,
- (c) cooperative banks,
- (d) credit unions,
- (e) homestead associations,
- (f) other similar depository institutions in the U.S., and
- (g) International Banking Facilities (IBFs) of other depository institutions in the U.S.

Deposits: The basic statutory and regulatory definitions of "deposits" are contained in Section 3(λ) of the Federal Deposit Insurance Act (FDI Act) and in Federal Reserve Regulation D. The definitions in these two legal sources differ in certain respects. Furthermore, for purposes of these reports, the reporting standards for deposits specified in these instructions do not strictly follow the precise legal definitions in these two sources. The definitions of deposits to be reported in the deposit items of the Reports of Condition and Income are discussed below under the following headings:

(I) FDI Act definition of deposits.
(II) Transaction-nontransaction deposit distinction.
(III) Interest-bearing-noninterest-bearing deposit distinction.

(I) FDI Act definition of deposits – Section 3(λ) states that the term “deposit” means --

(1) the unpaid balance of money or its equivalent received or held by a bank or savings association in the usual course of business and for which it has given or is obligated to give credit, either conditionally or unconditionally, to a commercial, checking, savings, time, or thrift account, or which is evidenced by its certificate of deposit, thrift certificate, investment certificate, certificate of indebtedness, or other similar name, or a check or draft drawn against a deposit account and certified by the bank or savings association, or a letter of credit or a traveler's check on which the bank or savings association is primarily liable: Provided, That, without limiting the generality of the term "money or its equivalent", any such account or instrument must be regarded as evidencing the receipt of the equivalent of money when credited or issued in exchange for checks or drafts or for a promissory note upon which the person obtaining any such credit or instrument is primarily or secondarily liable, or for a charge against a deposit account, or in settlement of checks, drafts, or other instruments forwarded to such bank or savings association for collection,

(2) trust funds as defined in this Act received or held by such bank or savings association, whether held in the trust department or held or deposited in any other department of such bank or savings association,

(3) money received or held by a bank or savings association, or the credit given for money or its equivalent received or held by a bank or savings association, in the usual course of business for a special or specific purpose, regardless of the legal relationship thereby established, including without being limited to, escrow funds, funds held as security for an obligation due to the bank or savings association or others (including funds held as dealers reserves) or for securities loaned by the bank or savings association, funds deposited by a debtor to meet maturing obligations, funds deposited as advance payment on subscriptions to United States Government securities, funds held for distribution or purchase of securities, funds held to meet its acceptances or letters of credit, and withheld taxes: Provided, That there shall not be included funds which are received by the bank or savings association for immediate application to the reduction of an indebtedness to the receiving bank or savings association, or under condition that the receipt thereof immediately reduces or extinguishes such an indebtedness,

Deposits (cont.):

(4) outstanding draft (including advice or authorization to charge a bank's or a savings association's balance in another bank or savings association), cashier's check, money order, or other officer's check issued in the usual course of business for any purpose, including without being limited to those issued in payment for services, dividends, or purchases, and

(5) such other obligations of a bank or savings association as the Board of Directors, after consultation with the Comptroller of the Currency, Director of the Office of Thrift Supervision, and the Board of Governors of the Federal Reserve System, shall find and prescribe by regulation to be deposit liabilities by general usage, except that the following shall not be a deposit for any of the purposes of this Act or be included as part of the total deposits or of an insured deposit:

(A) any obligation of a depository institution which is carried on the books and records of an office of such bank or savings association located outside of any State, unless --

(i) such obligation would be a deposit if it were carried on the books and records of the depository institution, and would be payable at, an office located in any State; and

(ii) the contract evidencing the obligation provides by express terms, and not by implication, for payment at an office of the depository institution located in any State; and

(B) any international banking facility deposit, including an international banking facility time deposit, as such term is from time to time defined by the Board of Governors of the Federal Reserve System in regulation D or any successor regulation issued by the Board of Governors of the Federal Reserve System; and

(C) any liability of an insured depository institution that arises under an annuity contract, the income of which is tax deferred under section 72 of the Internal Revenue Code of 1986.

(II) Transaction-nontransaction deposit distinction: The Monetary Control Act of 1980 and the current Federal Reserve Regulation D, "Reserve Requirements of Depository Institutions," establish, for purposes of federal reserve requirements on deposit liabilities, a category of deposits designated as "transaction accounts." All deposits that are not transaction accounts are "nontransaction accounts."

(1) Transaction accounts -- With the exceptions noted below, a "transaction account," as defined in Regulation D and in these instructions, is a deposit or account from which the depositor or account holder is permitted to make transfers or withdrawals by negotiable or transferable instruments, payment orders of withdrawal, telephone transfers, or other similar devices for the purpose of making payments or transfers to third persons or others or from which the depositor may make third party payments at an automated teller machine (ATM), a remote service unit (RSU), or another electronic device, including by debit card.

Excluded from transaction accounts are savings deposits (both money market deposit accounts (MMDAs) and other savings deposits) as defined below in the nontransaction account category, even though such deposits permit some third-party transfers. However, an account that otherwise meets the definition of a savings deposit but that authorizes or permits the depositor to exceed the transfer limitations specified for that account shall be reported as a transaction account. (Please refer to the definition of savings deposits for further detail.)

Deposits (cont.):

NOTE: Under the Federal Reserve's current Regulation D, no transaction account, regardless of its other characteristics, is classified either as a savings deposit or as a time deposit. Thus, those transaction accounts that are not demand deposits--NOW accounts, ATS (Automatic Transfer Service) accounts, and telephone and preauthorized transfer accounts--are excluded from Regulation D time and savings deposits. However, for FDIC insurance assessment purposes as set forth in the FDI Act, all such transaction accounts that are not demand deposits are included in "time and savings deposits." This FDIC usage is to be followed only in Schedule RC-O. For all other items in the Reports of Condition and Income involving time or savings deposits, a strict distinction, based on Regulation D definitions, is to be maintained between transaction accounts and time and savings accounts.

Transaction accounts consist of the following types of deposits: (a) demand deposits; (b) NOW accounts; (c) ATS accounts; and (d) telephone and preauthorized transfer accounts, all as defined below. Interest that is paid by the crediting of transaction accounts is also included in transaction accounts.

(a) Demand deposits are noninterest-bearing deposits that are payable immediately on demand, or that are issued with an original maturity or required notice period of less than seven days, or that represent funds for which the depository institution does not reserve the right to require at least seven days' written notice of an intended withdrawal. Demand deposits include any matured time deposits without automatic renewal provisions, unless the deposit agreement provides for the funds to be transferred at maturity to another type of account. Demand deposits do not include: (i) money market deposit accounts (MMDAs) or (ii) NOW accounts, as defined below in this entry.

(b) NOW accounts are interest-bearing deposits (i) on which the depository institution has reserved the right to require at least seven days' written notice prior to withdrawal or transfer of any funds in the account and (ii) that can be withdrawn or transferred to third parties by issuance of a negotiable or transferable instrument.

NOW accounts, as authorized by federal law, are limited to accounts held by:

(i) Individuals or sole proprietorships;

(ii) Organizations that are operated primarily for religious, philanthropic, charitable, educational, or other similar purposes and that are not operated for profit. These include organizations, partnerships, corporations, or associations that are not organized for profit and are described in section 501(c)(3) through (13) and (19) and section 528 of the Internal Revenue Code, such as church organizations; professional associations; trade associations; labor unions; fraternities, sororities and similar social organizations; and nonprofit recreational clubs; or

(iii) Governmental units including the federal government and its agencies and instrumentalities; state governments; county and municipal governments and their political subdivisions; the District of Columbia; the Commonwealth of Puerto Rico, American Samoa, Guam, and any territory or possession of the United States and their political subdivisions.

Also included are the balances of all NOW accounts of certain other nonprofit organizations that may not fall within the above description but that had established NOW accounts with the reporting institution prior to September 1, 1981.

Deposits (cont.):

NOTE: There are no regulatory requirements with respect to minimum balances to be maintained in a NOW account or to the amount of interest that may be paid on a NOW account.

(c) ATS accounts are deposits or accounts of individuals or sole proprietorships on which the depository institution has reserved the right to require at least seven days' written notice prior to withdrawal or transfer of any funds in the account and from which, pursuant to written agreement arranged in advance between the reporting institution and the depositor, withdrawals may be made automatically through payment to the depository institution itself or through transfer of credit to a demand deposit or other account in order to cover checks or drafts drawn upon the institution or to maintain a specified balance in, or to make periodic transfers to, such other accounts.

Some institutions may have entered into agreements with their customers providing that in the event the customer should overdraw a demand deposit (checking) or NOW account, the institution will transfer from that customer's savings account an amount sufficient to cover the overdraft. The availability of the overdraft protection plan would not in and of itself require that such a savings account be regarded as a transaction account provided that the overall transfer and withdrawal restrictions of a savings deposit are not exceeded. Please refer to the definition of savings deposit for further detail.

(d) Telephone or preauthorized transfer accounts consist of deposits or accounts, other than savings deposits, (1) in which the entire beneficial interest is held by a party eligible to hold a NOW account, (2) on which the reporting institution has reserved the right to require at least seven days' written notice prior to withdrawal or transfer of any funds in the account, and (3) under the terms of which, or by practice of the reporting institution, the depositor is permitted or authorized to make more than six withdrawals per month or statement cycle (or similar period) of at least four weeks for purposes of transferring funds to another account of the depositor at the same institution (including a transaction account) or for making payment to a third party by means of preauthorized transfer, or telephonic (including data transmission) agreement, order or instruction. An account that permits or authorizes more than six such withdrawals in a "month" (a calendar month or any period approximating a month that is at least four weeks long, such as a statement cycle) is a transaction account whether or not more than six such withdrawals actually are made in the "month."

A "preauthorized transfer" includes any arrangement by the reporting institution to pay a third party from the account of a depositor (1) upon written or oral instruction (including an order received through an automated clearing house (ACH)), or (2) at a predetermined time or on a fixed schedule.

Telephone and preauthorized transfer accounts also include:

(i) Deposits or accounts maintained in connection with an arrangement that permits the depositor to obtain credit directly or indirectly through the drawing of a negotiable or nonnegotiable check, draft, order or instruction or other similar device (including telephone or electronic order or instruction) on the issuing institution that can be used for the purpose of making payments or transfers to third parties or others, or to another deposit account of the depositor.

Deposits (cont.):

(ii) The balance of deposits or accounts that otherwise meet the definition of time deposits, but from which payments may be made to third parties by means of a debit card, an automated teller machine, remote service unit or other electronic device, regardless of the number of payments made.

However, an account is not a transaction account merely by virtue of arrangements that permit the following types of transfers or withdrawals, regardless of the number:

(i) Transfers for the purpose of repaying loans and associated expenses at the same depository institution (as originator or servicer).

(ii) Transfers of funds from this account to another account of the same depositor at the same depository institution when made by mail, messenger, automated teller machine, or in person.

(iii) Withdrawals for payment directly to the depositor when made by mail, messenger, automated teller machine, in person, or by telephone (via check mailed to the depositor).

(2) Nontransaction accounts -- All deposits that are not transaction accounts (as defined above) are nontransaction accounts. Nontransaction accounts include: (a) savings deposits ((i) money market deposit accounts (MMDAs) and (ii) other savings deposits) and (b) time deposits ((i) time certificates of deposit and (ii) time deposits, open account). Regulation D no longer distinguishes between money market deposit accounts (MMDAs) and other savings deposits. However, these two types of accounts are defined below for purposes of these reports, which call for separate data on each in Schedule RC-E, (part I,) Memorandum items 2.a.(1) and (2).

NOTE: Under the Federal Reserve's current Regulation D, no transaction accounts, regardless of other characteristics, are defined as savings or time deposits. Thus, savings deposits as defined here, under the heading nontransaction accounts, constitute the entire savings deposit category. Likewise, time deposits, also defined here under nontransaction accounts, constitute the entire time deposits category. However, for FDIC insurance assessment purposes, as set forth in the FDI Act, all transaction accounts other than demand deposits--i.e., NOW accounts, ATS accounts, and telephone and preauthorized transfer accounts--are included in "time and savings deposits." This FDIC usage is to be followed only in Schedule RC-0.

(a) Savings deposits are deposits with respect to which the depositor is not required by the deposit contract but may at any time be required by the depository institution to give written notice of an intended withdrawal not less than seven days before withdrawal is made, and that is not payable on a specified date or at the expiration of a specified time after the date of deposit.

The term savings deposit also means a deposit or account, such as an account commonly known as a passbook savings account, a statement savings account, or a money market deposit account (MMDA), that otherwise meets the requirements of the preceding paragraph and from which, under the terms of the deposit contract or by practice of the depository institution, the depositor is permitted or authorized to make no more than six transfers and withdrawals, or a combination of such transfers and withdrawals, per calendar month or statement cycle (or similar period) of at least four weeks, to another account (including a transaction account) of the depositor at the same institution or to a third party by means of a preauthorized or automatic transfer, or

Deposits (cont.):

telephonic (including data transmission) agreement, order, or instruction, and no more than three of the six such transfers may be made by check, draft, debit card, or similar order made by the depositor and payable to third parties. Transfers from savings deposits for purposes of covering overdrafts (overdraft protection plans) are included under the withdrawal limits specified for savings deposits.

There are no regulatory restrictions on the following types of transfers or withdrawals from a savings deposit account, regardless of the number:

(1) Transfers for the purpose of repaying loans and associated expenses at the same depository institution (as originator or servicer).

(2) Transfers of funds from this account to another account of the same depositor at the same institution when made by mail, messenger, automated teller machine, or in person.

(3) Withdrawals for payment directly to the depositor when made by mail, messenger, automated teller machine, in person, or by telephone (via check mailed to the depositor).

Further, for a savings deposit account, no minimum balance is required by regulation, there is no regulatory limitation on the amount of interest that may be paid, and no minimum maturity is required (although depository institutions must reserve the right to require at least seven days' written notice prior to withdrawal as stipulated above for a savings deposit).

Any depository institution may place restrictions and requirements on savings deposits in addition to those stipulated above. In the case of such further restrictions, the account would still be reported as a savings deposit.

On the other hand, an account that otherwise meets the definition of a savings deposit but that authorizes or permits the depositor to exceed the six-transfer/withdrawal rule or three-draft rule shall be reported as a transaction account, as follows:

(1) If the depositor is ineligible to hold a NOW account, such an account is considered a demand deposit.

(2) If the depositor is eligible to hold a NOW account, the account will be considered either a NOW account, a telephone or preauthorized transfer account, or an ATS account:

   (a) If withdrawals or transfers by check, draft, or similar instrument are permitted or authorized, the account is considered a NOW account.

   (b) If withdrawals or transfers by check, draft, or similar instrument are <u>not</u> permitted or authorized, the account is considered either an ATS account or a telephone or preauthorized transfer account.

Regulation D no longer distinguishes between money market deposit accounts (MMDAs) and other savings deposits. However, these two types of accounts are defined as follows for purposes of these reports, which call for separate data on each.

Deposits (cont.):

(1) Money market deposit accounts (MMDAs) are deposits or accounts that meet the above definition of a savings deposit and that permit up to (but no more than) three of the six allowable transfers to be made by check, draft, debit card or similar order made by the depositor and payable to third parties.

(2) Other savings deposits are deposits or accounts that meet the above definition of a savings deposit but that permit no transfers by check, draft, debit card, or similar order made by the depositor and payable to third parties. Other savings deposits are commonly known as passbook savings or statement savings accounts.

Examples illustrating distinctions between MMDAs and other savings deposits for purposes of these reports are provided at the end of this Glossary entry.

(b) Time deposits are deposits that the depositor does not have a right, and is not permitted, to make withdrawals from within six days after the date of deposit unless the deposit is subject to an early withdrawal penalty of at least seven days' simple interest on amounts withdrawn within the first six days after deposit. A time deposit from which partial early withdrawals are permitted must impose additional early withdrawal penalties of at least seven days' simple interest on amounts withdrawn within six days after each partial withdrawal. If such additional early withdrawal penalties are not imposed, the account ceases to be a time deposit. The account may become a savings deposit if it meets the requirements for a savings deposit; otherwise it becomes a demand deposit.

NOTE: The above prescribed penalties are the minimum required by Federal Reserve Regulation D. Institutions may choose to require penalties for early withdrawal in excess of the regulatory minimums.

Time deposits take two forms:

(i) Time certificates of deposit (including rollover certificates of deposit) are deposits evidenced by a negotiable or nonnegotiable instrument, or a deposit in book entry form evidenced by a receipt or similar acknowledgement issued by the bank, that provides, on its face, that the amount of such deposit is payable to the bearer, to any specified person, or to the order of a specified person, as follows:

(1) on a certain date not less than seven days after the date of deposit,

(2) at the expiration of a specified period not less than seven days after the date of the deposit, or

(3) upon written notice to the bank which is to be given not less than seven days before the date of withdrawal.

(ii) Time deposits, open account are deposits (other than time certificates of deposit) for which there is in force a written contract with the depositor that neither the whole nor any part of such deposit may be withdrawn prior to:

(1) the date of maturity which shall be not less than seven days after the date of the deposit, or

(2) the expiration of a specified period of written notice of not less than seven days.

Deposits (cont.):

These deposits include those club accounts, such as Christmas club and vacation club accounts, that are made under written contracts that provide that no withdrawal shall be made until a certain number of periodic deposits has been made during a period of not less than three months, even though some of the deposits are made within six days of the end of such period.

Time deposits do not include the following categories of liabilities even if they have an original maturity of seven days or more:

(1) Any deposit or account that otherwise meets the definition of a time deposit but that allows withdrawals within the first six days after deposit and that does not require an early withdrawal penalty of at least seven days' simple interest on amounts withdrawn within those first six days. Such deposits or accounts that meet the definition of a savings deposit shall be reported as savings deposits; otherwise they shall be reported as demand deposits.

(2) The remaining balance of a time deposit if a partial early withdrawal is made and the remaining balance is not subject to additional early withdrawal penalties of at least seven days' simple interest on amounts withdrawn within six days after each partial withdrawal. Such time deposits that meet the definition of a savings deposit shall be reported as savings deposits; otherwise they shall be reported as demand deposits.

Reporting of Retail Sweep Arrangements Affecting Transaction and Nontransaction Accounts – In an effort to reduce their reserve requirements, some banks have established sweep arrangements that involve transfers of retail customers' deposits between two subaccounts. In a typical arrangement, a bank creates a master account and two subaccounts: a transaction subaccount (either a demand deposit account or a NOW account), which is subject to reserve requirements, and a nontransaction savings subaccount (a special-purpose money market deposit account (MMDA)), which is not subject to reserve requirements. Depending upon the balances in the two subaccounts on a particular day, the bank will shift funds from the transaction subaccount to the MMDA subaccount or vice versa. On some days, the balance in the MMDA subaccount may be zero. (For purposes of the Federal Reserve's Regulation D, there is no distinction between an MMDA and any other form of savings account in terms of legally required restrictions on transfers.)

For purposes of these reports, the transaction subaccount and MMDA subaccount must be treated separately when a bank reports its quarter-end deposit information in Schedules RC, RC-E, and RC-O, its quarterly averages in Schedule RC-K, and its interest expense (if any) in Schedule RI. Thus, when reporting quarterly averages in Schedule RC-K, a bank should include the amounts held in the transaction subaccounts (if interest-bearing) and the MMDA (nontransaction savings) subaccounts each day or each week in the appropriate separate items for average deposits. In addition, if the bank pays interest on the accounts involved in retail sweep arrangements, the interest expense reported in Schedule RI should be allocated between the transaction subaccount and the MMDA (nontransaction savings) subaccount based on the balances in these subaccounts during the reporting period.

(III) Interest-bearing-noninterest-bearing deposit distinction:

(a) Interest-bearing deposit accounts consist of deposit accounts on which the issuing depository institution pays compensation to the holder for the use of the funds. Such compensation may be in the form of cash, merchandise, or property or as a credit to an account. Deposits with a zero percent interest rate that are issued on a discount basis are to be treated as interest-bearing.

Deposits (cont.):

(b) Noninterest-bearing deposit accounts consist of deposit accounts on which the issuing depository institution pays no compensation to the holder for the use of the funds.

Noninterest-bearing deposit accounts include (i) matured time deposits that are not automatically renewable (unless the deposit agreement provides for the funds to be transferred at maturity to another type of account) and (ii) deposits with a zero percent stated interest rate that are issued at face value.

See also "brokered deposits" and "hypothecated deposits."

Examples Illustrating Distinctions Between
MONEY MARKET DEPOSIT ACCOUNTS (MMDAs) and OTHER SAVINGS DEPOSITS

Example 1

A savings deposit account permits no transfers of any type to other accounts or to third parties.
Report this account as an other savings deposit.

Example 2

A savings deposit permits up to six, but no more than six, "preauthorized, automatic, or telephonic" transfers to other accounts or to third parties. None of the third-party payments may be made by check, draft, or similar order (including debit card).
Report this account as an other savings deposit.

Example 3

A savings deposit permits no more than six "preauthorized, automatic, or telephonic" transfers to other accounts or to third parties. Up to three, but no more than three, of the six transfers may be by check, draft, debit card or similar order made by the depositor and payable to third parties.
Report this account as an MMDA.

Example 4

A savings deposit permits up to three, but no more than three, "preauthorized, automatic, or telephonic" transfers to other accounts or to third parties, any or all which may be by check, draft, debit card or similar order made by the depositor and payable to third parties.
Report this account as an MMDA.

Derivative Contracts: Banks commonly use derivative instruments for managing (positioning or hedging) their exposure to market risk (including interest rate risk and foreign exchange risk), cash flow risk, and other risks in their operations and for trading. The accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities are set forth in FASB Statement No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended. Statement No. 133 requires all derivatives to be recognized on the balance sheet as either assets or liabilities at their fair value. A summary of the principal provisions of Statement No. 133 follows. For further information, see Statement No. 133 and the implementation guidance issued by the FASB's Derivatives Implementation Group, which may be found at the FASB's Web site at www.fasb.org.

Derivative Contracts (cont.):

Statement No. 133 is effective for fiscal years beginning after June 15, 2000. For purposes of these reports, banks must adopt Statement No. 133 upon the statement's effective date based on their fiscal year, with earlier application permitted consistent with the statement. Banks are also expected to follow the accounting guidance issued by the Derivatives Implementation Group.

Definition of Derivative

Statement No. 133 defines a "derivative instrument" as a financial instrument or other contract with all three of the following characteristics:

(1) It has one or more underlyings (i.e., specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable) and one or more notional amounts (i.e., number of currency units, shares, bushels, pounds, or other units specified in the contract) or payment provisions or both. These terms determine the amount of the settlement or settlements, and in some cases, whether or not a settlement is required.

(2) It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have similar response to changes in market factors.

(3) Its terms require or permit net settlement, it can be readily settled net by a means outside the contract, or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

Certain contracts that may meet the definition of a derivative are specifically excluded from the scope of Statement No. 133, including:

- "regular-way" securities trades, which are trades that are completed within the time period generally established by regulations and conventions in the marketplace or by the exchange on which the trade is executed;
- normal purchases and sales of an item other than a financial instrument or derivative instrument (e.g., a commodity) that will be delivered in quantities expected to be used or sold by the reporting entity over a reasonable period in the normal course of business;
- traditional life insurance and property and casualty contracts; and
- certain financial guarantee contracts.

However, a loan commitment may meet Statement No. 133's definition of a derivative instrument. For example, loan commitments to originate or acquire mortgage loans that will be resold as part of an institution's mortgage banking operations are derivative instruments.

Types of Derivatives

The most common types of freestanding derivatives are forwards, futures, swaps, options, caps, floors, and collars.

Forward contracts are agreements that obligate two parties to purchase (long) and sell (short) a specific financial instrument, foreign currency, or commodity at a specified price with delivery and settlement at a specified future date.

Futures contracts are standardized forward contracts that are traded on organized exchanges. Exchanges in the U.S. are registered with and regulated by the Commodity Futures Trading Commission. The deliverable financial instruments underlying interest-rate future contracts are specified investment-grade financial instruments, such as U.S. Treasury securities or mortgage-backed securities. Foreign currency futures contracts involve specified deliverable amounts of a particular

Derivative Contracts (cont.):

foreign currency. The deliverable products under commodity futures contracts are specified amounts and grades of commodities such as gold bullion. Equity futures contracts are derivatives that have a portion of their return linked to the price of a particular equity or to an index of equity prices, such as the Standard and Poor's 500.

Other forward contracts are traded over the counter and their terms are not standardized. Such contracts can only be terminated, other than by receipt of the underlying asset, by agreement of both buyer and seller. A forward rate agreement is a forward contract that specifies a reference interest rate and an agreed on interest rate (one to be paid and one to be received), an assumed principal amount (the notional amount), and a specific maturity and settlement date.

Swap contracts are forward-based contracts in which two parties agree to swap streams of payments over a specified period. The payments are based on an agreed upon notional principal amount. An interest rate swap generally involves no exchange of principal at inception or maturity. Rather, the notional amount is used to calculate the payment streams to be exchanged. However, foreign exchange swaps often involve the exchange of principal.

Option contracts (standby contracts) are traded on exchanges and over the counter. Option contracts grant the right, but do not obligate, the purchaser (holder) to buy (call) or sell (put) a specific or standard commodity, financial, or equity instrument at a specified price during a specified period or at a specified date. A purchased option is a contract in which the buyer has paid compensation (such as a fee or premium) to acquire the right to sell or purchase an instrument at a stated price on a specified future date. A written option obligates the option seller to purchase or sell the instrument at the option of the buyer of the contract. Option contracts may relate to purchases or sales of securities, money market instruments, futures contracts, other financial instruments, or commodities.

Interest rate caps are option contracts in which the cap seller, in return for a premium, agrees to limit the cap holder's risk associated with an increase in interest rates. If rates go above a specified interest-rate level (the strike price or cap rate), the cap holder is entitled to receive cash payments equal to the excess of the market rate over the strike price multiplied by the notional principal amount. For example, an issuer of floating-rate debt may purchase a cap to protect against rising interest rates, while retaining the ability to benefit from a decline in rates.

Interest rate floors are option contracts in which the floor seller, in return for a premium, agrees to limit the risk associated with a decline in interest rates based on a notional amount. If rates fall below an agreed rate, the floor holder will receive cash payments from the floor writer equal to the difference between the market rate and an agreed rate, multiplied by the notional principal amount.

Interest rate collars are option contracts that combine a cap and a floor (one held and one written). Interest rate collars enable a user with a floating rate contract to lock into a predetermined interest-rate range often at a lower cost than a cap or a floor.

Embedded Derivatives

Contracts that do not in their entirety meet the definition of a derivative instrument, such as bonds, insurance policies, and leases, may contain “embedded” derivative instruments. Embedded derivatives are implicit or explicit terms within a contract that affect some or all of the cash flows or the value of other exchanges required by the contract in a manner similar to a derivative instrument. The effect of embedding a derivative instrument in another type of contract (“the host contract”) is that some or all of the cash flows or other exchanges that otherwise would be required by the host contract, whether

Derivative Contracts (cont.):

unconditional or contingent upon the occurrence of a specified event, will be modified based on one or more of the underlyings. An embedded derivative instrument shall be separated from the host contract and accounted for as a derivative instrument if and only if all three of the following conditions are met:

(1) The economic characteristics and risks of the embedded derivative instrument are not clearly and closely related to the economic characteristics and risks of the host contract,

(2) The contract ("the hybrid instrument") that embodies the embedded derivative and the host contract is not remeasured at fair value under otherwise applicable generally accepted accounting principles with changes in fair value reported in earnings as they occur, and

(3) A separate instrument with the same terms as the embedded derivative instrument would be a considered a derivative.

An embedded derivative instrument in which the underlying is an interest rate or interest rate index that alters net interest payments that otherwise would be paid or received on an interest-bearing host contract is considered to be clearly and closely related to the host contract unless either of the following conditions exist:

(1) The hybrid instrument can contractually be settled in such a way that the investor (holder) would not recover substantially all of its initial recorded investment, or

(2) The embedded derivative could at least double the investor's initial rate of return on the host contract and could also result in a rate of return that is at least twice what otherwise would be the market return for a contract that has the same terms as the host contract and that involves a debtor with a similar credit quality.

Examples of hybrid instruments (not held for trading purposes) with embedded derivatives which meet the three conditions listed above and must be accounted for separately include debt instruments (including deposit liabilities) whose return or yield is indexed to: changes in an equity securities index (e.g., the Standard & Poor's 500); changes in the price of a specific equity security; or changes in the price of gold, crude oil, or some other commodity. For purposes of these reports, when an embedded derivative must be accounted for separately from the host contract under Statement No. 133, the carrying value of the host contract and the fair value of the embedded derivative may be combined and presented together on the balance sheet in the asset or liability category appropriate to the host contract.

Interest-only and principal-only strips are not subject to the requirements of Statement No. 133 provided they (1) initially resulted from separating the rights to receive contractual cash flows of a financial instrument that, in and of itself, did not contain an embedded derivative that otherwise would have been accounted for separately and (2) do not incorporate any terms not present in that original financial instrument. However, questions have been raised about how this provision of FAS 133 should be applied in light of other accounting guidance in FASB Statement No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities." As a result, the FASB Board has decided that, pending the issuance of further guidance, institutions should continue to account for interest-only and principal-only strips and other beneficial interests in securitizations in accordance with Statement No. 140. (For further information, see Derivatives Implementation Group Issue No. D1, "Application of Statement 133 to Beneficial Interests in Securitized Financial Assets.")

Derivative Contracts (cont.):

Recognition of Derivatives and Measurement of Derivatives and Hedged Items

A bank should recognize all of its derivative instruments on its balance sheet as either assets or liabilities at fair value. As defined in FASB Statement No. 133, fair value is the amount at which an asset (liability) could be bought (incurred) or sold (settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and should be used as the basis for the measurement, if available. If a quoted market price is available, the fair value is the product of the number of trading units times that market price. If a quoted market price is not available, the estimate of fair value should be based on the best information available in the circumstances. The estimate of fair value should consider prices for similar assets or similar liabilities and the results of valuation techniques to the extent available in the circumstances.

Examples of valuation techniques include the present value of expected future cash flows using discount rates commensurate with the risks involved, option-pricing models, matrix pricing, option-adjusted spread analysis, and fundamental analysis. Valuation techniques for measuring assets and liabilities should be consistent with the objective of measuring fair value. Those techniques should incorporate assumptions that market participants would use in their estimates of values, future revenues, and future expenses, including assumptions about interest rates, default, prepayment, and volatility.

If expected future cash flows are used to estimate fair value, those expected future cash flows should be the best estimate based on reasonable and supportable projections. All available evidence should be considered in developing estimates of expected future cash flows. The weight given to the evidence should be commensurate with the extent to which the evidence can be objectively verified. If a range is estimated for either the amount or the timing of possible cash flows, the likelihood of possible outcomes should be considered in determining the best estimate of future cash flows.

The accounting for changes in the fair value (that is, gains and losses) of a derivative depends on whether it has been designated and qualifies as part of a hedging relationship and, if so, on the reason for holding it. Either all or a proportion of a derivative may be designated as a hedging instrument. The proportion must be expressed as a percentage of the entire derivative. Gains and losses on derivative instruments are accounted for as follows:

(1) No hedging designation – The gain or loss on a derivative instrument not designated as a hedging instrument, including all derivatives held for trading purposes, is recognized currently in earnings.

(2) Fair value hedge – For a derivative designated as hedging the exposure to changes in the fair value of a recognized asset or liability or a firm commitment, which is referred to as a fair value hedge, the gain or loss on the derivative as well as the offsetting loss or gain on the hedged item attributable to the risk being hedged should be recognized currently.

(3) Cash flow hedge – For a derivative designated as hedging the exposure to variable cash flows of an existing recognized asset or liability or a forecasted transaction, which is referred to as a cash flow hedge, the effective portion of the gain or loss on the derivative should initially be reported outside of earnings as a component of other comprehensive income and subsequently reclassified into earnings in the same period or periods during which the hedged transaction affects earnings. The remaining gain or loss on the derivative instrument, if any, (i.e., the ineffective portion of the gain or loss and any component of the gain or loss excluded from the assessment of hedge effectiveness) should be recognized currently in earnings.

Derivative Contracts (cont.):

(4) Foreign currency hedge – For a derivative designated as hedging the foreign currency exposure of a net investment in a foreign operation, the gain or loss is reported outside of earnings in other comprehensive income as part of the cumulative translation adjustment. For a derivative designated as a hedge of the foreign currency exposure of an unrecognized firm commitment or an available-for-sale security, the accounting for a fair value hedge should be applied. Similarly, for a derivative designated as a hedge of the foreign currency exposure of a foreign-currency denominated forecasted transaction, the accounting for a cash flow hedge should be applied.

To qualify for hedge accounting, the risk being hedged must represent an exposure to an institution's earnings. In general, if the hedged item is a financial asset or liability, the designated risk being hedged can be (1) all risks, i.e., the risk of changes in the overall fair value of the hedged item or the risk of overall changes in the hedged cash flows; (2) the risk of changes in the fair value or cash flows of the hedged item attributable to changes in the benchmark interest rate;[1] (3) the risk of changes in the fair value or cash flows of the hedged item attributable to changes in foreign exchange rates; or (4) the risk of changes in the fair value or cash flows of the hedged item attributable to changes in the obligor's creditworthiness. For held-to-maturity securities, only credit risk, foreign exchange risk, or both may be hedged.

Designated hedging instruments and hedged items qualify for fair value or cash flow hedge accounting if all of the criteria specified in Statement No. 133 are met. These criteria include:

(1) At inception of the hedge, there is formal documentation of the hedging relationship and the institution's risk management objective and strategy for undertaking the hedge, including identification of the hedging instrument, the hedged item or transaction, the nature of the risk being hedged, and how the hedging instrument's effectiveness will be assessed. There must be a reasonable basis for how the institution plans to assess the hedging instrument's effectiveness.

(2) Both at inception of the hedge and on an ongoing basis, the hedging relationship is expected to be highly effective in achieving offsetting changes in fair value or offsetting cash flows attributable to the hedged risk during the period that the hedge is designated or the term of the hedge. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months. All assessments of effectiveness shall be consistent with the risk management strategy documented for that particular hedging relationship.

In a fair value hedge, an asset or a liability is eligible for designation as a hedged item if the hedged item is specifically identified as either all or a specific portion of a recognized asset or liability or of an unrecognized firm commitment, the hedged item is a single asset or liability (or a specific portion thereof) or is a portfolio of similar assets or a portfolio of similar liabilities (or a specific portion thereof), and certain other criteria specified in Statement No. 133 are met. If similar assets or similar liabilities are aggregated and hedged as a portfolio, the individual assets or individual liabilities must share the risk exposure for which they are designated as being hedged. The change in fair value attributable to the hedged risk for each individual item in a hedged portfolio must be expected to respond in a generally proportionate manner to the overall change in fair value of the aggregate portfolio attributable to the hedged risk.

In a cash flow hedge, the individual cash flows related to a recognized asset or liability and the cash flows related to a forecasted transaction are both referred to as a forecasted transaction. Thus, a forecasted transaction is eligible for designation as a hedged transaction if the forecasted transaction is

[1] The benchmark interest rate is a widely recognized and quoted rate in an active financial market that is broadly indicative of the overall level of interest rates attributable to high-credit-quality obligors in that market. In theory, this should be a risk-free rate. In the U.S., interest rates on U.S. Treasury securities and the LIBOR swap rate are considered benchmark interest rates.

Derivative Contracts (cont.):

specifically identified as a single transaction or a group of individual transactions, the occurrence of the forecasted transaction is probable, and certain other criteria specified in Statement No. 133 are met. If the hedged transaction is a group of individual transactions, those individual transactions must share the same risk exposure for which they are designated as being hedged.

An institution should discontinue prospectively its use of fair value or cash flow hedge accounting for an existing hedge if any of the qualifying criteria for hedge accounting is no longer met; the derivative expires or is sold, terminated, or exercised; or the institution removes the designation of the hedge. When this occurs for a cash flow hedge, the net gain or loss on the derivative should remain in "Accumulated other comprehensive income" and be reclassified into earnings in the periods during which the hedged forecasted transaction affects earnings. However, if it is probable that the forecasted transaction will not occur by the end of the originally specified time period (as documented at the inception of the hedging relationship) or within an additional two-month period of time thereafter (except as noted in Statement No. 133), the derivative gain or loss reported in "Accumulated other comprehensive income" should be reclassified into earnings immediately.

For a fair value hedge, in general, if a periodic assessment of hedge effectiveness indicates noncompliance with the highly effective criterion that must be met in order to qualify for hedge accounting, an institution should not recognize adjustment of the carrying amount of the hedged item for the change in the item's fair value attributable to the hedged risk after the last date on which compliance with the effectiveness criterion was established.

With certain limited exceptions, a nonderivative instrument, such as a U.S. Treasury security, may not be designated as a hedging instrument.

Reporting Derivative Contracts

When an institution enters into a derivative contract, it should classify the derivative as either held for trading or held for purposes other than trading (end-user derivatives) based on the reasons for entering into the contract. All derivatives must be reported at fair value on the balance sheet (Schedule RC).

Trading derivatives with positive fair values should be reported as trading assets in Schedule RC, item 5. Trading derivatives with negative fair values should be reported as trading liabilities in Schedule RC, item 15. Changes in the fair value (that is, gains and losses) of trading derivatives should be recognized currently in earnings and included in Schedule RI, item 5.c, "Trading revenue."

Derivatives held for purposes other than trading that have positive fair values should be included in Schedule RC-F, item 5, "Other" assets, and, if the total fair value exceeds 25 percent of "Other" assets, this amount should be disclosed in Schedule RC-F, item 5.d. Derivatives held for purposes other than trading that have negative fair values should be included in Schedule RC-G, item 4, "Other" liabilities, and, if the total fair value exceeds 25 percent of "Other" liabilities, this amount should be disclosed in Schedule RC-G, item 4.d. Net gains (losses) on derivatives held for purposes other than trading that are not designated as hedging instruments should be recognized currently in earnings and reported consistently as either "Other noninterest income" or "Other noninterest expense" in Schedule RI, item 5.l or item 7.d, respectively.

Netting of derivative assets and liabilities is prohibited on the balance sheet except as permitted under FASB Interpretation No. 39. See the Glossary entry for "offsetting."

Banks must report the notional amounts of their derivative contracts by risk exposure in Schedule RC-L, first by type of contract in Schedule RC-L, item 12, and then by purpose of contract (i.e., trading, other than trading) in Schedule RC-L, items 13 and 14. Banks with foreign offices or with $100 million or more in total assets must report the gross fair values of their derivatives, both positive and negative, by risk exposure and purpose of contract in Schedule RC-L, item 15.

Discounts: See "premiums and discounts."

Dividends: Cash dividends are payments of cash to stockholders in proportion to the number of shares they own. Cash dividends on preferred and common stock are to be reported on the date they are declared by the bank's board of directors (the declaration date) by debiting "retained earnings" and crediting "dividends declared not yet payable," which is to be reported in other liabilities. Upon payment of the dividend, "dividends declared not yet payable" is debited for the amount of the cash dividend with an offsetting credit, normally in an equal amount, to "dividend checks outstanding" which is reportable in the "demand deposits" category of the bank's deposit liabilities.

A liability for dividends payable may not be accrued in advance of the formal declaration of a dividend by the board of directors. However, the bank may segregate a portion of retained earnings in the form of a net worth reserve in anticipation of the declaration of a dividend.

Stock dividends are distributions of additional shares to stockholders in proportion to the number of shares they own. Stock dividends are to be reported by transferring an amount equal to the fair value of the additional shares issued from retained earnings to a category of permanent capitalization (common stock and surplus). However, the amount transferred from retained earnings must be reduced by the amount of any mandatory and discretionary transfers previously made (such as those from retained earnings to surplus for increasing the bank's legal lending limit) provided such transfers have not already been used to record a stock dividend. In any event, the amount transferred from retained earnings may not be less than the par or stated value of the additional shares being issued.

Property dividends, also known as dividends in kind, are distributions to stockholders of assets other than cash. The transfer of securities of other companies, real property, or any other asset owned by the reporting bank to a stockholder or related party is to be recorded at the fair value of the asset on the declaration date of the dividend. A gain or loss on the transferred asset must be recognized in the same manner as if the property had been disposed of in an outright sale at or near the declaration date. In those instances where a bank transfers bank premises to a parent holding company in the form of a property dividend and the parent immediately enters into a sale-leaseback transaction with a third party, the gain must be deferred by the bank and amortized over the life of the lease.

Domestic Office: For purposes of these reports, a domestic office of the reporting bank is a branch or subsidiary (other than an Edge or Agreement subsidiary) located in the 50 states of the United States or the District of Columbia or a branch on a U.S. military facility wherever located. The domestic offices of the reporting bank exclude all International Banking Facilities (IBFs); all offices of Edge and Agreement subsidiaries, including their U.S. offices; and all branches and other subsidiaries of the bank located in Puerto Rico, U.S. territories and possessions, or foreign countries.

Domicile: Domicile is used to determine the foreign (non-U.S. addressee) or domestic (U.S. addressee) status of a customer of the reporting bank for the purposes of these reports. Domicile is determined by the principal residence address of an individual or the principal business address of a corporation, partnership, or sole proprietorship. If other addresses are used for correspondence or other purposes, only the principal address, insofar as it is known to the reporting bank, should be used in determining whether a customer should be regarded as a U.S. or non-U.S. addressee.

For purposes of defining customers of the reporting bank, U.S. addressees include residents of the 50 states of the United States, the District of Columbia, Puerto Rico, and U.S. territories and possessions. Non-U.S. addressees includes residents of any foreign country. The term non-U.S. addressee generally includes foreign-based subsidiaries of other U.S. banks.

For customer identification purposes, the IBFs of other U.S. depository institutions are U.S. addressees. (This is in contrast to the treatment of the IBFs of the reporting bank, which are treated as foreign offices of the reporting bank.)

Due Bills: A due bill is an obligation that results when a bank sells an asset and receives payment, but does not deliver the security or other asset. A due bill can also result from a promise to deliver an asset in exchange for value received. In both cases, the receipt of the payment creates an obligation regardless of whether the due bill is issued in written form. Outstanding due bill obligations shall be reported as borrowings in Schedule RC, item 16, "Other borrowed money," by the issuing bank. Conversely, when the reporting bank is the holder of a due bill, the outstanding due bill obligation of the seller shall be reported as a loan to that party.

Edge and Agreement Corporation: An Edge corporation is a federally-chartered corporation organized under Section 25(a) of the Federal Reserve Act and subject to Federal Reserve Regulation K. Edge corporations are allowed to engage only in international banking or other financial transactions related to international business.

An Agreement corporation is a state-chartered corporation that has agreed to operate as if it were organized under Section 25 of the Federal Reserve Act and has agreed to be subject to Federal Reserve Regulation K. Agreement corporations are restricted, in general, to international banking operations. Banks must apply to the Federal Reserve for permission to acquire stock in an Agreement corporation.

A reporting bank's Edge or Agreement subsidiary, i.e., the bank's majority-owned Edge or Agreement corporation, is treated for purposes of these reports as a "foreign" office of the reporting bank.

Equity Method of Accounting: The equity method of accounting is used to account for investments in subsidiaries that have not been consolidated; associated companies; and corporate joint ventures, unincorporated joint ventures, general partnerships, and limited partnerships over which the bank exercises significant influence (collectively referred to as “investees”).

Under the equity method, the carrying value a bank’s investment in an investee is originally recorded at cost but is adjusted periodically to record as income the bank’s proportionate share of the investee’s earnings or losses and decreased by the amount of cash dividends or similar distributions received from the investee. For purposes of these reports, the date through which the carrying value of the bank’s investment in an investee has been adjusted should, to the extent practicable, match the report date of the Report of Condition, but in no case differ by more than 93 days from the report.

See also "subsidiaries."

Extinguishments of Liabilities: The accounting and reporting standards for extinguishments of liabilities are set forth in FASB Statement No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities." Under Statement No. 140, a bank should remove a previously recognized liability from its balance sheet if and only if the liability has been extinguished. A liability has been extinguished if either of the following conditions is met:

(1) The bank pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes delivering cash, other financial assets, goods, or services or the bank's reacquiring its outstanding debt.

(2) The bank is legally released from being the primary obligor under the liability, either judicially or by the creditor.

Extraordinary Items: Extraordinary items are material events and transactions that are (1) unusual and (2) infrequent. Both of those conditions must exist in order for an event or transaction to be reported as an extraordinary item.

To be unusual, an event or transaction must be highly abnormal or clearly unrelated to the ordinary and typical activities of banks. An event or transaction that is beyond bank management's control is not automatically considered to be unusual.

To be infrequent, an event or transaction should not reasonably be expected to recur in the foreseeable future. Although the past occurrence of an event or transaction provides a basis for estimating the likelihood of its future occurrence, the absence of a past occurrence does not automatically imply that an event or transaction is infrequent.

Only a limited number of events or transactions qualify for treatment as extraordinary items. Among these are losses which result directly from a major disaster such as an earthquake (except in areas where earthquakes are expected to recur in the foreseeable future), an expropriation, or a prohibition under a newly enacted law or regulation.

For further information, see APB Opinion No. 30, "Reporting the Results of Operations."

Fails: When a bank has sold an asset and, on settlement date, does not deliver the security or other asset and does not receive payment, a sales fail exists. When a bank has purchased a security or other asset and, on settlement date, does not receive the asset and does not pay for it, a purchase fail exists. Fails do not affect the way securities are reported in the Reports of Condition and Income.

Federal Funds Transactions: For purposes of the Reports of Condition and Income, federal funds transactions involve the reporting bank's lending (federal funds sold) or borrowing (federal funds purchased) in domestic offices of immediately available funds under agreements or contracts that have an original maturity of one business day or roll over under a continuing contract. However, funds lent or borrowed in the form of securities resale or repurchase agreements, due bills, borrowings from the Discount and Credit Department of a Federal Reserve Bank, deposits with and advances from a Federal Home Loan Bank, and overnight loans for commercial and industrial purposes are excluded from federal funds. Transactions that are to be reported as federal funds transactions may be secured or unsecured or may involve an agreement to resell loans or other instruments that are not securities.

Immediately available funds are funds that the purchasing bank can either use or dispose of on the same business day that the transaction giving rise to the receipt or disposal of the funds is executed.

The borrowing and lending of immediately available funds has an original maturity of one business day if the funds borrowed on one business day are to be repaid or the transaction reversed on the next business day, that is, if immediately available funds borrowed today are to be repaid tomorrow (in tomorrow's immediately available funds). Such transactions include those made on a Friday to mature or be reversed the following Monday and those made on the last business day prior to a holiday (for either or both of the parties to the transaction) to mature or be reversed on the first business day following the holiday.

A continuing contract is a contract or agreement that remains in effect for more than one business day, but has no specified maturity and does not require advance notice of either party to terminate. Such contracts may also be known as rollovers or as open-ended agreements.

Federal funds may take the form of the following two types of transactions in domestic offices provided that the transactions meet the above criteria (i.e., immediately available funds with an original maturity of one business day or under a continuing contract):

Federal Funds Transactions (cont.):

(1) Unsecured loans (federal funds sold) or borrowings (federal funds purchased). (In some market usage, the term "fed funds" or "pure fed funds" is confined to unsecured loans of immediately available balances.)

(2) Purchases (sales) of financial assets (other than securities) under agreements to resell (repurchase) that have original maturities of one business day (or are under continuing contracts) and are in immediately available funds.

Any borrowing or lending of immediately available funds in domestic offices that has an original maturity of more than one business day, other than securities repurchase or resale agreements, is to be treated as a borrowing or as a loan, not as federal funds. Such transactions are sometimes referred to as "term federal funds."

Federally-Sponsored Lending Agency: A federally-sponsored lending agency is an agency or corporation that has been chartered, authorized, or organized as a result of federal legislation for the purpose of providing credit services to a designated sector of the economy. These agencies include Banks for Cooperatives, Federal Home Loan Banks, the Federal Home Loan Mortgage Corporation, Federal Intermediate Credit Banks, Federal Land Banks, the Federal National Mortgage Association, and the Student Loan Marketing Association.

Fees, Loan: See "loan fees."

Foreclosed Assets: The accounting and reporting standards for foreclosed assets are set forth in FASB Statement No. 15, "Accounting by Debtors and Creditors for Troubled Debt Restructurings," and FASB Statement No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." A summary of the relevant provisions of these accounting standards follows. For further information, see FASB Statements No. 15 and 144.

A bank that receives from a borrower in full satisfaction of a loan either receivables from third parties, an equity interest in the borrower, or other types of assets (except long-lived assets that will be sold) shall account for those assets at their fair value at the time of the restructuring. A bank that receives long-lived assets that will be sold, such as real estate, from a borrower in full satisfaction of a loan shall account for those long-lived assets at their fair value less cost to sell. This fair value (less cost to sell) becomes the "cost" of the foreclosed asset. The amount, if any, by which the recorded amount of the loan exceeds the fair value (less cost to sell) of the asset is a loss which must be charged to the allowance for loan and lease losses at the time of foreclosure or repossession. (The recorded amount of the loan is the loan balance adjusted for any unamortized premium or discount and unamortized loan fees or costs, less any amount previously charged off, plus recorded accrued interest.)

If an asset is sold shortly after it is received in a foreclosure or repossession, it would generally be appropriate to substitute the value received in the sale (net of the cost to sell for long-lived assets that will be sold such as real estate) for the fair value (less cost to sell for long-lived assets that will be sold such as real estate) that had been estimated at the time of foreclosure or repossession. Any adjustments should be made to the loss charged against the allowance. In those cases where property is received in full satisfaction of an asset other than a loan (e.g., a debt security), the loss should be reported on the income statement in a manner consistent with the balance sheet classification of the asset satisfied.

Foreclosed Assets (cont.):

An asset received in partial satisfaction of a loan should be accounted for as described above and the recorded amount of the loan should be reduced by the fair value (less cost to sell) of the asset at the time of foreclosure.

For purposes of these reports, foreclosed assets include loans where the bank, as creditor, has received physical possession of a borrower's assets, regardless of whether formal foreclosure proceedings take place. In such situations, the secured loan should be recategorized on the balance sheet in the asset category appropriate to the underlying collateral (e.g., as other real estate owned for real estate collateral) and accounted for as described above.

The amount of any senior debt (principal and accrued interest) to which foreclosed real estate is subject at the time of foreclosure must be reported as a liability in Schedule RC, item 16, "Other borrowed money."

After foreclosure, each foreclosed real estate asset (including any real estate for which the bank receives physical possession, regardless of whether formal foreclosure proceedings take place) must be carried at the lower of (1) the fair value of the asset minus the estimated costs to sell the asset or (2) the cost of the asset (as defined in the preceding paragraphs). This determination must be made on an asset-by-asset basis. If the fair value of a foreclosed real estate asset minus the estimated costs to sell the asset is less than the asset's cost, the deficiency must be recognized as a valuation allowance against the asset which is created through a charge to expense. The valuation allowance should thereafter be increased or decreased (but not below zero) through charges or credits to expense for changes in the asset's fair value or estimated selling costs.

If an asset received in a foreclosure or repossession is held for more than a short period of time, any additional losses in value and any gain or loss from the sale or disposition of the asset shall not be reported as a loan or lease loss or recovery and shall not be debited or credited to the allowance for loan and lease losses. Such additional declines in value and the gain or loss from the sale or disposition shall be reported net on the income statement in Schedule RI, item 5.j, “Net gains (losses)

Dispositions of Foreclosed Real Estate -- The primary accounting guidance for sales of foreclosed real estate is FASB Statement No. 66, "Accounting for Sales of Real Estate." This standard, which applies to all transactions in which the seller provides financing to the buyer of the real estate, establishes the following methods to account for dispositions of real estate. If a profit is involved in the sale of real estate, each method sets forth the manner in which the profit is to be recognized. Regardless of which method is used, however, any losses on the disposition of real estate should be recognized immediately.

Full Accrual Method -- Under the full accrual method, the disposition is recorded as a sale. Any profit resulting from the sale is recognized in full and the asset resulting from the seller's financing of the transaction is reported as a loan. This method may be used when the following conditions have been met:

(1) A sale has been consummated;
(2) The buyer's initial investment (down payment) and continuing investment (periodic payments) are adequate to demonstrate a commitment to pay for the property;
(3) The receivable is not subject to future subordination; and
(4) The usual risks and rewards of ownership have been transferred.

Guidelines for the minimum down payment that must be made in order for a transaction to qualify for the full accrual method are set forth in the Appendix A to FASB Statement No. 66. These vary

Foreclosed Assets (cont.):

from five percent to 25 percent of the property's sales value. These guideline percentages vary by type of property and are primarily based on the inherent risk assumed for the type and characteristics of the property. To meet the continuing investment criteria, the contractual loan payments must be sufficient to repay the loan over the customary loan term for the type of property involved. Such periods may range up to 30 years for loans on single family residential property.

Installment Method -- Dispositions of foreclosed real estate that do not qualify for the full accrual method may qualify for the installment method. This method recognizes a sale and the corresponding loan. Any profits on the sale are only recognized as the bank receives payments from the purchaser/borrower. Interest income is recognized on an accrual basis, when appropriate.

The installment method is used when the buyer's down payment is not adequate to allow use of the full accrual method but recovery of the cost of the property is reasonably assured if the buyer defaults. Assurance of recovery requires careful judgment on a case-by-case basis. Factors which should be considered include: the size of the down payment, loan-to-value ratios, projected cash flows from the property, recourse provisions, and guarantees.

Since default on the loan usually results in the seller's reacquisition of the real estate, reasonable assurance of cost recovery may often be achieved with a relatively small down payment. This is especially true in situations involving loans with recourse to borrowers who have verifiable net worth, liquid assets, and income levels. Reasonable assurance of cost recovery may also be achieved when the purchaser/borrower pledges additional collateral.

Cost Recovery Method -- Dispositions of foreclosed real estate that do not qualify for either the full accrual or installment methods are sometimes accounted for using the cost recovery method. This method recognizes a sale and the corresponding loan, but all income recognition is deferred. Principal payments are applied as a reduction of the loan balance and interest increases the unrecognized gross profit. No profit or interest income is recognized until either the aggregate payments by the borrower exceed the recorded amount of the loan or a change to another accounting method is appropriate (e.g., installment method). Consequently, the loan is maintained in nonaccrual status while this method is being used.

Reduced-Profit Method -- This method is used in certain situations where the bank receives an adequate down payment, but the loan amortization schedule does not meet the requirements for use of the full accrual method. The method recognizes a sale and the corresponding loan. However, like the installment method, any profit is apportioned over the life of the loan as payments are received. The method of apportionment differs from the installment method in that profit recognition is based on the present value of the lowest level of periodic payments required under the loan agreement.

Since sales with adequate down payments are generally not structured with inadequate loan amortization requirements, this method is seldom used in practice.

Deposit Method -- The deposit method is used in situations where a sale of the foreclosed real estate has not been consummated. It may also be used for dispositions that could be accounted for under the cost recovery method. Under this method a sale is not recorded and the asset continues to be reported as foreclosed real estate. Further, no profit or interest income is recognized. Payments received from the borrower are reported as a liability until sufficient payments or other events have occurred which allow the use of one of the other methods.

The preceding discussion represents a brief summary of the methods included in FASB Statement No. 66 for accounting for sales of real estate. Refer to FASB Statement No. 66 for a more complete description of the accounting principles that apply to sales of real estate, including the determination of the down payment percentage.

Foreign Banks: See "banks, U.S. and foreign."

Foreign Currency Transactions and Translation: Foreign currency transactions are transactions occurring in the ordinary course of business (e.g., purchases, sales, borrowings, and lendings) denominated in a currency other than the office's functional currency (as described below).

Foreign currency translation, on the other hand, is the process of translating financial statements from the foreign office's functional currency into the reporting currency. Such translation normally is performed only at reporting dates.

A functional currency is the currency of the primary economic environment in which an office operates. For most banks, the functional currency will be the U.S. dollar. However, if a bank has foreign offices, one or more foreign offices may have a functional currency other than the U.S. dollar.

Accounting for foreign currency transactions -- A change in exchange rates between the functional currency and the currency in which a transaction is denominated will increase or decrease the amount of the functional currency expected to be received or paid. These increases or decreases in the expected functional currency cash flow are foreign currency transaction gains and losses and are to be included in the determination of the income of the period in which the transaction takes place, or if the transaction has not yet settled, the period in which the rate change takes place.

Except for foreign currency derivatives and transactions described in the following section, banks should consistently report net gains (losses) from foreign currency transactions other than trading transactions in Schedule RI, item 5.l, "Other noninterest income," or item 7.d, "Other noninterest expense." Net gains (losses) from foreign currency trading transactions should be reported in Schedule RI, item 5.c, "Trading revenue."

Foreign currency transaction gains or losses to be excluded from the determination of net income -- Gains and losses on the following foreign currency transactions shall not be included in "Noninterest income" or "Noninterest expense," but shall be reported in the same manner as translation adjustments (as described below):

(1) Foreign currency transactions that are designated as, and are effective as, economic hedges of a net investment in a foreign office.

(2) Intercompany foreign currency transactions that are of a long-term investment nature (i.e., settlement is not planned or anticipated in the foreseeable future), when the parties to the transaction are consolidated, combined, or accounted for by the equity method in the bank's Reports of Condition and Income.

See the Glossary entry for "derivative contracts" for information on the accounting and reporting for foreign currency derivatives.

Accounting for foreign currency translation (applicable only to banks with foreign offices)--The Reports of Condition and Income must be reported in U.S. dollars. Balances of foreign subsidiaries or branches of the reporting bank denominated in a functional currency other than U.S. dollars shall be converted to U.S. dollar equivalents and consolidated into the reporting bank's Reports of Condition and Income. The translation adjustments for each reporting period, determined utilizing the current rate method, should be reported in Schedule RI-A, item 10, "Other comprehensive income." Amounts accumulated in the "Cumulative foreign currency translation adjustments" component of "Accumulated other comprehensive income" in Schedule RC, item 26.b, will not be included in the bank's results of operations until such time as the foreign office is disposed of, when they will be used as an element to determine the gain or loss on disposition.

For further guidance, refer to FASB Statement No. 52, "Foreign Currency Translation."

Foreign Debt Exchange Transactions: Foreign debt exchange transactions generally fall into three categories: (1) loan swaps, (2) debt/equity swaps, and (3) debt-for-development swaps. These transactions are to be reported in the Reports of Condition and Income in accordance with generally accepted accounting principles as summarized below. The accounting pronouncements mentioned below should be consulted for more detailed reporting guidance in these areas.

Generally accepted accounting principles require that these transactions be reported at their fair value. There is a significant amount of precedent in the accounting for exchange transactions to consider both the fair value of the consideration given up as well as the fair value of the assets received in arriving at the most informed valuation, especially if the value of the consideration given up is not readily determinable or may not be a good indicator of the value received. It is the responsibility of management to make the valuation considering all of the circumstances. Such valuations are subject to examiner review.

Among the factors to consider in determining fair values for foreign debt exchange transactions are:

(1) Similar transactions for cash;

(2) Estimated cash flows from the debt or equity instruments or other assets received;

(3) Market values, if any, of similar instruments; and

(4) Currency restrictions, if any, affecting payments on or sales of the debt or equity instruments, local currency, or other assets received, including where appropriate those affecting the repatriation of capital.

Losses arise from swap transactions when the fair value determined for the transaction is less than the recorded investment in the sovereign debt and other consideration paid, if any. Such losses should generally be charged to the allowance for loan and lease losses (or allocated transfer risk reserve, if appropriate) and must include any discounts from official exchange rates that are imposed by sovereign obligors as transaction fees. All other fees and transaction costs involved in such transactions must be charged to expense as incurred.

Loss recoveries or even gains might be indicated in a swap transaction as a result of the valuation process. However, due to the subjective nature of the valuation process, such loss recoveries or gains ordinarily should not be recorded until the debt or equity instruments, local currency, or other assets received in the exchange transaction are realized in unrestricted cash or cash equivalents.

Loan swaps -- The reporting guidance for this type of transaction is presented in the AICPA's Notice to Practitioners, "Accounting for Foreign Loan Swaps," issued on May 27, 1985.

Foreign loan swaps, or debt/debt swaps, involve the exchange of one foreign loan for another. This type of transaction represents an exchange of monetary assets that must be reported at current fair value. Normally, when monetary assets are exchanged, with or without additional cash payments, and the parties have no remaining obligations to each other, the earnings process is complete.

Debt/equity swaps -- The reporting treatment for this type of transaction is presented in AICPA Practice Bulletin No. 4, "Accounting for Foreign Debt/Equity Swaps."

A foreign debt/equity swap represents an exchange of monetary for nonmonetary assets that must be measured at fair value. This type of swap is typically accomplished when holders of U.S. dollar-denominated sovereign debt agree to convert that debt into approved local equity investments. The holders are generally credited with local currency at the official exchange rate. A discount from the

Foreign Debt Exchange Transactions (cont.):

official exchange rate is often imposed as a transaction fee. The local currency is generally not available to the holders for any purposes other than approved equity investments. Restrictions may be placed on dividends on the equity investments and capital usually cannot be repatriated for several years.

In arriving at the fair value of the transaction, both the secondary market price of the debt given up and the fair value of the equity investment or assets received should be considered.

Debt-for-development swaps -- In this type of exchange, sovereign debt held by a bank is generally purchased by a nonprofit organization or contributed to the nonprofit the nonprofit organization. When the sovereign debt is purchased by or donated to a nonprofit organization, the organization may enter into an agreement with the debtor country to cancel the debt in return for the country's commitment to provide local currency or other assets for use in connection with specific projects or programs in that country. Alternatively, a bank may exchange the sovereign debt with the country and receive local currency. In this alternative, the local currency will be donated or sold to the nonprofit organization for use in connection with specific projects or programs in that country.

These transactions, including amounts charged to expense as donations, must be reported at their fair values in accordance with generally accepted accounting principles applicable to foreign debt exchange transactions. This includes appropriate consideration of the market value of the instruments involved in the transaction and the fair value of any assets received, taking into account any restrictions that would limit the use of the assets. In debt-for-development swaps where a bank receives local currency in exchange for the sovereign loan it held and the local currency has no restrictions on its use and is freely convertible, it is generally appropriate for fair value to be determined by valuing the local currency received at its fair market exchange value.

Foreign Governments and Official Institutions: Foreign governments and official institutions are central, state, provincial, and local governments in foreign countries and their ministries, departments, and agencies. These include treasuries, ministries of finance, central banks, development banks, exchange control offices, stabilization funds, diplomatic establishments, fiscal agents, and nationalized banks and other banking institutions that are owned by central governments and that have as an important part of their function activities similar to those of a treasury, central bank, exchange control office, or stabilization fund. For purposes of these reports, other government-owned enterprises are not included.

Also included as foreign official institutions are international, regional, and treaty organizations, such as the International Monetary Fund, the International Bank for Reconstruction and Development (World Bank), the Bank for International Settlements, the Inter-American Development Bank, and the United Nations.

Foreign Office: For purposes of these reports, a foreign office of the reporting bank is a branch or subsidiary located in Puerto Rico, in a U.S. territory or possession, or in a foreign country; an Edge or Agreement subsidiary, including both its U.S. and its foreign offices; or an IBF. Branches on U.S. military facilities wherever located are treated as domestic offices, not foreign offices.

Forward Contracts: See "derivative contracts."

Functional Currency: See "foreign currency transactions and translation."

Futures Contracts: See "derivative contracts."

Goodwill: See "purchase acquisition" in the entry for "business combinations."

Hypothecated Deposit: A hypothecated deposit is the aggregation of periodic payments on an installment contract received by a reporting institution in a state in which, under law, such payments are not immediately used to reduce the unpaid balance of the installment note, but are accumulated until the sum of the payments equals the entire amount of principal and interest on the contract, at which time the loan is considered paid in full. For purposes of these reports, hypothecated deposits are to be netted against the related loans.

Deposits that simply serve as collateral for loans are not considered hypothecated deposits for purposes of these reports.

See also "deposits."

IBF: See "International Banking Facility (IBF)."

Income Taxes: All banks, regardless of size, are required to report income taxes (federal, state and local, and foreign) in the Reports of Condition and Income on an accrual basis. Note that, in almost all cases, applicable income taxes as reported on the Report of Income will differ from amounts reported to taxing authorities. The applicable income tax expense or benefit that is reflected in the Report of Income should include both taxes currently paid or payable (or receivable) and deferred income taxes. The following discussion of income taxes is based on FASB Statement No. 109, "Accounting for Income Taxes."

Applicable income taxes in the year-end Report of Income shall be the sum of the following:

(1) Taxes currently paid or payable (or receivable) for the year determined from the bank's federal, state, and local income tax returns for that year. Since the bank's tax returns will not normally be prepared until after the year-end Reports of Condition and Income have been completed, the bank must estimate the amount of the current income tax liability (or receivable) that will ultimately be reported on its tax returns. Estimation of this liability (or receivable) may involve consultation with the bank's tax advisers, a review of the previous year's tax returns, the identification of significant expected differences between items of income and expense reflected on the Report of Income and on the tax returns, and the identification of expected tax credits.)

and

(2) Deferred income tax expense or benefit measured as the change in the net deferred tax assets or liabilities for the period reported. Deferred tax liabilities and assets represent the amount by which taxes payable (or receivable) are expected to increase or decrease in the future as a result of "temporary differences" and net operating loss or tax credit carryforwards that exist at the reporting date.

The actual tax liability (or receivable) calculated on the bank's tax returns may differ from the estimate reported as currently payable or receivable on the year-end Report of Income. An amendment to the bank's year-end and subsequent Reports of Condition and Income may be appropriate if the difference is significant. Minor differences should be handled as accrual adjustments to applicable income taxes in Reports of Income during the year the differences are detected. The reporting of applicable income taxes in the Report of Income for report dates other than year-end is discussed below under "interim period applicable income taxes."

Income Taxes (cont.):

Temporary differences result when events are recognized in one period on the bank's books but are recognized in another period on the bank's tax return. These differences result in amounts of income or expense being reported in the Report of Income in one period but in another period in the tax returns. There are two types of temporary differences. Deductible temporary differences reduce taxable income in future periods. Taxable temporary differences result in additional taxable income in future periods.

For example, a bank's provision for loan and lease losses is expensed for financial reporting purposes in one period. However, for some banks, this amount may not be deducted for tax purposes until the loans are actually charged off in a subsequent period. This deductible temporary difference "originates" when the provision for loan and lease losses is recorded in the financial statements and "turns around" or "reverses" when the loans are subsequently charged off, creating tax deductions. Other deductible temporary differences include writedowns of other real estate owned, the recognition of loan origination fees, and other postemployment benefits expense.

Depreciation can result in a taxable temporary difference if a bank uses the straight-line method to determine the amount of depreciation expense to be reported in the Report of Income but uses an accelerated method for tax purposes. In the early years, tax depreciation under the accelerated method will typically be larger than book depreciation under the straight-line method. During this period, a taxable temporary difference originates. Tax depreciation will be less than book depreciation in the later years when the temporary difference reverses. Therefore, in any given year, the depreciation reported in the Report of Income will differ from that reported in the bank's tax returns. However, total depreciation taken over the useful life of the asset will be the same under either method. Other taxable temporary differences include the undistributed earnings of unconsolidated subsidiaries and associated companies and amounts funded to pension plans that exceed the recorded expense.

Some events do not have tax consequences and therefore do not give rise to temporary differences. Certain revenues are exempt from taxation and certain expenses are not deductible. These events were previously known as "permanent differences." Examples of such events (for federal income tax purposes) are interest received on certain obligations of states and political subdivisions in the U.S., premiums paid on officers' life insurance policies where the bank is the beneficiary, and 70 percent of cash dividends received on the corporate stock of domestic U.S. corporations owned less than 20 percent.

Deferred tax assets shall be calculated at the report date by applying the "applicable tax rate" (defined below) to the bank's total deductible temporary differences and operating loss carryforwards. A deferred tax asset shall also be recorded for the amount of tax credit carryforwards available to the bank. Based on the estimated realizability of the deferred tax asset, a valuation allowance should be established to reduce the recorded deferred tax asset to the amount that is considered "more likely than not" (i.e., greater than 50 percent chance) to be realized.

Deferred tax liabilities should be calculated by applying the "applicable tax rate" to total taxable temporary differences at the report date.

Operating loss carrybacks and carryforwards and tax credit carryforwards -- When a bank's deductions exceed its income for federal income tax purposes, it has sustained an operating loss. An operating loss that occurs in a year following periods when the bank had taxable income may be carried back to recover income taxes previously paid. The tax effects of any loss carrybacks that are realizable through a refund of taxes previously paid is recognized in the year the loss occurs. In this situation, the applicable income taxes on the Report of Income will reflect a credit rather than an expense. Banks may carry back operating losses for two years.

Income Taxes (cont.):

Generally, an operating loss that occurs when loss carrybacks are not available (e.g., occurs in a year following periods of losses) becomes an operating loss carryforward. Banks may carry operating losses forward 20 years.

Tax credit carryforwards are tax credits which cannot be used for tax purposes in the current year, but which can be carried forward to reduce taxes payable in a future period.

Deferred tax assets are recognized for operating loss and tax credit carryforwards just as they are for deductible temporary differences. As a result, a bank can recognize the benefit of a net operating loss for tax purposes or a tax credit carryforward to the extent the bank determines that a valuation allowance is not considered necessary (i.e., if the realization of the benefit is more likely than not).

Applicable tax rate -- The income tax rate to be used in determining deferred tax assets and liabilities is the rate under current tax law that is expected to apply to taxable income in the periods in which the deferred tax assets or liabilities are expected to be realized or paid. If the bank's income level is such that graduated tax rates are a significant factor, then the bank shall use the average graduated tax rate applicable to the amount of estimated taxable income in the period in which the deferred tax asset or liability is expected to be realized or settled. When the tax law changes, banks shall determine the effect of the change, adjust the deferred tax asset or liability and include the effect of the change in Schedule RI, item 9, "Applicable income taxes (on item 8)."

Valuation allowance -- A valuation allowance must be recorded, if needed, to reduce the amount of deferred tax assets to an amount that is more likely than not to be realized. Changes in the valuation allowance generally shall be reported in Schedule RI, item 9, "Applicable income taxes (on item 8)." The following discussion of the valuation allowance relates to the allowance, if any, included in the amount of net deferred tax assets or liabilities to be reported on the balance sheet (Schedule RC) and in Schedule RC-F, item 2, or Schedule RC-G, item 2. This discussion does not address the determination of the amount of deferred tax assets, if any, that is disallowed for regulatory capital purposes and reported in Schedule RC-R, item 9.

Banks must consider all available evidence, both positive and negative, in assessing the need for a valuation allowance. The future realization of deferred tax assets ultimately depends on the existence of sufficient taxable income of the appropriate character in either the carryback or carryforward period. Four sources of taxable income may be available to realize the deferred tax assets:

(1) Taxable income in carryback years (which can be offset to recover taxes previously paid),

(2) Reversing taxable temporary differences,

(3) Future taxable income (exclusive of reversing temporary differences and carryforwards.

(4) Tax-planning strategies.

In general, positive evidence refers to the existence of one or more of the four sources of taxable income. To the extent evidence about one or more sources of income is sufficient to support a conclusion that a valuation allowance is not necessary (i.e., the bank can conclude that the deferred tax asset is more likely than not to be realized), other sources need not be considered. However, if a valuation allowance is needed, each source of income must be evaluated to determine the appropriate amount of the allowance needed.

Evidence used in determining the valuation allowance should be subject to objective verification. The weight given to evidence when both positive and negative evidence exist should be consistent with the extent to which it can be verified. Sources (1) and (2) listed above are more susceptible to objective verification and, therefore, may provide sufficient evidence regardless of future events.

Income Taxes (cont.):

The consideration of future taxable income (exclusive of reversing temporary differences and carryforwards) as a source for the realization of deferred tax assets will require subjective estimates and judgments about future events which may be less objectively verifiable.

Examples of negative evidence include:

- Cumulative losses in recent years.
- A history of operating loss or tax credit carryforwards expiring unused.
- Losses expected in early future years by a presently profitable bank.
- Unsettled circumstances that, if unfavorably resolved, would adversely affect future profit levels.
- A brief carryback or carryforward that would limit the ability to realize the deferred tax asset.

Examples of positive evidence include:

- A strong earnings history exclusive of the loss that created the future deductible amount (tax loss carryforward or deductible temporary difference) coupled with evidence indicating that the loss is an aberration rather than a continuing condition.
- Existing contracts that will generate significant income.
- An excess of appreciated asset value over the tax basis of an entity's net assets in an amount sufficient to realize the deferred tax asset.

When realization of a bank's deferred tax assets is dependent upon future taxable income, the reliability of a bank's projections is very important. The bank's record in achieving projected results under an actual operating plan will be a strong measure of this reliability. Other factors a bank should consider in evaluating evidence about its future profitability include but are not limited to current and expected economic conditions, concentrations of credit risk within specific industries and geographical areas, historical levels and trends in past due and nonaccrual assets, historical levels and trends in loan loss reserves, and the bank's interest rate sensitivity.

When strong negative evidence, such as the existence of cumulative losses, exists, it is extremely difficult for a bank to determine that no valuation allowance is needed. Positive evidence of significant quality and quantity would be required to counteract such negative evidence.

For purposes of determining the valuation allowance, a tax-planning strategy is a prudent and feasible action that would result in realization of deferred tax assets and that management ordinarily might not take, but would do so to prevent an operating loss or tax credit carryforward from expiring unused. For example, a bank could accelerate taxable income to utilize carryforwards by selling or securitizing loan portfolios, selling appreciated securities, or restructuring nonperforming assets. Actions that management would take in the normal course of business are not considered tax-planning strategies.

Significant expenses to implement the tax-planning strategy and any significant losses that would result from implementing the strategy shall be considered in determining any benefit to be realized from the tax-planning strategy. Also, banks should consider all possible consequences of any tax-planning strategies. For example, loans pledged as collateral would not be available for sale.

The determination of whether a valuation allowance is needed for deferred tax assets should be made for total deferred tax assets, not for deferred tax assets net of deferred tax liabilities. In addition, the evaluation should be made on a jurisdiction-by-jurisdiction basis. Separate analyses should be performed for amounts related to each taxing authority (e.g., federal, state, and local).

Deferred tax assets (net of the valuation allowance) and deferred tax liabilities related to a particular tax jurisdiction (e.g., federal, state, and local) may be offset against each other for reporting purposes. A resulting debit balance shall be included in "Other assets" and reported in Schedule RC-F, item 2. A

Income Taxes (cont.):

resulting credit balance shall be included in "Other liabilities" and reported in Schedule RC-G, item 2. (A bank may report a net deferred tax debit, or asset, for one tax jurisdiction (e.g., federal taxes) and also report a net deferred tax credit, or liability, for another tax jurisdiction (e.g., state taxes).

Interim period applicable income taxes -- When preparing its year-to-date Report of Income as of the end of March, June, and September ("interim periods"), a bank generally should determine its best estimate of its effective annual tax rate for the full year, including both current and deferred portions and considering all tax jurisdictions (e.g., federal, state and local). To arrive at its estimated effective annual tax rate, a bank should divide its estimated total applicable income taxes (current and deferred) for the year by its estimated pretax income for the year (excluding extraordinary items). This rate would then be applied to the year-to-date pretax income to determine the year-to-date applicable income taxes at the interim date.

Intraperiod allocation of income taxes -- When the Report of Income for a period includes "Extraordinary items and other adjustments" that are reportable in Schedule RI, item 11, the total amount of the applicable income taxes for the year to date shall be allocated in Schedule RI between item 9, "Applicable income taxes (on item 8)," and item 11, "Extraordinary items and other adjustments, net of income taxes."

The applicable income taxes on operating income (item 9) shall be the amount that the total applicable income taxes on pretax income, including both current and deferred taxes (calculated as described above), would have been for the period had "Extraordinary items and other adjustments" been zero. The difference between item 9, "Applicable income taxes (on item 8)," and the total amount of the applicable taxes shall then be reflected in item 11 as applicable income taxes on extraordinary items and other adjustments.

Tax calculations by tax jurisdiction -- Separate calculations of income taxes, both current and deferred amounts, are required for each tax jurisdiction. However, if the tax laws of the state and local jurisdictions do not significantly differ from federal income tax laws, then the calculation of deferred income tax expense can be made in the aggregate. The bank would calculate both current and deferred tax expense considering the combination of federal, state and local income tax rates. The rate used should consider whether amounts paid in one jurisdiction are deductible in another jurisdiction. For example, since state and local taxes are deductible for federal purposes, the aggregate combined rate would generally be (1) the federal tax rate plus (2) the state and local tax rates minus (3) the federal tax effect of the deductibility of the state and local taxes at the federal tax rate.

Income taxes of a bank subsidiary of a holding company -- A bank should generally report income tax amounts in its Reports of Condition and Income as if it were a separate entity. A bank's separate entity taxes include taxes of subsidiaries of the bank that are included with the bank in a consolidated tax return. In other words, when a bank has subsidiaries of its own, the bank and its consolidated subsidiaries are treated as one separate taxpayer for purposes of computing the bank's applicable income taxes. This treatment is also applied in determining net deferred tax asset limitations for regulatory capital purposes.

During profitable periods, a bank subsidiary of a holding company that files a consolidated tax return should record current tax expense for the amount that would be due on a separate entity basis. Certain adjustments resulting from the consolidated status may, however, be made to the separate entity calculation as long as these adjustments are made on a consistent and equitable basis. For example, the consolidated group's single surtax exemption may be allocated among the holding company affiliates if such an allocation is equitable and applied consistently. Such allocations should be reflected in the bank's applicable income taxes, rather than as "Other transactions with parent holding company" in Schedule RI-A, Changes in Equity Capital.

Income Taxes (cont.):

In addition, bank subsidiaries should first compute their taxes on a separate entity basis without considering the alternative minimum tax (AMT). The AMT should be determined on a consolidated basis, and if it exceeds the regular tax on a consolidated basis, the holding company should allocate that excess to its affiliates on an equitable and consistent basis. The allocation method must be based upon the portion of tax preferences, adjustments, and other items causing the AMT to be applicable at the consolidated level that are generated by the parent holding company and each bank and nonbank subsidiary. In no case should amounts be allocated to bank subsidiaries that have not generated any tax preference or positive tax adjustment items. Furthermore, the AMT allocated to banks within the consolidated group should not exceed the consolidated AMT in any year.

In future years when a consolidated AMT credit carryforward is utilized, the credit must be reallocated to the subsidiary banks. The allocation should be done on an equitable and consistent basis based upon the amount of AMT giving rise to the credit that had been previously allocated. In addition, the amount of AMT credit reallocated to affiliates within the consolidated group should not exceed the consolidated AMT credit in any year. All AMT allocations should be reflected in the bank's applicable income taxes, rather than as "Other transactions with parent holding company" in Schedule RI-A, Changes in Equity Capital.

Similarly, bank subsidiaries incurring a loss should record an income tax benefit and receive an equitable refund from their parent, if appropriate. The refund should be based on the amount they would have received on a separate entity basis, adjusted for statutory tax considerations, and shall be made on a timely basis.

An exception to this rule is made when the bank, on a separate entity basis, would not be entitled to a current refund because it has exhausted benefits available through carryback on a separate entity basis, yet the holding company can utilize the bank's tax loss to reduce the consolidated liability for the current year. In this situation, realization of the tax benefit is assured. Accordingly, the bank may recognize a current tax benefit in the year in which the operating loss occurs, provided the holding company reimburses the bank on a timely basis for the amount of benefit recognized. Any such tax benefits recognized in the loss year should be reflected in the bank's applicable income taxes and not as an extraordinary item. If timely reimbursement is not made, the bank cannot recognize the tax benefit in the current year. Rather, the tax loss becomes a net operating loss carryforward for the bank.

A parent holding company shall not adopt an arbitrary tax allocation policy within its consolidated group if it results in a significantly different amount of subsidiary bank applicable income taxes than would have been provided on a separate entity basis. If a holding company forgives payment by the subsidiary of all or a significant portion of the current portion of the applicable income taxes computed in the manner discussed above, such forgiveness should be treated as a capital contribution and reported in Schedule RI-A in "Other transactions with parent holding company" and in Schedule RI-E, item 5.

Further, if the subsidiary bank pays an amount greater than its separate entity current tax liability (calculated as previously discussed), the excess should be reported as a cash dividend to the holding company in Schedule RI-A, item 9. Payment by the bank of its deferred tax liability, in addition to its current tax liability, is considered an excessive payment of taxes. As a result, the deferred portion should likewise be reported as a cash dividend. Failure to pay the subsidiary bank an equitable refund attributable to the bank's net operating loss should also be considered a cash dividend paid by the bank to the parent holding company.

Income Taxes (cont.):

Purchase business combinations -- In purchase business combinations (as described in the Glossary entry for "business combinations"), banks shall recognize as a temporary difference the difference between the tax basis of acquired assets or liabilities and the amount of the purchase price allocated to the acquired assets and liabilities (with certain exceptions specified in FASB Statement No. 109). As a result, the acquired asset or liability shall be recorded gross and a deferred tax asset or liability shall be recorded for any resulting temporary difference.

In a purchase business combination, a deferred tax asset shall generally be recognized at the date of acquisition for deductible temporary differences and net operating loss and tax credit carryforwards of either company in the transaction, net of an appropriate valuation allowance. The determination of the valuation allowance should consider any provisions in the tax law that may restrict the use of an acquired company's carryforwards.

Subsequent recognition (i.e., by elimination of the valuation allowance) of the benefit of deductible temporary differences and net operating loss or tax credit carryforwards not recognized at the acquisition date will depend on the source of the benefit. If the valuation allowance relates to deductible temporary differences and carryforwards of the acquiring company established before the acquisition, then subsequent recognition is reported as a reduction of income tax expense. If the benefit is related to the acquired company's deductible temporary differences and carryforwards, then the benefit is subsequently recognized by first reducing any goodwill related to the acquisition, then by reducing all other noncurrent intangible assets related to the acquisition, and finally, by reducing income tax expense.

Alternative Minimum Tax -- Any taxes a bank must pay in accordance with the alternative minimum tax (AMT) shall be included in the bank's current tax expense. Amounts of AMT paid can be carried forward in certain instances to reduce the bank's regular tax liability in future years. The bank may record a deferred tax asset for the amount of the AMT credit carryforward, which shall then be evaluated in the same manner as other deferred tax assets to determine whether a valuation allowance is needed.

Other tax effects -- A bank may have transactions or items that are reportable in Schedule RI-A of the Report of Income such as "Restatements due to corrections of material accounting errors and changes in accounting principles," and, on the FFIEC 031 only, "Foreign currency translation adjustments" that are included in “Other comprehensive income.” These transactions or other items will enter into the determination of taxable income in some year (not necessarily the current year), but are not included in the pretax income reflected in Schedule RI of the Report of Income. They shall be reported in Schedule RI-A net of related income tax effects. These effects may increase or decrease the bank's total tax liability calculated on its tax returns for the current year or may be deferred to one or more future periods.

For further information, see FASB Statement No. 109, "Accounting for Income Taxes."

Income Taxes (cont.):
The following table has been included to aid banks in calculating their "applicable income taxes" for purposes of the Reports of Condition and Income. The table includes the tax rates in effect for the years presented.

FEDERAL INCOME TAX RATES APPLICABLE TO BANKS

Year	First $25,000	Second $25,000	Third $25,000	Fourth $25,000	Over $100,000	Capital Gains	Alternative Minimum Tax
1993-2001	15%	15%	25%	34%	[1]	Regular tax rates	20%

Intangible Assets: See "business combinations" and the instruction to Report of Condition Schedule RC-M, item 2.

Interest-Bearing Account: See "deposits."

Interest Capitalization: See "capitalization of interest costs."

Interest Rate Swaps: See "derivative contracts."

Internal-Use Computer Software: Guidance on the accounting and reporting for the costs of internal-use computer software is set forth in AICPA Statement of Position 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use." A summary of this accounting guidance follows. For further information, see AICPA Statement of Position 98-1.

Internal-use computer software is software that meets both of the following characteristics:

(1) The software is acquired, internally developed, or modified solely to meet the bank's internal needs; and

(2) During the software's development or modification, no substantive plan exists or is being developed to market the software externally.

Statement of Position 98-1 identifies three stages of development for internal-use software: the preliminary project stage, the application development stage, and the post-implementation/operation stage. The processes that occur during the preliminary project stage of software development are the conceptual formulation of alternatives, the evaluation of alternatives, the determination of the existence of needed technology, and the final selection of alternatives. The application development stage involves the design of the chosen path (including software configuration and software interfaces), coding, installation of software to hardware, and testing (including the parallel processing phase). Generally, training and application maintenance occur during the post-implementation/operation stage. Upgrades of and enhancements to existing internal-use software, i.e., modifications to software that result in additional functionality, also go through the three aforementioned stages of development.

[1] A 39% tax rate applies to taxable income from $100,001 to $335,000; a 34% tax rate applies to taxable income from $335,001 to $10,000,000; a tax rate of 35% applies to taxable income from $10,000,001 to $15,000,000; a taxrate of 38% applies to taxable income from $15,000,001 to $18,333,333; and a 35% tax rate applies to taxable income over $18,333,333.

Internal-Use Computer Software (cont.):

Computer software costs that are incurred in the preliminary project stage should be expensed as incurred.

Internal and external costs incurred to develop internal-use software during the application development stage should be capitalized. Capitalization of these costs should begin once (a) the preliminary project stage is completed and (b) management, with the relevant authority, implicitly or explicitly authorizes and commits to funding a computer software project and it is probable that the project will be completed and the software will be used to perform the function intended. Capitalization should cease no later than when a computer software project is substantially complete and ready for its intended use, i.e., after all substantial testing is completed. Capitalized internal-use software costs generally should be amortized on a straight-line basis over the estimated useful life of the software.

Only the following application development stage costs should be capitalized:

(1) External direct costs of materials and services consumed in developing or obtaining internal-use software;

(2) Payroll and payroll-related costs for employees who are directly associated with and who devote time to the internal-use computer software project (to the extent of the time spent directly on the project); and

(3) Interest costs incurred when developing internal-use software.

Costs to develop or obtain software that allows for access or conversion of old data by new systems also should be capitalized. Otherwise, data conversion costs should be expensed as incurred. General and administrative costs and overhead costs should not be capitalized as internal-use software costs.

During the post-implementation/operation stage, internal and external training costs and maintenance costs should be expensed as incurred.

Impairment of capitalized internal-use computer software costs should be recognized and measured in accordance with FASB Statement No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of."

The costs of internally developed computer software to be sold, leased, or otherwise marketed as a separate product or process should be reported in accordance with FASB Statement No. 86, "Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed." If, after the development of internal-use software is completed, a bank decides to market the software, proceeds received from the license of the software, net of direct incremental marketing costs, should be applied against the carrying amount of the software.

International Banking Facility (IBF): General definition -- An International Banking Facility (IBF) is a set of asset and liability accounts, segregated on the books and records of the establishing entity, which reflect international transactions. An IBF is established in accordance with the terms of Federal Reserve Regulation D and after appropriate notification to the Federal Reserve. The establishing entity may be a U.S. depository institution, a U.S. office of an Edge or Agreement corporation, or a U.S. branch or agency of a foreign bank pursuant to Federal Reserve Regulations D and Q. An IBF is permitted to hold only certain assets and liabilities. In general, IBF accounts are limited, as specified in the paragraphs below, to non-U.S. residents of foreign countries, residents of Puerto Rico and U.S. territories and possessions, other IBFs, and U.S. and non-U.S. offices of the establishing entity.

International Banking Facility (IBF) (cont.):

Permissible IBF assets include extensions of credit to the following:

(1) non-U.S. residents (including foreign branches of other U.S. banks);
(2) other IBFs; and
(3) U.S. and non-U.S. offices of the establishing entity.

Credit may be extended to non-U.S. nonbank residents only if the funds are used in their operations outside the United States. IBFs may extend credit in the form of a loan, deposit, placement, advance, security, or other similar asset.

Permissible IBF liabilities include (as specified in Federal Reserve Regulations D and Q) liabilities to non-U.S. nonbank residents only if such liabilities have a minimum maturity or notice period of at least two business days. IBF liabilities also may include overnight liabilities to:

(1) non-U.S. offices of other depository institutions and of Edge or Agreement corporations;
(2) non-U.S. offices of foreign banks;
(3) foreign governments and official institutions;
(4) other IBFs; and
(5) the establishing entity.

IBF liabilities may be issued in the form of deposits, borrowings, placements, and other similar instruments. However, IBFs are prohibited from issuing negotiable certificates of deposit, bankers acceptances, or other negotiable or bearer instruments.

Treatment of the reporting bank's IBFs in the Reports of Condition and Income -- IBFs established by the reporting bank (i.e., by the bank or by its Edge or Agreement subsidiaries) are to be consolidated in the Reports of Condition and Income. In the consolidated balance sheet (Schedule RC) and income statement (Schedule RI), transactions between the IBFs of the reporting bank and between these IBFs and other offices of the bank are to be eliminated. (See the discussion of consolidation in the General Instructions section of this book.)

For purposes of these reports, the reporting bank's IBFs are to be treated as foreign offices of the bank. Thus, a bank with an IBF, even if it has no other foreign offices, must submit the Reports of Condition and Income applicable to banks with foreign offices (FFIEC 031). Similarly, the reporting bank's IBFs are to be treated as foreign offices where, in the supporting schedules, a distinction is made between foreign and domestic offices of the reporting bank.

Assets of the reporting bank's IBFs should be reported in the asset categories of the report by type of instrument and customer, as appropriate. For example, IBFs are to report their holdings of securities in Schedule RC, item 2, and in the appropriate items of Schedule RC-B; their holdings of loans that the IBF has the intent and ability to hold for the foreseeable future or until maturity or payoff in Schedule RC, item 4.b, and in the appropriate items of Schedule RC-C, part I; and federal funds sold and securities purchased under agreements to resell in Schedule RC, item 3.

For purposes of these reports, all liabilities of the reporting bank's IBFs to outside parties are classified under three headings:

(1) federal funds purchased and securities sold under agreements to repurchase, which are to be reported in Schedule RC, item 14;

(2) accrued liabilities, which are to be reported in Schedule RC, item 20; and

International Banking Facility (IBF) (cont.):

(3) all other liabilities, including deposits, placements, and borrowings, which are to be treated as deposit liabilities in foreign offices and reported in Schedule RC, item 13.b, and by customer detail in Schedule RC-E, part II.

In addition to being included in the appropriate items of the balance sheet, the total assets and total liabilities of the reporting bank's IBFs are to be reported separately in Schedule RC-I, Assets and Liabilities of IBFs, by banks with IBFs and other "foreign" offices. For a bank whose only foreign offices are IBFs, the total assets and liabilities of the reporting bank's IBFs are not reported separately in Schedule RC-I, but are derived from Schedule RC-H, Selected Balance Sheet Items for Domestic Offices.

Treatment of transactions with IBFs of other depository institutions -- Transactions between the reporting bank and IBFs outside the scope of the reporting bank's consolidated Reports of Condition and Income are to be reported as transactions with depository institutions in the U.S., as appropriate. (Note, however, that only foreign offices of the reporting bank and the reporting bank's IBFs are permitted to have transactions with other IBFs.)

Interoffice Accounts: See "suspense accounts."

Investments in Common Stock of Unconsolidated Subsidiaries: See “equity method of accounting” and “subsidiaries.”

Joint Venture: See "subsidiaries."

Lease Accounting: A lease is an agreement that transfers the right to use land, buildings, or equipment for a specified period of time. This financing device is essentially an extension of credit evidenced by an obligation between a lessee and a lessor.

Standards for lease accounting are set forth in FASB Statement No. 13, "Accounting for Leases," as amended and interpreted.

Accounting with bank as lessee -- Any lease entered into by a lessee bank that meets certain criteria (defined in the following paragraph) shall be accounted for as a property acquisition financed with a debt obligation. The property shall be amortized according to the bank's normal depreciation policy (except, if appropriate, the amortization period shall be the lease term) unless the lease involves land only. The interest expense portion of each lease payment shall be calculated to result in a constant rate of interest on the balance of the debt obligation. In the Report of Condition, the property "asset" is to be reported in Schedule RC, item 6, and the liability for capitalized leases in Schedule RC, item 16, "Other borrowed money." In the Report of Income, the interest expense portion of the capital lease payments is to be reported in Schedule RI, item 2.c, "Interest on trading liabilities and other borrowed money," and the amortization expense on the asset is to be reported in Schedule RI, item 7.b, "Expenses of premises and fixed assets."

If any one of the following criteria is met, a lease must be accounted for as a capital lease:

(1) ownership of the property is transferred to the lessee at the end of the lease term, or

(2) the lease contains a bargain purchase option, or

Lease Accounting (cont.):

(3) the lease term represents at least 75 percent of the estimated economic life of the leased property, or

(4) the present value of the minimum lease payments at the beginning of the lease term is 90 percent or more of the fair value of the leased property to the lessor at the inception of the lease less any related investment tax credit retained by and expected to be realized by the lessor.

If none of the above criteria is met, the lease should be accounted for as an operating lease. Normally, rental payments should be charged to expense over the term of the operating lease as they become payable.

NOTE: If a lease involves land only, the lease must be capitalized if either of the first two criteria above is met. Where a lease that involves land and building meets either of these two criteria, the land and building must be separately capitalized by the lessee. The accounting for a lease involving land and building that meets neither of the first two criteria should conform to the standards prescribed by FASB Statement No. 13.

Accounting for sales with leasebacks -- Sale-leaseback transactions involve the sale of property by the owner and a lease of the property back to the seller. If a bank sells premises or fixed assets and leases back the property, the lease shall be treated as a capital lease if it meets any one of the four criteria above for capitalization. Otherwise, the lease shall be accounted for as an operating lease.

As a general rule, the bank shall defer any gain resulting from the sale. For capital leases, this deferred gain is amortized in proportion to the depreciation taken on the leased asset. For operating leases, the deferred gain is amortized in proportion to the rental payments the bank will make over the lease term. The unamortized deferred gain is to be reported in Schedule RC-G, item 4, "Other" liabilities. (Exceptions to the general rule on deferral that permit full or partial recognition of a gain at the time of the sale may occur if the leaseback covers less than substantially all of the property that was sold or if the total gain exceeds the minimum lease payments.)

If the fair value of the property at the time of the sale is less than the book value of the property, the difference between these two amounts shall be recognized as a loss immediately. In this case, if the sales price is less than the fair value of the property, the additional loss shall be deferred since it is in substance a prepayment of rent. Similarly, if the fair value of the property sold is greater than its book value, any loss on the sale shall also be deferred. Deferred losses shall be amortized in the same manner as deferred gains as described above.

For further information, see FASB Statement No. 28, "Accounting for Sales with Leasebacks."

Accounting with bank as lessor -- Unless a long-term creditor is also involved in the transaction, a lease entered into by a lessor bank that meets one of the four criteria above for a capital lease plus two additional criteria (as defined below) shall be treated as a direct financing lease. The unearned income (minimum lease payments plus estimated residual value plus initial direct costs less the cost of the leased property) shall be amortized to income over the lease term in a manner which produces a constant rate of return on the net investment (minimum lease payments plus estimated residual value plus initial direct costs less unearned income). Other methods of income recognition may be used if the results are not materially different.

The following two additional criteria must be met for a lease to be classified as a direct financing lease:

(1) Collectability of the minimum lease payments is reasonably predictable.

(2) No important uncertainties surround the amount of unreimbursable costs yet to be incurred by the lessor under the lease.

Lease Accounting (cont.):

When a lessor bank enters into a lease that has all the characteristics of a direct financing lease but where a long-term creditor provides nonrecourse financing to the lessor, the transaction shall be accounted for as a leveraged lease. The lessor's net investment in a leveraged lease shall be recorded in a manner similar to that for a direct financing lease but net of the principal and interest on the nonrecourse debt. Based on a projected cash flow analysis for the lease term, unearned and deferred income shall be amortized to income at a constant rate only in those years of the lease term in which the net investment is positive. In the years in which the net investment is not positive, no income is to be recognized on the leveraged lease.

If a lease is neither a direct financing lease nor a leveraged lease, the lessor bank shall account for it as an operating lease. The leased property shall be reported as "Other assets" and depreciated in accordance with the bank's normal policy. Rental payments are generally credited to income over the term of an operating lease as they become receivable.

Letter of Credit: A letter of credit is a document issued by a bank on behalf of its customer (the account party) authorizing a third party (the beneficiary), or in special cases the account party, to draw drafts on the bank up to a stipulated amount and with specified terms and conditions. The letter of credit is a conditional commitment (except when prepaid by the account party) on the part of the bank to provide payment on drafts drawn in accordance with the terms of the document.

As a matter of sound practice, letters of credit should:

(1) be conspicuously labeled as a letter of credit;

(2) contain a specified expiration date or be for a definite term;

(3) be limited in amount;

(4) call upon the issuing bank to pay only upon the presentation of a draft or other documents as specified in the letter of credit and not require the issuing bank to make determinations of fact or law at issue between the account party and the beneficiary; and

(5) be issued only subject to an agreement between the account party and the issuing bank that establishes the unqualified obligation of the account party to reimburse the issuing bank for all payments made under the letter of credit.

There are four basic types of letters of credit:

(1) commercial letters of credit,
(2) letters of credit sold for cash,
(3) travelers' letters of credit, and
(4) standby letters of credit,

each of which is discussed separately on the following page.

A commercial letter of credit is issued specifically to facilitate trade or commerce. Under the terms of a commercial letter of credit, as a general rule, drafts will be drawn when the underlying transaction is consummated as intended.

A letter of credit sold for cash is a letter of credit for which the bank has received funds from the account party at the time of issuance. This type of letter of credit is not to be reported as an outstanding letter of credit but as a demand deposit. These letters are considered to have been sold for cash even though the bank may have advanced funds to the account party for the purchase of such letters of credit on a secured or unsecured basis.

Letter of Credit (cont.):

A travelers' letter of credit is issued to facilitate travel. This letter of credit is addressed by the bank to its correspondents authorizing the correspondents to honor drafts drawn by the person named in the letter of credit in accordance with specified terms. These letters are generally sold for cash.

A standby letter of credit is a letter of credit or similar arrangement that:

(1) represents an obligation on the part of the issuing bank to a designated third party (the beneficiary) contingent upon the failure of the issuing bank's customer (the account party) to perform under the terms of the underlying contract with the beneficiary, or
(2) obligates the bank to guarantee or stand as surety for the benefit of a third party to the extent permitted by law or regulation.

The underlying contract may entail either financial or nonfinancial undertakings of the account party with the beneficiary. The underlying contract may involve such things as the customer's payment of commercial paper, delivery of merchandise, completion of a construction contract, release of maritime liens, or repayment of the account party's obligations to the beneficiary. Under the terms of a standby letter, as a general rule, drafts will be drawn only when the underlying event fails to occur as intended.

Limited-Life Preferred Stock: See "preferred stock."

Loan: For purposes of these reports, a loan is generally an extension of credit resulting from direct negotiations between a lender and a borrower. The reporting bank may originate a loan by directly negotiating with a borrower or it may purchase a loan or a portion of a loan originated by another lender that directly negotiated with a borrower. The reporting bank may also sell a loan or a portion of a loan, regardless of the method by which it acquired the loan.

Loans may take the form of promissory notes, acknowledgments of advance, due bills, invoices, overdrafts, acceptances, and similar written or oral obligations.

Among the extensions of credit reportable as loans in Schedule RC-C, which covers both loans held for sale and loans that the reporting bank has the intent and ability to hold for the foreseeable future or until maturity or payoff, are:

(1) acceptances of other banks purchased in the open market, not held for trading;

(2) acceptances executed by or for the account of the reporting bank and subsequently acquired by it through purchase or discount;

(3) customers' liability to the reporting bank on drafts paid under letters of credit for which the bank has not been reimbursed;

(4) "advances" and commodity or bill-of-lading drafts payable upon arrival of goods against which drawn, for which the reporting bank has given deposit credit to customers;

(5) paper pledged by the bank whether for collateral to secure bills payable (e.g., margin collateral to secure bills rediscounted) or for any other purpose;

(6) sales of so-called "term federal funds" (i.e., sales of immediately available funds with a maturity of more than one business day), other than those involving security resale agreements;

(7) factored accounts receivable;

Loan (cont.):

(8) loans arising out of the purchase of assets (other than securities) under resale agreements with a maturity of more than one business day if the agreement requires the bank to resell the identical asset purchased; and

(9) participations (acquired or held) in a single loan or in a pool of loans or receivables (see the discussion of loan participations in the Glossary entry for "transfers of financial assets").

Loan assets held for trading are to be reported in Schedule RC, item 5, "Trading assets."

See also "loan secured by real estate," "overdraft," and "transfers of financial assets."

Loan Fees: The accounting standards for nonrefundable fees and costs associated with lending, committing to lend, and purchasing a loan or group of loans are set forth in FASB Statement No. 91, "Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases," a summary of which follows. The statement applies to all types of loans as well as to debt securities (but not to loans or debt securities carried at market value if the changes in market value are included in earnings) and to all types of lenders. For further information, see FASB Statement No. 91.

A bank may acquire a loan by originating the loan (lending) or by acquiring a loan from a party other than the borrower (purchasing). Lending, committing to lend, refinancing or restructuring loans, arranging standby letters of credit, syndicating loans, and leasing activities are all considered "lending activities." Nonrefundable loan fees paid by the borrower to the lender may have many different names, such as origination fees, points, placement fees, commitment fees, application fees, management fees, restructuring fees, and syndication fees, but in this Glossary entry, they are referred to as loan origination fees, commitment fees, or syndication fees.

FASB Statement No. 91 applies to both a lender and a purchaser, and should be applied to individual loan contracts. Aggregation of similar loans for purposes of recognizing net fees or costs and purchase premiums or discounts is permitted under certain circumstances specified in FASB Statement No. 91 or if the result does not differ materially from the amount that would have been recognized on an individual loan-by-loan basis. In general, the statement specifies that:

(1) Loan origination fees should be deferred and recognized over the life of the related loan as an adjustment of yield (interest income). Once a bank adopts FASB Statement No. 91, recognizing a portion of loan fees as revenue to offset all or part of origination costs in the reporting period in which a loan is originated is no longer acceptable.

(2) Certain direct loan origination costs specified in the Statement should be deferred and recognized over the life of the related loan as a reduction of the loan's yield. Loan origination fees and related direct loan origination costs for a given loan should be offset and only the net amount deferred and amortized.

(3) Direct loan origination costs should be offset against related commitment fees and the net amounts deferred except for: (a) commitment fees (net of costs) where the likelihood of exercise of the commitment is remote, which generally should be recognized as service fee income on a straight line basis over the loan commitment period, and (b) retrospectively determined fees, which are recognized as service fee income on the date as of which the amount of the fee is determined. All other commitment fees (net of costs) shall be deferred over the entire commitment period and recognized as an adjustment of yield over the related loan's life or, if the commitment expires unexercised, recognized in income upon expiration of the commitment.

Loan Fees (cont.):

(4) Loan syndication fees should be recognized by the bank managing a loan syndication (the syndicator) when the syndication is complete unless a portion of the syndication loan is retained. If the yield on the portion of the loan retained by the syndicator is less than the average yield to the other syndication participants after considering the fees passed through by the syndicator, the syndicator should defer a portion of the syndication fee to produce a yield on the portion of the loan retained that is not less than the average yield on the loans held by the other syndication participants.

(5) Loan fees, certain direct loan origination costs, and purchase premiums and discounts on loans shall be recognized as an adjustment of yield generally by the interest method based on the contractual term of the loan. However, if the bank holds a large number of similar loans for which prepayments are probable and the timing and amount of prepayments can be reasonably estimated, the bank may consider estimates of future principal prepayments in the calculation of the constant effective yield necessary to apply the interest method. Once a bank adopts FASB Statement No. 91, the practice of recognizing fees over the estimated average life of a group of loans is no longer acceptable.

(6) A refinanced or restructured loan, other than a troubled debt restructuring, should be accounted for as a new loan if the terms of the new loan are at least as favorable to the lender as the terms for comparable loans to other customers with similar collection risks who are not refinancing or restructuring a loan. Any unamortized net fees or costs and any prepayment penalties from the original loan should be recognized in interest income when the new loan is granted. If the refinancing or restructuring does not meet these conditions or if only minor modifications are made to the original loan contract, the unamortized net fees or costs from the original loan and any prepayment penalties should be carried forward as a part of the net investment in the new loan. The investment in the new loan should consist of the remaining net investment in the original loan, any additional amounts loaned, any fees received, and direct loan origination costs associated with the transaction. In a troubled debt restructuring involving a modification of terms, fees received should be applied as a reduction of the recorded investment in the loan, and all related costs, including direct loan origination costs, should be charged to expense as incurred. (See the Glossary entry for "troubled debt restructurings" for further guidance.)

(7) Deferred net fees or costs shall not be amortized during periods in which interest income on a loan is not being recognized because of concerns about realization of loan principal or interest.

Direct loan origination costs of a completed loan are defined to include only (a) incremental direct costs of loan origination incurred in transactions with independent third parties for that particular loan and (b) certain costs directly related to specified activities performed by the lender for that particular loan.[1] Incremental direct costs are costs to originate a loan that (a) result directly from and are essential to the lending transaction and (b) would not have been incurred by the lender had that lending transaction not occurred. The specified activities performed by the lender are evaluating the prospective borrower's financial condition; evaluating and recording guarantees, collateral, and other security arrangements; negotiating loan terms; preparing and processing loan documents; and closing the transaction. The costs directly related to those activities include only that portion of the employees' total compensation and payroll-related fringe benefits directly related to time spent performing those activities for that particular loan and other costs related to those activities that would not have been incurred but for that particular loan.

[1] For purposes of these reports, a bank which deems its costs for these lending activities not to be material and which need not maintain records on a loan-by-loan basis for other purposes may expense such costs as incurred.

Loan Fees (cont.):

All other lending-related costs, whether or not incremental, should be charged to expense as incurred, including costs related to activities performed by the lender for advertising, identifying potential borrowers, soliciting potential borrowers, servicing existing loans, and other ancillary activities related to establishing and monitoring credit policies, supervision, and administration. Employees' compensation and fringe benefits related to these activities, unsuccessful loan origination efforts, and idle time should be charged to expense as incurred. Administrative costs, rent, depreciation, and all other occupancy and equipment costs are considered indirect costs and should be charged to expense as incurred.

Net unamortized loan fees represent an adjustment of the loan yield, and shall be reported in the same manner as unearned income on loans, i.e., deducted from the related loan balances (to the extent possible) or deducted from total loans in "Any unearned income on loans reflected in items 1-9 above" in Schedule RC-C, part I. Net unamortized direct loan origination costs shall be added to the related loan balances in Schedule RC-C, part I. Amounts of loan origination, commitment, and other fees and costs recognized as an adjustment of yield should be reported under the appropriate subitem of item 1, "Interest income," in Schedule RI. Other fees, such as (a) commitment fees that are recognized during the commitment period or included in income when the commitment expires (i.e. fees retrospectively determined and fees for commitments where exercise is remote) and (b) syndication fees that are not deferred, should be reported as "Other noninterest income" on Schedule RI.

Loan Impairment: The accounting standard for impaired loans is FASB Statement No. 114, "Accounting by Creditors for Impairment of a Loan." For further information, refer to FASB Statement No. 114.

Each institution is responsible for maintaining an allowance for loan and lease losses (allowance) adequate to absorb estimated credit losses in its entire loan and lease portfolio. As indicated in the Interagency Policy Statement on the Allowance for Loan and Lease Losses dated December 21, 1993, a bank should rely on several methods when analyzing its loan and lease portfolio and determining the appropriate level for its allowance. FASB Statement No. 114 sets forth measurement methods for estimating the portion of the overall allowance for loan and lease losses attributable to individually impaired loans. An appropriate allowance must be maintained for other loans in accordance with FASB Statement No. 5. "Accounting for Contingencies." For comprehensive guidance on the maintenance of an adequate allowance, banks should refer to the Interagency Policy Statement and the Glossary entry for "allowance for loan and lease losses." National banks should also refer to the Office of the Comptroller of the Currency's Handbook for National Bank Examiners discussing the allowance for loan and lease losses.

In general, certain loans are impaired under FASB Statement No. 114 when, based on current information and events, it is likely that an institution will be unable to collect all amounts due (i.e., both principal and interest) according to the contractual terms of the original loan agreement. An institution should apply its normal loan review procedures when determining whether a loan covered by FASB Statement No. 114 is impaired. When an individually reviewed loan is deemed impaired under FASB Statement No. 114, an institution may choose to measure impairment using (1) the present value of expected future cash flows discounted at the loan's effective interest rate (i.e., the contractual interest rate adjusted for any net deferred loan fees or costs, premium, or discount existing at the origination or acquisition of the loan), (2) the loan's observable market price, or (3) the fair value of the collateral, if the loan is collateral dependent. (See the additional regulatory reporting guidance on collateral dependent loans in the following paragraph.) A loan is collateral dependent if repayment of the loan is expected to be provided solely by the underlying collateral and there are no other available and reliable sources of repayment. A creditor should consider estimated costs to sell, on a discounted basis, in the measurement of impairment if those costs are expected to reduce the cash flows available to repay or otherwise satisfy the loan. If the measure of an impaired loan is less than the recorded investment in the loan, an impairment should be recognized by creating an allowance for estimated credit losses for the impaired loan or by adjusting an existing allowance with a corresponding charge or credit to "Provision for loan and lease losses."

Loan Impairment (cont.):

For purposes of the Reports of Condition and Income, impairment of a collateral dependent loan must be measured using the fair value of the collateral. In general, any portion of the recorded investment in a collateral dependent loan (including recorded accrued interest, net deferred loan fees or costs, and unamortized premium or discount) in excess of the fair value of the collateral that can be identified as uncollectible should be promptly charged off against the allowance for loan and lease losses.

An institution should not provide an additional allowance for estimated credit losses on an individually impaired loan over and above what is specified by FASB Statement No. 114. The allowance established under FASB Statement No. 114 should take into consideration all available information existing as of the Call Report date that indicates that it is probable that a loan has been impaired. All available information would include existing environmental factors such as industry, geographical, economic, and political factors that affect collectibility.

FASB Statement No. 114 also addresses the accounting by creditors for all loans that are restructured in a troubled debt restructuring involving a modification of terms, except loans that are measured at fair value or the lower of cost or fair value. For guidance on troubled debt restructurings, see the Glossary entry for "troubled debt restructurings."

As with all other loans, all impaired loans should be reported as past due or nonaccrual loans in Schedule RC-N in accordance with the schedule's instructions. Since full collection of principal and interest is not expected for impaired loans, income accrual should normally be discontinued on such loans at the time that they first become impaired. Any cash payments received on impaired loans should be reported in accordance with the criteria for the cash basis recognition of income in the Glossary entry for "nonaccrual status." For further guidance, see that Glossary entry.

Loan Secured by Real Estate: For purposes of these reports, loans secured by real estate are loans predicated upon a security interest in real property. A loan predicated upon a security interest in real property is a loan secured wholly or substantially by a lien on real property for which the lien is central to the extension of the credit--that is, the borrower would not have been extended credit in the same amount or on terms as favorable without the lien on real property. All loans satisfying the criteria above are to be reported as loans secured by real estate (Schedule RC-C, part I, item 1), regardless of whether secured by first or junior liens, regardless of the department within the bank or bank subsidiary that made the loans, regardless of how the loans are categorized in the bank's records, and regardless of the purpose of the financing. Only in transactions where a lien on real property has been taken as collateral solely through an abundance of caution and where the terms as a consequence have not been made more favorable than they would have been in the absence of the lien, would the loans not be considered to be secured by real estate and not be classifiable as loans secured by real estate in the Report of Condition.

Loss Contingencies: A loss contingency is an existing condition, situation, or set of circumstances that involves uncertainty as to possible loss that will be resolved when one or more future events occur or fail to occur. An estimated loss (or expense) from a loss contingency (for example, pending or threatened litigation) must be accrued by a charge to income if it is probable that an asset has been impaired or a liability incurred as of the report date and the amount of the loss can be reasonably estimated.

A contingency that might result in a gain, for example, the filing of an insurance claim, shall not be recognized as income prior to realization.

For further information, see FASB Statement No. 5, "Accounting for Contingencies."

Majority-Owned Subsidiary: See "subsidiaries."

Mandatory Convertible Debt: Mandatory convertible debt is a subordinated note or debenture with a maturity of 12 years or less that obligates the holder to take the common or perpetual preferred stock of the issuer in lieu of cash for repayment of principal by a date at or before the maturity date of the debt instrument (so-called "equity contract notes").

Market Value of Securities: The market value of securities should be determined, to the extent possible, by timely reference to the best available source of current market quotations or other data on relative current values. For example, securities traded on national, regional, or foreign exchanges or in organized over-the-counter markets should be valued at the most recently available quotation in the most active market. Rated securities for which no organized market exists should be valued on the basis of a yield curve estimate. Quotations from brokers or others making markets in securities that are neither widely nor actively traded are acceptable if prudently used. Unrated debt securities for which no reliable market price data are available may be valued at cost adjusted for amortization of premium or accretion of discount unless credit problems of the obligor or upward movements in the level of interest rates warrant a lower estimate of current value. Equity securities that do not have readily determinable fair values such as Federal Reserve stock or equity securities in closely held businesses should be valued at historical cost.

Mergers: See "business combinations."

Money Market Deposit Account (MMDA): See "deposits."

Nonaccrual Status: This entry covers, for purposes of these reports, the criteria for placing assets in nonaccrual status (presented in the general rule below) and related exceptions, the reversal of previously accrued but uncollected interest, the treatment of cash payments received on nonaccrual assets and the criteria for cash basis income recognition, the restoration of a nonaccrual asset to accrual status, and the treatment of multiple extensions of credit to one borrower.

General rule -- Banks shall not accrue interest, amortize deferred net loan fees or costs, or accrete discount on any asset (1) which is maintained on a cash basis because of deterioration in the financial condition of the borrower, (2) for which payment in full of principal or interest is not expected, or (3) upon which principal or interest has been in default for a period of 90 days or more unless the asset is both well secured and in the process of collection.

An asset is "well secured" if it is secured (1) by collateral in the form of liens on or pledges of real or personal property, including securities, that have a realizable value sufficient to discharge the debt (including accrued interest) in full, or (2) by the guarantee of a financially responsible party. An asset is "in the process of collection" if collection of the asset is proceeding in due course either (1) through legal action, including judgment enforcement procedures, or, (2) in appropriate circumstances, through collection efforts not involving legal action which are reasonably expected to result in repayment of the debt or in its restoration to a current status in the near future.

For purposes of applying the third test for nonaccrual status listed above, the date on which an asset reaches nonaccrual status is determined by its contractual terms. If the principal or interest on an asset becomes due and unpaid for 90 days or more on a date that falls between report dates, the asset should be placed in nonaccrual status as of the date it becomes 90 days past due and it should remain in nonaccrual status until it meets the criteria for restoration to accrual status described below.

Any state statute, regulation, or rule that imposes more stringent standards for nonaccrual of interest takes precedence over this instruction.

Nonaccrual Status (cont.):

Exceptions to the general rule -- In the following situations, an asset need not be placed in nonaccrual status:

(1) The criteria for amortization (i.e., accretion of discount) specified in AICPA Practice Bulletin No. 6[1] are met with respect to a loan or other debt instrument acquired at a discount (because there is uncertainty as to the amounts or timing of future cash flows) from an unaffiliated third party (such as another institution or the receiver of a failed institution), including those that the seller had maintained in nonaccrual status.

(2) The asset upon which principal or interest is due and unpaid for 90 days or more is a consumer loan or a loan secured by a 1-to-4 family residential property. Nevertheless, such loans should be subject to other alternative methods of evaluation to assure that the bank's net income is not materially overstated.

Treatment of previously accrued interest -- The reversal of previously accrued but uncollected interest applicable to any asset placed in nonaccrual status should be handled in accordance with generally accepted accounting principles. Acceptable accounting treatment includes a reversal of all previously accrued but uncollected interest applicable to assets placed in a nonaccrual status against appropriate income and balance sheet accounts.

For example, one acceptable method of accounting for such uncollected interest on a loan placed in nonaccrual status is (1) to reverse all of the unpaid interest by crediting the "accrued interest receivable" account on the balance sheet, (2) to reverse the uncollected interest that has been accrued during the calendar year-to-date by debiting the appropriate "interest and fee income on loans" account on the income statement, and (3) to reverse any uncollected interest that had been accrued during previous calendar years by debiting the "allowance for loan and lease losses" account on the balance sheet. The use of this method presumes that bank management's additions to the allowance through charges to the "provision for loan and lease losses" on the income statement have been based on an evaluation of the collectability of the loan and lease portfolios and the "accrued interest receivable" account.

Treatment of cash payments and criteria for the cash basis recognition of income -- When doubt exists as to the collectability of the remaining book balance of an asset in nonaccrual status, any payments received must be applied to reduce principal to the extent necessary to eliminate such doubt. Placing an asset in nonaccrual status does not, in and of itself, require a charge-off, in whole or in part, of the asset's principal. However, any identified losses must be charged off.

While an asset is in nonaccrual status, some or all of the cash interest payments received may be treated as interest income on a cash basis as long as the remaining book balance of the asset (i.e., after charge-off of identified losses, if any) is deemed to be fully collectible.[2] A bank's determination as to the ultimate collectability of the asset's remaining book balance must be supported by a current, well documented credit evaluation of the borrower's financial condition and prospects for repayment, including consideration of the borrower's historical repayment performance and other relevant factors.

When recognition of interest income on a cash basis is appropriate, it should be handled in accordance with generally accepted accounting principles. One acceptable accounting practice involves allocating

[1] American Institute of Certified Public Accountants Practice Bulletin No. 6, "Amortization of Discounts on Certain Acquired Loans," August 1989.

[2] An asset subject to the cost recovery method required by AICPA Practice Bulletin No. 6 should follow that method for reporting purposes.

Nonaccrual Status (cont.):

contractual interest payments among interest income, reduction of principal, and recovery of prior charge-offs. If this method is used, the amount of income that is recognized would be equal to that which would have been accrued on the asset's remaining book balance at the contractual rate. A bank may also choose to account for the contractual interest in its entirety either as income, reduction of principal, or recovery of prior charge-offs, depending on the condition of the loan, consistent with its accounting policies for other financial reporting purposes.

Restoration to accrual status -- As a general rule, a nonaccrual asset may be restored to accrual status when (1) none of its principal and interest is due and unpaid, and the bank expects repayment of the remaining contractual principal and interest, or (2) when it otherwise becomes well secured and in the process of collection.

For purposes of meeting the first test, the bank must have received repayment of the past due principal and interest unless, as discussed below, (1) the asset has been formally restructured and qualifies for accrual status, (2) the asset has been acquired at a discount (because there is uncertainty as to the amounts or timing of future cash flows) from an unaffiliated third party and meets the criteria for amortization (i.e., accretion of discount) specified in AICPA Practice Bulletin No. 6, or (3) the borrower has resumed paying the full amount of the scheduled contractual interest and principal payments on a loan that is past due and in nonaccrual status, even though the loan has not been brought fully current, and the following two criteria are met. These criteria are, first, that all principal and interest amounts contractually due (including arrearages) are reasonably assured of repayment within a reasonable period and, second, that there is a sustained period of repayment performance (generally a minimum of six months) by the borrower in accordance with the contractual terms involving payments of cash or cash equivalents. A loan that meets these two criteria may be restored to accrual status but must continue to be disclosed as past due in Schedule RC-N until it has been brought fully current or until it later must be placed in nonaccrual status.

A loan or other debt instrument that has been formally restructured so as to be reasonably assured of repayment and of performance according to its modified terms need not be maintained in nonaccrual status, provided the restructuring and any charge-off taken on the asset are supported by a current, well documented credit evaluation of the borrower's financial condition and prospects for repayment under the revised terms. Otherwise, the restructured asset must remain in nonaccrual status. The evaluation must include consideration of the borrower's sustained historical repayment performance for a reasonable period prior to the date on which the loan or other debt instrument is returned to accrual status. A sustained period of repayment performance generally would be a minimum of six months and would involve payments of cash or cash equivalents. (In returning the asset to accrual status, sustained historical repayment performance for a reasonable time prior to the restructuring may be taken into account.) Such a restructuring must improve the collectability of the loan or other debt instrument in accordance with a reasonable repayment schedule and does not relieve the bank from the responsibility to promptly charge off all identified losses.

A formal restructuring may involve a multiple note structure in which, for example, a troubled loan is restructured into two notes. The first or "A" note represents the portion of the original loan principal amount that is expected to be fully collected along with contractual interest. The second or "B" note represents the portion of the original loan that has been charged off and, because it is not reflected as an asset and is unlikely to be collected, could be viewed as a contingent receivable. The "A" note may be returned to accrual status provided the conditions in the preceding paragraph are met and: (1) there is economic substance to the restructuring and it qualifies as a troubled debt restructuring under generally accepted accounting principles, (2) the portion of the original loan represented by the "B" note has been charged off before or at the time of the restructuring, and (3) the "A" note is reasonably assured of repayment and of performance in accordance with the modified terms.

Nonaccrual Status (cont.):

Until the restructured asset is restored to accrual status, if ever, cash payments received must be treated in accordance with the criteria stated above in the preceding section of this entry. In addition, after a formal restructuring, if a restructured asset that has been returned to accrual status later meets the criteria for placement in nonaccrual status as a result of past due status based on its modified terms or for any other reasons, the asset must be placed in nonaccrual status.

For further information on formally restructured assets, see the Glossary entry for "troubled debt restructurings."

Treatment of multiple extensions of credit to one borrower -- As a general principle, nonaccrual status for an asset should be determined based on an assessment of the individual asset's collectability and payment ability and performance. Thus, when one loan to a borrower is placed in nonaccrual status, a bank does not automatically have to place all other extensions of credit to that borrower in nonaccrual status. When a bank has multiple loans or other extensions of credit outstanding to a single borrower, and one loan meets the criteria for nonaccrual status, the bank should evaluate its other extensions of credit to that borrower to determine whether one or more of these other assets should also be placed in nonaccrual status.

Noninterest-Bearing Account: See "deposits."

Nontransaction Account: See "deposits."

NOW Account: See "deposits."

Offsetting: Offsetting is the reporting of assets and liabilities on a net basis in the balance sheet. Banks are permitted to offset assets and liabilities recognized in the Report of Condition when a "right of setoff" exists. Under FASB Interpretation No. 39, "Offsetting of Amounts Related to Certain Contracts," a right of setoff exists when all of the following conditions are met:

(1) Each of two parties owes the other determinable amounts. Thus, only bilateral netting is permitted.

(2) The reporting party has the right to set off the amount owed with the amount owed by the other party.

(3) The reporting party intends to set off. This condition does not have to be met for fair value amounts recognized for conditional or exchange contracts that have been executed with the same counterparty under a master netting arrangement.

(4) The right of setoff is enforceable at law. Legal constraints should be considered to determine whether the right of setoff is enforceable. Accordingly, the right of setoff should be upheld in bankruptcy (or receivership). Offsetting is appropriate only if the available evidence, both positive and negative, indicates that there is reasonable assurance that the right of setoff would be upheld in bankruptcy (or receivership).

According to Interpretation No. 39, for forward, interest rate swap, currency swap, option, and other conditional and exchange contracts, a master netting arrangement exists if the reporting bank has multiple contracts, whether for the same type of conditional or exchange contract or for different types of contracts, with a single counterparty that are subject to a contractual agreement that provides for the net settlement of all contracts through a single payment in a single currency in the event of default or termination of any one contract.

Offsetting (cont.):

Offsetting the assets and liabilities recognized for conditional or exchange contracts outstanding with a single counterparty results in the net position between the two counterparties being reported as an asset or a liability in the Report of Condition. The reporting entity's choice to offset or not to offset assets and liabilities recognized for conditional or exchange contracts must be applied consistently.

Offsetting of assets and liabilities is also permitted by other accounting pronouncements identified in Interpretation No. 39. These pronouncements apply to such items as leveraged leases, pension plan and other postretirement benefit plan assets and liabilities, and deferred tax assets and liabilities. In addition, FASB Interpretation No. 41, "Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements," describes the circumstances in which amounts recognized as payables under repurchase agreements may be offset against amounts recognized as receivables under reverse repurchase agreements and reported as a net amount in the balance sheet. The reporting entity's choice to offset or not to offset payables and receivables under Interpretation No. 41 must be applied consistently.

See also "reciprocal balances."

One-Day Transaction: See "federal funds transactions."

Option: See "derivative contracts."

Organization Costs: See "start-up activities."

Other Depository Institutions in the U.S.: See "depository institutions in the U.S."

Other Real Estate Owned: See "foreclosed assets" and the instruction to Schedule RC-M, item 3.

Overdraft: An overdraft can be either planned or unplanned. An unplanned overdraft occurs when a depository institution honors a check or draft drawn against a deposit account when insufficient funds are on deposit and there is no advance contractual agreement to honor the check or draft. When a contractual agreement has been made in advance to allow such credit extensions, overdrafts are referred to as planned or prearranged. Any overdraft, whether planned or unplanned, is an extension of credit and is to be treated and reported as a "loan" rather than being treated as a negative deposit balance.

Planned overdrafts in depositors' accounts are to be classified in Schedule RC-C, part I, by type of loan according to the nature of the overdrawn depositor. For example, a planned overdraft by a commercial customer is to be classified as a "commercial and industrial loan."

Unplanned overdrafts in depositors' accounts are to be classified in Schedule RC-C, part I, as "All other loans," unless the depositor is a depository institution, a foreign government or foreign official institution, or a state or political subdivision in the U.S. Such unplanned overdrafts would be reported in Schedule RC-C, part I, item 2, "Loans to depository institutions and acceptances of other banks," item 7, "Loans to foreign governments and official institutions," and item 8, "Obligations (other than securities and leases) of states and political subdivisions in the U.S.," respectively.

For purposes of treatment of overdrafts in depositors' accounts, a group of related transaction accounts of a single type (i.e., demand deposit accounts or NOW accounts, but not a combination thereof) maintained in the same right and capacity by a customer (a single legal entity) that is established under a bona fide cash management arrangement by this customer function as, and are regarded as, one account rather than as multiple separate accounts. In such a situation, overdrafts in one or more of the

Overdraft (cont.):
transaction accounts within the group are not to be classified as loans unless there is a net overdraft position in the group of related transaction accounts taken as a whole. (NOTE: Affiliates and subsidiaries are considered separate legal entities.) For further information, see "cash management arrangements."

The reporting bank's overdrafts on deposit accounts it holds with other banks (i.e., its "due from" accounts) are to be reported as borrowings in Schedule RC, item 16, except overdrafts arising in connection with checks or drafts drawn by the reporting bank and drawn on, or payable at or through, another depository institution either on a zero-balance account or on an account that is not routinely maintained with sufficient balances to cover checks or drafts drawn in the normal course of business during the period until the amount of the checks or drafts is remitted to the other depository institution (in which case, report the funds received or held in connection with such checks or drafts as deposits in Schedule RC-E until the funds are remitted).

Participations: See "transfers of financial assets."

Participations in Acceptances: See "bankers acceptances."

Participations in Pools of Securities: See "repurchase/resale agreements."

Pass-through Reserve Balances: Under the Monetary Control Act of 1980, and as reflected in Federal Reserve Regulation D, depository institutions that are members of the Federal Reserve System must maintain their required reserves (in excess of vault cash) directly with a Federal Reserve Bank. However, nonmember depository institutions may maintain their required reserves (in excess of vault cash) in one of two ways: either (1) directly with a Federal Reserve Bank or (2) indirectly in an account with another institution (referred to here as a "correspondent"), which, in turn, is required to pass the reserves through to a Federal Reserve Bank. This second type of account is called a "pass-through account," and a depository institution passing its reserves to the Federal Reserve through a correspondent is referred to here as a "respondent." This pass-through reserve relationship is legally and for supervisory purposes considered to constitute an asset/debt relationship between the respondent and the correspondent, and an asset/debt relationship between the correspondent and the Federal Reserve. The required reporting of the "pass-through reserve balances" reflects this structure of asset/debt relationships.

In the balance sheet of the respondent bank, the pass-through reserve balances are to be treated as a claim on the correspondent (not as a claim on the Federal Reserve) and, as such, are to be reflected in the balance sheet of the Report of Condition, Schedule RC, item 1.a, "Noninterest-bearing balances and currency and coin," or item 1.b, "Interest-bearing balances," as appropriate. For respondent banks with foreign offices or with $300 million or more in total assets, the pass-through reserve balances would also be reflected in Schedule RC-A, item 2, "Balances due from depository institutions in the U.S."

In the balance sheet of the correspondent bank, the pass-through reserve balances are to be treated as balances due to respondents and, to the extent that the balances have actually been passed through to the Federal Reserve, as balances due from the Federal Reserve. The balances due to respondents are to be reflected in the balance sheet of the Report of Condition, Schedule RC, item 13.a, "Deposits in domestic offices," and on in Schedule RC-E, Deposit Liabilities, (part I), item 4.[1] The balances due from the Federal Reserve are to be reflected on the balance sheet in Schedule RC, item 1.a, "Noninterest-bearing balances and currency and coin," and, for correspondent banks with foreign offices or with $300 million or more in total assets, in Schedule RC-A, item 4.

[1] When an Edge or Agreement Corporation acts as a correspondent, its balances due to respondents are to be reflected on the FFIEC 031 report form in Schedule RC, item 13.b, "Deposits in foreign offices," and in Schedule RC-E, part II, item 2.

Perpetual Preferred Stock: See "preferred stock."

Placements and Takings: Placements and takings are deposits between a foreign office of the reporting bank and a foreign office of another bank and are to be treated as due from or due to depository institutions. Such transactions are always to be reported gross and are not to be netted as reciprocal balances.

Pooling of Interests: See "business combinations."

Preauthorized Transfer Account: See "deposits."

Preferred Stock: Preferred stock is a form of ownership interest in a bank or other company which entitles its holders to some preference or priority over the owners of common stock, usually with respect to dividends or asset distributions in a liquidation.

Limited-life preferred stock is preferred stock that has a stated maturity date or that can be redeemed at the option of the holder. It excludes those issues of preferred stock that automatically convert into perpetual preferred stock or common stock at a stated date.

Perpetual preferred stock is preferred stock that does not have a stated maturity date or that cannot be redeemed at the option of the holder. It includes those issues of preferred stock that automatically convert into common stock at a stated date.

Premiums and Discounts: A premium arises when a bank purchases a security, loan, or other asset at a price in excess of its par or face value, typically because the current level of interest rates for such assets is less than its contract or stated rate of interest. The difference between the purchase price and par or face value represents the premium, which all banks are required to amortize.

A discount arises when a bank purchases a security, loan, or other asset at a price below its par or face value, typically because the current level of interest rates for such assets is greater than its contract or stated rate of interest. A discount is also present on instruments that do not have a stated rate of interest such as U.S. Treasury bills and commercial paper. The difference between par or face value and the purchase price represents the discount that all banks are required to accrete.

Premiums and discounts are accounted for as adjustments to the yield on an asset over the life of the asset. A premium must be amortized and a discount must be accreted from date of purchase to maturity, not to call or put date.[1] The preferable method for amortizing premiums and accreting discounts involves the use of the interest method for accruing income on the asset. The objective of the interest method is to produce a constant yield or rate of return on the carrying value of the asset (par or face value plus unamortized premium or less unaccreted discount) at the beginning of each amortization period over the asset's remaining life. The difference between the periodic interest income that is accrued on the asset and interest at the stated rate is the periodic amortization or accretion. However, a straight-line method of amortization or accretion is acceptable if the results are not materially different from the interest method.

A premium or discount may also arise when the reporting bank, acting either as a lender or a borrower, is involved in an exchange of a note for assets other than cash and the interest rate is either below the market rate or not stated, or the face amount of the note is materially different from the fair value of the

[1] For an asset acquired at a premium prior to the effective date of a bank's adoption of FASB Statement No. 91, the premium should be amortized to the asset's maturity date unless it is more conservative in its effect on current income to amortize the premium in two stages: (1) first to the call or "put" date and price and (2) then to the maturity date and par or face value.

Premiums and Discounts (cont.):
noncash assets exchanged. The noncash assets and the related note shall be recorded at either the fair value of the noncash assets or the market value of the note, whichever is more clearly determinable. The market value of the note would be its present value as determined by discounting all future payments on the note using an appropriate interest rate, i.e., a rate comparable to that on new loans of similar risk. The difference between the face amount and the recorded value of the note is a premium or discount. This discount or premium shall be accounted for as an adjustment of the interest income or expense over the life of the note using the interest method described above.

For further information, see APB Opinion No. 21, "Interest on Receivables and Payables."

Purchase Acquisition: See "business combinations."

Put Option: See "derivative contracts."

Real Estate ADC Arrangements: See "acquisition, development, or construction (ADC) arrangements."

Real Estate, Loan Secured By: See "loan secured by real estate."

Reciprocal Balances: Reciprocal balances arise when two depository institutions maintain deposit accounts with each other; that is, when a reporting bank has both a due to and a due from balance with another depository institution.

For purposes of the balance sheet of the Report of Condition, reciprocal balances between the reporting bank and other depository institutions may be reported on a net basis when a right of setoff exists. See the Glossary entry for "offsetting" for the conditions that must be met for a right of setoff to exist.

Renegotiated Troubled Debt: See "troubled debt restructurings."

Reorganizations: See "business combinations."

Repurchase/Resale Agreements: A repurchase agreement is a transaction involving the "sale" of financial assets by one party to another, subject to an agreement by the "seller" to repurchase the assets at a specified date or in specified circumstances. A resale agreement (also known as a reverse repurchase agreement) is a transaction involving the "purchase" of financial assets by one party from another, subject to an agreement by the "purchaser" to resell the assets at a specified date or in specified circumstances.

As stated in the AICPA's Audit and Accounting Guide for Banks and Savings Institutions, dollar repurchase agreements (also called dollar rolls) are agreements to sell and repurchase similar but not identical securities. The dollar roll market consists primarily of agreements that involve mortgage-backed securities (MBS). Dollar rolls differ from regular repurchase agreements in that the securities sold and repurchased, which are usually of the same issuer, are represented by different certificates, are collateralized by different but similar mortgage pools (for example, single-family residential mortgages), and generally have different principal amounts.

General rule -- Consistent with FASB Statement No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," repurchase and resale agreements involving financial assets (e.g. securities and loans), including dollar repurchase agreements, are either reported as (a) secured borrowings and loans or (b) sales and forward repurchase commitments based on whether the transferring ("selling") institution maintains control over the transferred assets. (See the Glossary entry for "transfers of financial assets" for further discussion of control criteria).

Repurchase/Resale Agreements (cont.):

If a repurchase agreement both entitles and obligates the "selling" bank to repurchase or redeem the transferred assets from the transferee ("purchaser"), the "selling" bank should report the transaction as a secured borrowing if and only if the following conditions have been met:

(1) The assets to be repurchased or redeemed are the same or "substantially the same" as those transferred, as defined by FASB Statement No. 140.

(2) The "selling" institution has the ability to repurchase or redeem the transferred assets on substantially the agreed terms, even in the event of default by the transferee ("purchaser"). This ability is presumed to exist if the "selling" bank has obtained cash or other collateral sufficient to fund substantially all of the cost of purchasing replacement assets from others.

(3) The agreement is to repurchase or redeem the transferred assets before maturity, at a fixed or determinable price.

(4) The agreement is entered into concurrently with the transfer.

Participations in pools of securities are to be reported in the same manner as security repurchase/resale transactions.

Repurchase agreements reported as secured borrowings. If a repurchase agreement qualifies as a secured borrowing, the "selling" institution should report the transaction as indicated below based on whether the agreement involves a security or some other financial asset.

(1) Securities "sold" under agreements to repurchase are reported in Schedule RC, item 14.b, "Securities sold under agreements to repurchase."

(2) Financial assets (other than securities) "sold" under agreements to repurchase are reported as follows:

(a) If the repurchase agreement has an original maturity of one business day (or is under a continuing contract) and is in immediately available funds, it should be reported in Schedule RC, item 14.a, "Federal funds purchased (in domestic offices)," if it is in a domestic office, and in Schedule RC, item 16, "Other borrowed money," if it is in a foreign office.
(b) If the repurchase agreement has an original maturity of more than one business day or is not in immediately available funds, it should be reported in Schedule RC, item 16.

In addition, the "selling" institution may need to record further entries depending on the terms of the agreement. If the "purchaser" has the right to sell or repledge noncash assets, the "selling" institution should recategorize the transferred financial assets as "assets receivable" and report them in Schedule RC, item 11, "Other assets." Otherwise, the financial assets should continue to be reported in the same asset category as before the transfer (e.g., securities should continue to be reported in Schedule RC, item 2, "Securities," or item 5, "Trading assets," as appropriate).

Resale agreements reported as secured borrowings. Similarly, if a resale agreement qualifies as a secured borrowing, the "purchasing" institution should report the transaction as indicated below based on whether the agreement involves a security or some other financial asset.

(1) Securities "purchased" under agreements to resell are reported in Schedule RC, item 3.b, "Securities purchased under agreements to resell."

(2) Financial assets (other than securities) "purchased" under agreements to resell are reported as follows:

Repurchase/Resale Agreements (cont.):

(a) If the resale agreement has an original maturity of one business day (or is under a continuing contract) and is in immediately available funds, it should be reported in Schedule RC, item 3.a, "Federal funds sold (in domestic offices)," if it is in a domestic office, and in Schedule RC, item 4.b, "Loans and leases, net of unearned income," if it is in a foreign office.

(b) If the resale agreement has an original maturity of more than one business day or is not in immediately available funds, it should be reported in Schedule RC, item 4.b.

In addition, the "purchasing" institution may need to record further entries depending on the terms of the agreement. If the "purchasing" institution has the right to sell the noncash assets it has "purchased" and sells these assets, it should recognize the proceeds from the sale and report its obligation to return the assets in Schedule RC, item 20, "Other liabilities." If the "selling" institution defaults under the terms of the repurchase agreement and is no longer entitled to redeem the noncash assets, the "purchasing" bank should recognize these assets on its own balance sheet (e.g., securities should be reported in Schedule RC, item 2, "Securities," or item 5, "Trading assets," as appropriate) and initially measure them at fair value. However, if the "purchasing" bank has already sold the assets it has "purchased," it should derecognize its obligation to return the assets. Otherwise, the "purchasing" bank should not recognize the transferred financial assets (i.e., the financial assets "purchased" under the resale agreement) on its balance sheet.

Repurchase/resale agreements reported as sales -- If a repurchase agreement does not qualify as a secured borrowing under FASB Statement No. 140, the selling bank should account for the transaction as a sale of financial assets and a forward repurchase commitment. The selling bank should remove the transferred assets from its balance sheet, record the proceeds from the sale of the transferred assets (including the forward repurchase commitment), and record any gain or loss on the transaction. Similarly, if a resale agreement does not qualify as a borrowing under Statement No. 140, the purchasing bank should account for the transaction as a purchase of financial assets and a forward resale commitment. The purchasing bank should record the transferred assets on its balance sheet, initially measure them at fair value, and record the payment for the purchased assets (including the forward resale commitment).

Reserve Balances, Pass-through: See "pass-through reserve balances."

Retail Sweep Arrangements: See “deposits.”

Sales of Assets for Risk-Based Capital Purposes: This entry should be read in conjunction with the banking agencies' final rule revising the regulatory capital treatment of recourse arrangements and direct credit substitutes, including residual interests and credit-enhancing interest-only strips, which was published on November 29, 2001. This entry provides guidance for determining whether sales of loans, securities, receivables, and other assets are subject to the agencies' risk-based capital standards and are reportable in Schedule RC-R, Regulatory Capital, and Schedule RC-S, Securitization and Asset Sale Activities. For information on the reporting of transfers of financial assets for purposes of the balance sheet, income statement, and related schedules, see the Glossary entry for "transfers of financial assets."

For purposes of reporting in Schedules RC-R and RC-S, some transfers of assets that qualify as sales under generally accepted accounting principles are subject to the agencies' risk-based capital standards because they meet the following definition of "recourse" that is set forth in those standards.

Definition of "recourse" for risk-based capital purposes – As defined in the agencies' risk-based capital standards, recourse means an arrangement in which a bank retains, in form or in substance, any credit risk directly or indirectly associated with an asset it has sold (in accordance with generally accepted accounting principles) that exceeds a pro rata share of the bank's claim on the asset. If a bank has no claim on an asset it has sold, then the retention of any credit risk is recourse.

Sales of Assets for Risk-Based Capital Purposes (cont.):

A recourse obligation typically arises when an institution transfers assets on a sale and retains an obligation to repurchase the assets or absorb losses due to a default of principal or interest or any other deficiency in the performance of the underlying obligor or some other party. Recourse may also exist implicitly where a bank provides credit enhancement beyond any contractual obligation to support assets it has sold.

The following are examples of recourse arrangements:

(1) Credit-enhancing representations and warranties made on the transferred assets, i.e., representations and warranties that are made in connection with a transfer of assets (including loan servicing assets) and that obligate a bank to protect investors from losses arising from credit risk in the assets transferred or the loans serviced. Credit-enhancing representations and warranties include promises to protect a party from losses resulting from the default or nonperformance of another party or from an insufficiency in the value of collateral. Credit-enhancing representations and warranties do not include:

(a) Early-default clauses and similar warranties that permit the return of, or premium refund clauses covering, qualifying 1-4 family residential first mortgage loans, i.e., those that qualify for a 50 percent risk weight for risk-based capital purposes, for a period of 120 days from the date of transfer. These warranties may cover only those loans that were originated within 1 year of the date of transfer.

(b) Premium refund clauses covering assets guaranteed, in whole or in part, by the U.S. Government, a U.S. Government agency, or a U.S. Government-sponsored agency, provided the premium refund clauses are for a period not to exceed 120 days from the date of transfer.

(c) Warranties that permit the return of assets in instances of fraud, misrepresentation, or incomplete documentation.

(2) Loan servicing assets retained pursuant to an agreement under which the bank does one or more of the following:

(a) Is responsible for losses associated with the loans serviced.

(b) Is responsible for making mortgage servicer cash advances, i.e., funds that a residential mortgage servicer advances to ensure an uninterrupted flow of payments or the timely collection of residential mortgage loans, including disbursements made to cover foreclosure costs or other expenses arising from a mortgage loan to facilitate its timely collection. A mortgage servicer cash advance is not a recourse obligation if:

(i) the mortgage servicer is entitled to full reimbursement or, for any one residential mortgage loan, nonreimbursable advances are limited to an insignificant amount of the outstanding principal on that loan, and

(ii) the servicer's entitlement to reimbursement is not subordinated.

(c) Makes credit-enhancing representations and warranties on the serviced loans.

(3) Retained subordinated interests that absorb more than their pro rata share of losses from the underlying assets.

(4) Assets sold under an agreement to repurchase, if the assets are not already included on the balance sheet.

Sales of Assets for Risk-Based Capital Purposes (cont.):

(5) Loan strips sold without contractual recourse where the maturity of the transferred portion of the loan is shorter than the maturity of the commitment under which the loan is drawn.

(6) Credit derivative contracts under which the bank retains more than its pro rata share of credit risk on transferred assets.

(7) Clean-up calls, except that calls that are exercisable at the option of the bank (as servicer or as an affiliate of the servicer) only when the pool balance is 10 percent or less of the original pool balance are not recourse.

In addition, all recourse arrangements in the form of on-balance sheet assets are "residual interests." The agencies' risk-based capital standards define "residual interest" to mean any on-balance sheet asset that represents an interest (including a beneficial interest) created by a transfer that qualifies as a sale (in accordance with generally accepted accounting principles) of financial assets, whether through a securitization or otherwise, and that exposes a bank to credit risk directly or indirectly associated with the transferred asset that exceeds a pro rata share of the bank's claim on the asset, whether through subordination provisions or other credit enhancement techniques. In general, residual interests include credit-enhancing interest-only strips, spread accounts, cash collateral accounts, retained subordinated interests, other forms of overcollateralization, accrued but uncollected interest on transferred assets that (when collected) will be available to serve in a credit-enhancing capacity, and similar on-balance sheet assets that function as a credit enhancement.

If an asset transfer that qualifies for sale treatment under generally accepted accounting principles meets the preceding definition of "recourse," the transaction must be treated as an "asset sale with recourse" for purposes of reporting risk-based capital information in Schedule RC-R. The transaction must also be reported as an asset sale with recourse in Schedule RC-S, item 1 or item 11, as appropriate, depending on whether the asset was securitized by the reporting bank.

Assets transferred in transactions that do not qualify as sales under generally accepted accounting principles should continue to be reported as assets on the Call Report balance sheet and are subject to the agencies' regulatory capital requirements.

Summary Description of the Risk-Based Capital Treatment of Recourse Arrangements -- Under the agencies' capital standards, in general, a bank must hold risk-based capital against the entire outstanding amount of the assets sold with recourse. However, some of the exceptions to this general rule include the following:

(1) Under the low-level exposure provisions of the agencies' capital standards, the risk-based capital requirement for a recourse arrangement is limited to the maximum contractual loss exposure when this amount is less than the amount of risk-based capital that would be required to be held against the entire outstanding amount of the assets sold.

(2) For a residual interest or other recourse exposure in a securitization (other than a credit-enhancing interest-only strip) that qualifies for the ratings-based approach, the required amount of risk-based capital is determined based on the relative risk of loss of the residual interest or other recourse exposure.

(3) For a residual interest that does not qualify for the ratings-based approach, including a credit-enhancing interest-only strip that is not deducted from Tier 1 capital under the concentration limit, the residual interest is subject to a dollar-for-dollar capital charge.

(4) Under Section 208 of the Riegle Community Development and Regulatory Improvement Act of 1994, risk-based capital must be held against the amount of recourse retained on small business obligations transferred with recourse.

Sales of Assets for Risk-Based Capital Purposes (cont.):

For further information on the reporting of recourse arrangements for risk-based capital calculation purposes, refer to the instructions for Schedule RC-R, Regulatory Capital, including the sections of instructions on "Risk-Weighted Assets" and "Balance Sheet Asset Categories" and the instructions for the following Schedule RC-R items:

- Item 49, "Retained recourse on small business obligations sold with recourse;"
- Item 50, "Recourse and direct credit substitutes (other than financial standby letters of credit) subject to the low level exposure rule and residual interests subject to a dollar-for-dollar capital requirement;" and
- Item 51, "All other financial assets sold with recourse."

Interpretations and illustrations of the definition of "recourse" for risk-based capital purposes:

(1) For any given asset transfer, the determination of whether credit risk is retained by the transferring institution in excess of a pro rata share of its claim on the asset is to be based upon the substance of the transfer agreement or other relevant documents or informal commitments and understandings, or subsequent actions of the parties to the transactions, not upon the form or particular terminology used. The presence of a bona fide "sale with recourse" provision would establish the transaction as an asset sale with recourse for purposes of risk-based capital and Schedules RC-R and RC-S. However, the absence of a recourse provision, the absence of the term "recourse," even the presence of a statement to the effect that there is no recourse or, in the case of a participation, the use of the terms "pass-through" or "pure pass-through" will not by themselves establish a transaction as a sale that is not subject to risk-based capital. If other conditions and provisions of the transfer are such as to leave the transferor with credit risk as described in the definition of recourse, the transfer is an asset sale with recourse for purposes of risk-based capital and Schedules RC-R and RC-S.

(2) If assets are sold subject to specific contractual terms that limit the seller's recourse liability to a percentage of the amount of assets sold or to a specific dollar amount and this percentage or amount exceeds a pro rata share of the seller's claim on the assets, the transaction represents an asset sale with recourse for risk-based capital purposes. For example, if assets are sold subject to a ten percent recourse liability provision (i.e., the seller's credit risk is limited to ten percent of the amount of assets sold) with no other retention of credit risk by the seller, the total outstanding amount of the assets sold is subject to risk-based capital, not just ten percent of the assets sold, unless the low level exposure rule (discussed in the instructions to Schedule RC-R, item 50) applies.

Sales of Assets for Risk-Based Capital Purposes (cont.):

(3) Among the transfers where credit risk has been retained by the seller and that should be considered by the seller as asset sales with recourse for purposes of risk-based capital and Schedules RC-R and RC-S are arrangements such as the following (this list is illustrative of the principles involved in the application of the definition of "recourse" and is not all-inclusive) --

(a) the sale of an asset with a realistic bona fide put option allowing the purchaser, at its option, to return the asset to the seller;

(b) the sale of an asset guaranteed by a standby letter of credit issued by the seller;

(c) the sale of an asset guaranteed by a standby letter of credit issued by any other party in which the credit risk on the asset sold, either directly or indirectly, rests with the seller;

(d) the sale of an asset guaranteed by an insurance contract in which the seller, either directly or indirectly, indemnifies or otherwise protects the insurer in any manner against credit risk; and

(e) sales and securitizations of assets which use contractual cash flows (e.g., interest-only strips receivable and so-called "spread accounts"), retained subordinated interests, or retained securities (e.g., collateral invested amounts and cash collateral accounts) as credit enhancements.

(4) The sale of a loan or other asset subject to an agreement under which the seller will pass through to the purchaser a rate of interest that differs from the stated rate of interest on the transferred asset would not, for this reason alone, require the transaction to be treated as an asset sale with recourse for risk-based capital purposes provided (1) the seller's obligation to pass interest through to the purchaser is contingent upon the continued interest payment performance of the underlying obligor of the transferred asset (i.e., the seller has no obligation to pass interest through if the obligor defaults in whole or in part on interest or principal) and (2) none of the other characteristics of the sale or participation causes the transaction to meet the definition of "recourse."

(5) The definition of "recourse" applies to all transfers of assets, including sales of a single asset or of a pool of assets and sales of participations in a single asset or in a pool of assets (whether of similar or dissimilar instruments). In participations that qualify for sale treatment under generally accepted accounting principles and are not "syndications" (as described in the Glossary item for that term), the seller of the participations should handle the transfer of shares to participants in accordance with the definition of "recourse", even though the assets being participated were acquired or accumulated for the express purpose of issuing participations and even though the participation was prearranged with the purchasers of the participations. However, the definition of "recourse" does not apply to the initial operation and distribution of participations in the form of syndications, since in a syndication there is no transfer of assets involved of the type to which this definition is addressed. Any subsequent transfers of shares, or parts of shares, in a syndicated loan would be subject to the "recourse" definition.

(6) The definition of "recourse" (and these interpretations and illustrations) is also applicable to asset transfers that are made to special or limited purpose entities that are not technically affiliated with the seller. Regardless of the legal structure of the transaction, if credit risk is retained by the seller, either contractually or otherwise, either directly or indirectly, the seller should treat the transaction as an asset sale with recourse for purposes of risk-based capital and Schedules RC-R and RC-S even if the sale to the special purpose entity is stated as being without recourse.

Savings Deposits: See "deposits."

Securities Activities: Institutions should categorize each security as trading, available-for-sale, or held-to-maturity consistent with FASB Statement No. 115, "Accounting for Certain Investments in Debt and Equity Securities," as amended. Management should periodically reassess its security categorization decisions to ensure that they remain appropriate.

Securities that are intended to be held principally for the purpose of selling them in the near term should be classified as trading assets. Trading activity includes active and frequent buying and selling of securities for the purpose of generating profits on short-term fluctuations in price. Securities held for trading purposes must be reported at fair value, with unrealized gains and losses recognized in current earnings and regulatory capital.

Held-to-maturity securities are debt securities that an institution has the positive intent and ability to hold to maturity. Held-to-maturity securities are generally reported at amortized cost. Securities not categorized as trading or held-to-maturity must be reported as available-for-sale. An institution must report its available-for-sale securities at fair value on the balance sheet, but unrealized gains and losses are excluded from earnings and reported in a separate component of equity capital.

If a decline in fair value of a held-to-maturity or available-for-sale security is judged to be other than temporary, the cost basis of the individual security shall be written down to fair value as a new cost basis and the amount of the write-down shall be included in earnings. For example, if it is probable that an institution will be unable to collect all amounts due according to the contractual terms of a debt security not impaired at acquisition, an other-than-temporary impairment has occurred.

The proper categorization of securities is important to ensure that trading gains and losses are promptly recognized in earnings and regulatory capital. This will not occur when securities intended to be held for trading purposes are categorized as held-to-maturity or available-for-sale. The following practices are considered trading activities:

(1) Gains Trading -- Gains trading is characterized by the purchase of a security and the subsequent sale of the same security at a profit after a short holding period, while securities acquired for this purpose that cannot be sold at a profit are typically retained in the available-for-sale or held-to-maturity portfolio. Gains trading may be intended to defer recognition of losses, as unrealized losses on available-for-sale and held-to-maturity debt securities do not directly affect regulatory capital and generally are not reported in income until the security is sold.

(2) When-Issued Securities Trading -- When-issued securities trading is the buying and selling of securities in the period between the announcement of an offering and the issuance and payment date of the securities. A purchase of a "when-issued" security acquires the risks and rewards of owning a security and may sell the when-issued security at a profit before having to take delivery and pay for it. Because such transactions are intended to generate profits from short-term price movements, they should be categorized as trading.

(3) Pair-offs -- Pair-offs are security purchase transactions that are closed-out or sold at, or prior to, settlement date. In a pair-off, an institution commits to purchase a security. Then, prior to the predetermined settlement date, the institution will pair-off the purchase with a sale of the same security. Pair-offs are settled net when one party to the transaction remits the difference between the purchase and the sale price to the counterparty. Pair-offs may also involve the same sequence of events using swaps, options on swaps, forward commitments, options on forward commitments, or other off-balance sheet derivative contracts.

Securities Activities (cont.):

(4) Extended Settlements -- In the U.S., regular-way settlement for federal government and federal agency securities (except mortgage-backed securities and derivative contracts) is one business day after the trade date. Regular-way settlement for corporate and municipal securities is three business days after the trade date. For mortgage-backed securities, it can be up to 60 days or more after the trade date. The use of extended settlements may be offered by securities dealers in order to facilitate speculation on the part of the purchaser, often in connection with pair-off transactions. Securities acquired through the use of a settlement period in excess of the regular-way settlement periods in order to facilitate speculation should be reported as trading assets.

(5) Repositioning Repurchase Agreements -- A repositioning repurchase agreement is a funding technique offered by a dealer in an attempt to enable an institution to avoid recognition of a loss. Specifically, an institution that enters into a "when-issued" trade or a "pair-off" (which may include an extended settlement) that cannot be closed out at a profit on the payment or settlement date will be provided dealer financing in an effort to fund its speculative position until the security can be sold at a gain. The institution purchasing the security typically pays the dealer a small margin that approximates the actual loss in the security. The dealer then agrees to fund the purchase of the security, typically buying it back from the purchaser under a resale agreement. Any securities acquired through a dealer financing technique such as a repositioning repurchase agreement that is used to fund the speculative purchase of securities should be reported as trading assets.

(6) Short Sales -- A short sale is the sale of a security that is not owned. The purpose of a short sale generally is to speculate on a fall in the price of the security. (For further information, *see* the Glossary entry for "short position.")

One other practice, referred to as "adjusted trading," is not acceptable under any circumstances. Adjusted trading involves the sale of a security to a broker or dealer at a price above the prevailing market value and the contemporaneous purchase and booking of a different security, frequently a lower-rated or lower quality issue or one with a longer maturity, at a price above its market value. Thus, the dealer is reimbursed for losses on the purchase from the institution and ensured a profit. Such transactions inappropriately defer the recognition of losses on the security sold and establish an excessive cost basis for the newly acquired security. Consequently, such transactions are prohibited and may be in violation of 18 U.S.C. Sections 1001--False Statements or Entries and 1005--False Entries.

See also "trading account."

Securities Borrowing/Lending Transactions: Securities borrowing/lending transactions are typically initiated by broker-dealers and other financial institutions that need specific securities to cover a short sale or a customer's failure to deliver securities sold. A transferee ("borrower") of securities generally is required to provide "collateral" to the transferor ("lender") of securities, commonly cash but sometimes other securities or standby letters of credit, with a value slightly higher than that of the securities "borrowed."

Most securities borrowing/lending transactions do not qualify as sales under FASB Statement No. 140 because the agreement entitles and obligates the securities lender to repurchase or redeem the transferred assets before their maturity. (See the Glossary entry for "transfers of financial assets" for further discussion of sale criteria.) When such transactions do not qualify as sales, securities lenders and borrowers should account for the transactions as secured borrowings in which cash (or securities that the holder is permitted by contract or custom to sell or repledge) received as "collateral" by the securities lender is considered the amount borrowed, the securities "loaned" are considered pledged as collateral against the amount borrowed, and the "loaned" securities are recategorized on the securities lender's balance sheet as "assets receivable" and reported in Schedule RC, item 11, "Other assets."

Securities Borrowing/Lending Transactions (cont.):
If the securities borrowing/lending transaction meets the criteria for a sale under FASB Statement No. 140, the lender of the securities should remove the securities from its balance sheet, record the proceeds from the sale of the securities (including the forward repurchase commitment), and recognize any gain or loss on the transaction. The borrower of the securities should record the securities on its balance sheet at fair value and record the payment for the purchased assets (including the forward resale commitment).

Securities, Participations in Pools of: See "repurchase/resale agreements."

Servicing Assets and Liabilities: The accounting and reporting standards for servicing assets and liabilities are set forth in FASB Statement No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities" and FASB Statement No. 65, "Accounting for Certain Mortgage Banking Activities," as amended by Statement No. 140. A summary of the relevant sections of these accounting standard follows. For further information, see FASB Statements No. 140 and No. 65 and the Glossary entry for "transfers of financial assets."

Servicing of mortgage loans, credit card receivables, or other financial assets includes, but is not limited to, collecting principal, interest, and escrow payments from borrowers; paying taxes and insurance from escrowed funds; monitoring delinquencies; executing foreclosure if necessary; temporarily investing funds pending distribution; remitting fees to guarantors, trustees, and others providing services; and accounting for and remitting principal and interest payments to the holders of beneficial interests in the financial assets. Servicers typically receive certain benefits from the servicing contract and incur the costs of servicing the assets.

Servicing is inherent in all financial assets; it becomes a distinct asset or liability only when contractually separated from the underlying financial assets by sale or securitization of the assets with servicing retained or by a separate purchase or assumption of the servicing. When a bank undertakes an obligation to service financial assets, it must recognize a servicing asset or liability for that servicing contract unless it securitizes the assets, retains all of the resulting securities, and classifies the securities as held-to-maturity debt securities. Servicing assets result from contracts to service financial assets for which the benefits of servicing (revenues from contractually specified servicing fees, late charges, and other ancillary sources) are expected to more than adequately compensate the servicer for performing the servicing. Servicing liabilities result from contracts to service financial assets for which the benefits of servicing are not expected to adequately compensate the servicer for performing the servicing. Contractually specified servicing fees are all amounts that, per contract, are due to the servicer in exchange for servicing the financial asset and would no longer be received by a servicer if the beneficial owners of the serviced assets or their trustees or agents were to exercise their actual or potential authority under the contract to shift the servicing to another servicer. Adequate compensation is the amount of benefits of servicing that would fairly compensate a substitute servicer should one be required including the profit that would be demanded by a substitute servicer in the marketplace.

When a bank sells or securitizes financial assets and retains the servicing asset, the bank shall allocate the cost of the financial assets to the servicing assets and the financial assets (without the servicing) based on their relative fair values. If it is not practicable to estimate the fair values of the servicing assets and the financial assets (without the servicing), the entire cost shall be allocated to the financial assets (without the servicing) and no cost shall be allocated to the servicing assets. If a bank incurs a servicing liability in a sale or securitization, the servicing liability should initially be measured at fair value. If a bank securitizes assets, retains all of the resulting securities, and classifies the securities as held-to-maturity debt securities, no separate servicing asset or liability shall be recorded. If a bank purchases servicing assets or assumes servicing liabilities in a transaction other than a sale or securitization of the financial assets being serviced, the asset or liability shall be recorded at fair value. For purchased servicing assets, the fair value is presumptively the price paid to acquire the servicing.

Servicing Assets and Liabilities (cont.):
All servicing assets and liabilities carried on the books of reporting banks shall be amortized in proportion to, and over the period of, estimated net servicing income (servicing revenue in excess of servicing costs) or net servicing loss (servicing costs in excess of servicing revenue). The book value of servicing assets and liabilities should be reviewed at least quarterly. The servicing assets shall be stratified into groups based on one or more of the predominant risk characteristics of the underlying financial assets for purposes of determining fair value. If the book value of a stratum of a servicing asset exceeds its fair value, the servicing asset is considered to be impaired and the book value shall be reduced to fair value through a valuation allowance for that stratum. If the fair value of a servicing liability increases above the book value, the increased obligation shall be recognized as a loss in current earnings. The fair value of servicing assets (liabilities) is the amount at which the assets (liabilities) could be bought (incurred) or sold (settled) in a bona fide transaction between willing parties.

For purposes of these reports, servicing assets resulting from contracts to service loans secured by real estate (as defined for Schedule RC-C, Part I, item 1, in the Glossary entry for "Loans secured by real estate") should be reported in Schedule RC-M, item 2.a, "Mortgage servicing assets." Servicing assets resulting from contracts to service all other financial assets should be reported in Schedule RC-M, item 2.b, "Purchased credit card relationships and nonmortgage servicing assets." In addition, certain information about assets serviced by the reporting bank should be reported in Schedule RC-S, Securitization and Asset Sale Activities.

Settlement Date Accounting: See "trade date and settlement date accounting."

Shell Branches: Shell branches are limited service branches that do not conduct transactions with residents, other than with other shell branches, in the country in which they are located. Transactions at shell branches are usually initiated and effected by their head office or by other related branches outside the country in which the shell branches are located, with records and supporting documents maintained at the initiating offices. Examples of such locations are the Bahamas and the Cayman Islands.

Short Position: When a bank sells an asset that it does not own, it has established a short position. If on the report date a bank is in a short position, it shall report its liability to purchase the asset in Schedule RC, item 15, "Trading liabilities." In this situation, the right to receive payment shall be reported in Schedule RC-F, item 5, "Other" assets. Short positions shall be reported gross. Short trading positions shall be revalued consistent with the method used by the reporting bank for the valuation of its trading assets.

Significant Subsidiary: See "subsidiaries."

Standby Letter of Credit: See "letter of credit."

Start-Up Activities: Guidance on the accounting and reporting for the costs of start-up activities, including organization costs, is set forth in AICPA Statement of Position 98-5, "Reporting on the Costs of Start-Up Activities." A summary of this accounting guidance follows. For further information, see AICPA Statement of Position 98-5.

Start-up activities are defined broadly as those one-time activities related to opening a new facility, introducing a new product or service, conducting business in a new territory, conducting business with a new class of customer, or commencing some new operation. Start-up activities include activities related to organizing a new entity, such as a new bank, the costs of which are commonly referred to as organization costs. [1]

[1] Organization costs for a bank are the direct costs incurred to incorporate and charter the bank. Such costs include, but are not limited to, professional (e.g., legal, accounting, and consulting) fees and printing costs directly related to the chartering or incorporation process, filing fees paid to chartering authorities, and the cost of economic impact studies.

Start-Up Activities (cont.):

Costs of start-up activities, including organization costs, should be expensed as incurred. Costs of acquiring or constructing premises and fixed assets and getting them ready for their intended use are not start-up costs, but the costs of using such assets that are allocated to start-up activities (e.g., depreciation of computers) are considered start-up costs.

For a new bank, pre-opening expenses such as salaries and employee benefits, rent, depreciation, supplies, directors' fees, training, travel, postage, and telephone are considered start-up costs. Pre-opening income earned and expenses incurred from the bank's inception until the date the bank commences operations should be reported in the Report of Income using one of the two following methods, consistent with the manner in which the bank reports pre-opening income and expenses for other financial reporting purposes:

(1) Pre-opening income and expenses for the entire period from the bank's inception until the date the bank commences operations should be reported in the appropriate items of Schedule RI, Income Statement, each quarter during the calendar year in which operations commence; or

(2) Pre-opening income and expenses for the period from the bank's inception until the beginning of the calendar year in which the bank commences operations should be included, along with the bank's opening (original) equity capital, in Schedule RI-A, item 5, "Sale, conversion, acquisition, or retirement of capital stock, net." The net amount of these pre-opening income and expenses should be identified and described in Schedule RI-E, item 7. Pre-opening income earned and expenses incurred during the calendar year in which the bank commences operations should be reported in the appropriate items of Schedule RI, Income Statement, each quarter during the calendar year in which operations commence.

STRIPS: See "coupon stripping, Treasury receipts, and STRIPS."

Subordinated Notes and Debentures: A subordinated note or debenture is a form of debt issued by a bank or a consolidated subsidiary. When issued by a bank, a subordinated note or debenture is not insured by a federal agency, is subordinated to the claims of depositors, and has an original weighted average maturity of five years or more. Such debt shall be issued by a bank with the approval of, or under the rules and regulations of, the appropriate federal bank supervisory agency and is to be reported in Schedule RC, item 19, "Subordinated notes and debentures."

When issued by a subsidiary, a note or debenture may or may not be explicitly subordinated to the deposits of the parent bank and is to be reported in Schedule RC, item 16, "Other borrowed money," or item 19, "Subordinated notes and debentures," as appropriate.

Those subordinated notes and debentures that are to be reported in Schedule RC, item 19, include mandatory convertible debt.

Subsidiaries: The treatment of subsidiaries in the Reports of Condition and Income depends upon the degree of ownership held by the reporting bank.

A majority-owned subsidiary of the reporting bank is a subsidiary in which the parent bank directly or indirectly owns more than 50 percent of the outstanding voting stock.

A significant subsidiary of the reporting bank is a majority-owned subsidiary that meets any one or more of the following tests:

Subsidiaries (cont.):

(1) The bank's direct and indirect investment in and advances to the subsidiary equals five percent or more of the total equity capital of the parent bank.

NOTE: For the purposes of this test, the amount of direct and indirect investments and advances is either (a) the amount carried on the books of the parent bank or (b) the parent's proportionate share in the total equity capital of the subsidiary, whichever is greater.

(2) The parent bank's proportional share (based on equity ownership) of the subsidiary's gross operating income or revenue amounts to five percent or more of the gross operating income or revenue of the consolidated parent bank.

(3) The subsidiary's income or loss before income taxes amounts to five percent or more of the parent bank's income or loss before income taxes.

(4) The subsidiary is, in turn, the parent of one or more subsidiaries which, when consolidated with the subsidiary, constitute a significant subsidiary as defined in one or more of the above tests.

An associated company is a corporation in which the bank, directly or indirectly, owns 20 to 50 percent of the outstanding voting stock *and* over which the bank exercises significant influence. This 20 to 50 percent ownership is presumed to carry "significant" influence unless the bank can demonstrate the contrary to the satisfaction of the appropriate federal supervisory authority.

A corporate joint venture is a corporation owned and operated by a group of banks or other businesses ("joint venturers"), no one of which has a majority interest, as a separate and specific business or project for the mutual benefit of the joint venturers. Each joint venturer may participate, directly or indirectly, in the management of the joint venture. An entity that is a majority-owned subsidiary of one of the joint venturers is not a corporate joint venture.

The equity ownership in majority-owned subsidiaries that are not consolidated on the Reports of Condition and Income (e.g., subsidiaries held on a temporary basis) and in associated companies is accounted for using the equity method of accounting and is reported in Schedule RC-M, item 4, and in Schedule RC, item 8, "Investments in unconsolidated subsidiaries and associated companies."

Ownership in a corporate joint venture is to be treated in the same manner as an associated company (defined above) only to the extent that the equity share represents significant influence over management. Otherwise, equity holdings in a joint venture are treated as holdings of corporate stock and income is recognized only when distributed in the form of dividends.

See also “equity method of accounting.”

Suspense Accounts: Suspense accounts are temporary holding accounts in which items are carried until they can be identified and their disposition to the proper account can be made. Such accounts may also be known as interoffice or clearing accounts. The balances of suspense accounts as of the report date should not automatically be reported as "Other assets" or "Other liabilities." Rather, the items included in these accounts should be reviewed and material amounts should be reported in the appropriate accounts of the Reports of Condition and Income.

Syndications: A syndication is a participation, usually involving shares in a single loan, in which several participants agree to enter into an extension of credit under a bona fide binding agreement that provides that, regardless of any event, each participant shall fund and be at risk only up to a specified percentage of the total extension of credit or up to a specified dollar amount. In a syndication, the participants agree to the terms of the participation prior to the execution of the final agreement and the contract is executed by the obligor and by all the participants, although there is usually a lead institution organizing or managing the credit. Large commercial and industrial loans, large loans to finance companies, and large foreign loans may be handled through such syndicated participations.

Each participant in the syndicate, including the lead bank, records its own share of the participated loan and the total amount of the loan is not entered on the books of one bank to be shared through transfers of loans. Thus, the initial operation and distribution of this type of participation does not require a determination as to whether a transfer that should be accounted for as a sale has occurred. However, any subsequent transfers of shares, or parts of shares, in the syndicated loan would be subject to the provisions of FASB Statement No. 140 governing whether these transfers should be accounted for as a sale or a secured borrowing. (See the Glossary entry for "transfers of financial assets.")

Telephone Transfer Account: See "deposits."

Term Federal Funds: See "federal funds transactions."

Time Deposits: See "deposits."

Trade Date and Settlement Date Accounting: For purposes of the Reports of Condition and Income, the preferred method for reporting transactions in held-to-maturity securities, available-for-sale securities, and trading assets (including money market instruments) other than derivative contracts (see the Glossary entry for "derivative contracts") is on the basis of trade date accounting. However, if the reported amounts under settlement date accounting would not be materially different from those under trade date accounting, settlement date accounting is acceptable. Whichever method a bank elects should be used consistently, unless the bank has elected settlement date accounting and subsequently decides to change to the preferred trade date method.

Under trade date accounting, assets purchased shall be recorded in the appropriate asset category on the trade date and the bank's obligation to pay for those assets shall be reported in Schedule RC-G, item 4, "Other" liabilities. Conversely, when an asset is sold, it shall be removed on the trade date from the asset category in which it was recorded, and the proceeds receivable resulting from the sale shall be reported in Schedule RC-F, item 5, "Other" assets. Any gain or loss resulting from such transaction shall also be recognized on the trade date. On the settlement date, disbursement of the payment or receipt of the proceeds will eliminate the respective "Other liability" or "Other asset" entry resulting from the transaction.

Under settlement date accounting, assets purchased are not recorded until settlement date. On the trade date, no entries are made. Upon receipt of the assets on the settlement date, the asset is reported in the proper asset category and payment is disbursed. The selling bank, on the trade date, would make no entries. On settlement date, the selling bank would reduce the appropriate asset category and reflect the receipt of the payment. Any gain or loss resulting from such transaction would be recognized on the settlement date.

Trading Account: Banks that (a) regularly underwrite or deal in securities, interest rate contracts, foreign exchange rate contracts, other off-balance sheet commodity and equity contracts, other financial instruments, and other assets for resale, (b) acquire or take positions in such items principally for the purpose of selling in the near term or otherwise with the intent to resell in order to profit from short-term price movements, or (c) acquire or take positions in such items as an accommodation to customers or for other trading purposes shall report such assets or positions as trading assets or liabilities.

Trading Account (cont.):

All trading assets should be segregated from a bank's other assets and reported in Schedule RC, item 5, "Trading assets." In addition, for banks that reported average trading assets (Schedule RC-K, item 7) of $2 million or more for any quarter of the preceding calendar year should detail the types of assets and liabilities in the trading account in Schedule RC-D, Trading Assets and Liabilities. A bank's failure to establish a separate account for assets that are used for trading purposes does not prevent such assets from being designated as trading for purposes of these reports. For further information, see FASB Statement No. 115, "Accounting for Certain Investments in Debt and Equity Securities."

All trading account assets should be reported at their fair value with unrealized gains and losses recognized in current income. When a security or other asset is acquired, a bank should determine whether it intends to hold the asset for trading or for investment (e.g., for securities, available-for-sale or held-to-maturity). A bank should not record a newly acquired asset in a suspense account and later determine whether it was acquired for trading or investment purposes. Regardless of how a bank categorizes a newly acquired asset, management should document its decision.

All trading liabilities should be segregated from other transactions and reported in Schedule RC, item 15, "Trading liabilities." The trading liability account includes the fair value of derivative contracts held for trading that are in loss positions and short positions arising from sales of securities and other assets that the bank does not own. (See the Glossary entry for "short position.") Trading account liabilities should be reported at fair value with unrealized gains and losses recognized in current income in a manner similar to trading account assets.

Given the nature of the trading account, transfers into or from the trading category should be rare. Transfers between a trading account and any other account of the bank must be recorded at fair value at the time of the transfer. For a security transferred from the trading category, the unrealized holding gain or loss at the date of the transfer will already have been recognized in earnings and should not be reversed. For a security transferred into the trading category, the unrealized holding gain or loss at the date of the transfer should be recognized in earnings.

Transaction Account: See "deposits."

Transfers of Financial Assets: The accounting and reporting standards for transfers of financial assets are set forth in FASB Statement No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," which replaces FASB Statement No. 125 of the same name. These standards are based on consistent application of a financial components approach that focuses on control. Under the financial components approach, after the reporting bank transfers financial assets, it recognizes the financial and servicing assets it controls and the liabilities it has incurred, removes financial assets from the balance sheet when control has been surrendered, and removes liabilities from the balance sheet when extinguished. A summary of these accounting and reporting standards follows. For further information, see FASB Statement No. 140, the FASB staff implementation guide to Statement No. 140, and the Glossary entries for "Extinguishments of Liabilities" and "Servicing Assets and Liabilities."

FASB Statement No. 140 is effective for transfers of assets, including repurchase agreements, loan participations, dollar-rolls, securities lending, and similar transactions, occurring after March 31, 2001. However, the provisions of Statement No. 140 governing the accounting for collateral are effective for December 31, 2000, year-end financial statements. Banks should apply Statement No. 140 prospectively after its effective dates, with earlier or retroactive application not permitted, except for the provisions of this accounting standard applicable to servicing contracts in existence before January 1, 1997 (see the Glossary entry for "Servicing Assets and Liabilities"), and financial assets subject to prepayment held on or acquired after January 1, 1997 (discussed below in this Glossary entry). FASB Statement No. 125 generally applies to transfers of financial assets occurring after December 31, 1996, but before April 1, 2001.

Transfers of Financial Assets (cont.):

A financial asset is cash, evidence of an ownership interest in another entity, or a contract that conveys to the bank a contractual right either to receive cash or another financial instrument from another entity or to exchange other financial instruments on potentially favorable terms with another entity. Most of the assets on a bank's balance sheet are financial assets, including balances due from depository institutions, securities, federal funds sold, securities purchased under agreements to resell, loans and lease financing receivables, and interest-only strips receivable.[1] However, servicing assets are not financial assets. Financial assets also include financial futures contracts, forward contracts, interest rate swaps, interest rate caps, interest rate floors, and certain option contracts.

Determining Whether a Transfer Should be Accounted for as a Sale or a Secured Borrowing -- A bank should account for a transfer of its financial assets (or a transfer of all or a portion of one of its financial assets) in which it surrenders control over those financial assets as a sale to the extent that it receives consideration other than beneficial interests in the transferred assets in exchange. According to FASB Statement No. 140, a transferor (i.e., the entity that transfers all or a portion of one or more financial assets) has surrendered control over transferred assets, and therefore has sold the assets, if and only if all three of the following conditions are met:

(1) The transferred assets have been isolated from the transferor, i.e., put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.

(2) Each transferee (i.e., the entity that receives all or a portion of one or more financial assets from the transferor), or each holder of the beneficial interests in a qualifying special purpose entity that is a transferee, has the right to pledge or exchange the assets it received, and no condition both constrains the transferee from taking advantage of that right and provides more than a trivial benefit to the transferor.

(3) The transferor does not maintain effective control over the transferred assets through (a) an agreement that both entitles and obligates it to repurchase or redeem the transferred assets before their maturity or (b) the ability to unilaterally cause the holder to return specific assets, other than through a cleanup call option.

If a transfer of financial assets in exchange for cash or other consideration (other than beneficial interests in the transferred assets) does not satisfy the criteria for sale treatment, the transfer should be accounted for as a secured borrowing with pledge of collateral.

Accounting for a Transfer That Qualifies as a Sale -- Upon the completion of a transfer of financial assets that satisfies all three of the conditions to be accounted for as a sale, the purchaser(s) must recognize on the balance sheet all assets obtained and any liabilities incurred and initially measure them at fair value. The aggregate fair value is presumed to be the price paid by the purchaser(s). As for the selling bank, it must:

(1) Remove all assets sold from the balance sheet while continuing to carry on its balance sheet any retained interest in the transferred assets, including, if applicable, servicing assets, retained undivided interests, and beneficial interests in assets transferred to a qualifying special-purpose entity in a securitization. The selling bank must allocate the amount at which the transferred assets were carried on the balance sheet at the date of the transfer between the assets sold and the retained interests, if any, based on their relative fair values at that date.

[1] Both FASB Statement Nos. 125 and 140 define an interest-only strip receivable as the contractual right to receive some or all of the interest due on a bond, mortgage loan, collateralized mortgage obligation, or other interest-bearing financial asset.

Transfers of Financial Assets (cont.):

(2) Recognize on the balance sheet all cash, derivative financial instruments, and other assets obtained and all servicing liabilities and other liabilities incurred in consideration as proceeds of the sale. Derivatives include put or call options held or written (e.g., guarantee or recourse obligations), forward commitments (e.g., commitments to deliver additional receivables in some securitizations), and swaps (e.g., provisions that convert interest rates from fixed to variable).

(3) Initially measure the assets obtained and liabilities incurred in a sale at fair value. However, if it is not practicable to estimate the fair value of an asset obtained, the selling bank must record the asset at zero. If it is not practicable to estimate the fair value of a liability incurred, the selling bank must not recognize any gain on the sale. The liability should be recorded on the balance sheet at the greater of:

(a) The amount, if any, by which the fair values of the assets obtained in the sale less the fair values of the liabilities incurred in the sale exceeds the sum of the carrying values of the assets transferred, or

(b) The amount of loss that is probable of occurring in accordance with FASB Statement No. 5, "Accounting for Contingencies," as interpreted by FASB Interpretation No. 14, "Reasonable Estimation of the Amount of a Loss." Under that interpretation, when the reasonable estimate of the loss is a range and some amount within the range appears at the time to be a better estimate than any other amount within the range, that amount should be considered probable. When no amount within the range is a better estimate than any other amount, the minimum amount in the range should be considered probable.

(4) Recognize in income any gain or loss on the sale.

Banks should refer to FASB Statement No. 140 for implementation guidance for accounting for transfers of partial interests, transfers of certain lease receivables, securities lending transactions, repurchase agreements including "dollar rolls," "wash sales," loan syndications, loan participations (discussed below), risk participations in bankers acceptances, factoring arrangements, and transfers of receivables with recourse. However, this accounting standard does not provide guidance on the accounting for most assets and liabilities recorded on the balance sheet following a transfer accounted for as a sale. As a result, after their initial measurement or carrying amount allocation, these assets and liabilities should be accounted for in accordance with the existing generally accepted accounting principles applicable to them.

Loan Participations – FASB Statement No. 140 applies to loan participations occurring after March 31, 2001, including transfers by the originating lender to a participating institution that take place after that date under loan participation agreements that originated before April 1, 2001. However, for transfers by an FDIC-insured institution, the isolation test in Statement No. 140 (described above under "Determining Whether a Transfer Should be Accounted for as a Sale or a Secured Borrowing") applies to transfers occurring after December 31, 2001. If a loan participation agreement gives a participating institution the right to pledge or exchange the participation, the isolation test has been met, and the originating lender does not maintain effective control over the participation, then the conditions for the surrender of control have been met and the originating lender should account for transfers to the participating institution as sales of financial assets.

An originating lender's right of first refusal on a bona fide offer to the participating institution from a third party, a requirement for a participating institution to obtain the originating lender's permission that shall not be unreasonably withheld, or a prohibition on the participating institution's sale of the participation to the originating lender's competitor (if other potential willing buyers exist) is a limitation on the participating institution's rights, but is presumed not to constrain a participant from exercising its right to

Transfers of Financial Assets (cont.):

pledge or exchange the participation. However, if the participation agreement constrains the participating institution from pledging or exchanging its participation, the originating lender presumptively receives more than a trivial benefit, has not relinquished control over the loan, and should account for the transfer as a secured borrowing.

A loan participation agreement may give the originating lender the contractual right to repurchase a loan participation at any time. In this situation, the right to repurchase is effectively a call option on a specific loan participation, i.e., a participation that is not readily obtainable in the marketplace. Regardless of whether this option is freestanding or attached, it either constrains the participating institution from pledging or exchanging its participation or results in the originating lender maintaining effective control over the participation. As a consequence, the contractual right to repurchase precludes sale accounting and the transfer should be accounted for as a secured borrowing.

In addition, under a loan participation agreement, the originating lender may give the participating institution the right to resell the participation, but reserves the right to call the loan participation at any time from whomever holds it and can enforce that right by discontinuing the flow of interest to the holder of the participation at the call date. In this situation, the originating lender has maintained effective control over the participation and the transfer should be accounted for as a secured borrowing, not as a sale.

If an originating FDIC-insured lender has transferred a loan participation to a participating institution with recourse prior to January 1, 2002, the existence of the recourse obligation in and of itself does not preclude sale accounting for the transfer under FASB Statement No. 140. If a loan participation transferred with recourse prior to January 1, 2002, meets the three conditions identified above in order for the transferor to have surrendered control over the transferred assets, the transfer should be accounted for as a sale for financial reporting purposes. However, a loan participation sold with recourse is subject to the banking agencies' risk-based capital requirements as discussed in the Glossary entry for "sales of assets for risk-based capital purposes" and in the instructions for Schedule RC-R, Regulatory Capital.

If an originating FDIC-insured lender transfers a loan participation with recourse after December 31, 2001, the participation generally will not be considered isolated from the transferor, i.e., the originating lender, in the event of an FDIC receivership. Section 360.6 of the FDIC's regulations limits the FDIC's ability to reclaim loan participations transferred "without recourse," as defined in the regulations, but does not limit the FDIC's ability to reclaim loan participations transferred with recourse. Under Section 360.6, a participation that is subject to an agreement that requires the originating lender to repurchase the participation or to otherwise compensate the participating institution due to a default on the underlying loan is considered a participation "with recourse." As a result, a loan participation transferred "with recourse" after December 31, 2001, generally should be accounted for as a secured borrowing and not as a sale for financial reporting purposes. This means that the originating lender should not remove the participation from its loan assets on the balance sheet, but should report the secured borrowing in Schedule RC, item 16, "Other borrowed money."

Financial Assets Subject to Prepayment -- Financial assets such as interest-only strips receivable and certain loans, debt securities, other receivables, and retained interests in securitizations can be contractually prepaid or otherwise settled in such a way that the holder of the financial asset would not recover substantially all of its recorded investment. After their initial recording on the balance sheet, financial assets of this type must be subsequently measured at fair value like available-for-sale securities or trading securities.

Traveler's Letter of Credit: See "letter of credit."

Treasury Receipts: See "coupon stripping, Treasury receipts, and STRIPS."

Treasury Stock: Treasury stock is stock that the bank has issued and subsequently acquired, but that has not been retired or resold. As a general rule, treasury stock, whether carried at cost or at par value, is a deduction from a bank's total equity capital. For purposes of the Reports of Condition and Income, the carrying value of treasury stock should be reported (as a negative number) in Schedule RC, item 27, "Other equity capital components."

"Gains" and "losses" on the sale, retirement, or other disposal of treasury stock are not to be reported in Schedule RI, Income Statement, but should be reflected in Schedule RI-A, item 6, "Treasury stock transactions, net." Such gains and losses, as well as the excess of the cost over the par value of treasury stock carried at par, are generally to be treated as adjustments to Schedule RC, item 25, "Surplus."

NOTE: National banks are generally prohibited by 12 USC 83 from purchasing shares of their own stock.

For further information, see Accounting Research Bulletin No. 43, as amended by APB Opinion No. 6.

Troubled Debt Restructurings: The accounting standards for troubled debt restructurings are set forth in FASB Statement No. 15, "Accounting by Debtors and Creditors for Troubled Debt Restructurings," as amended by FASB Statement No. 114, "Accounting by Creditors for Impairment of a Loan." A summary of this amended accounting standard follows. For further information, see FASB Statements No. 15 and No. 114.

A troubled debt restructuring is a restructuring in which a bank, for economic or legal reasons related to a borrower's financial difficulties, grants a concession to the borrower that it would not otherwise consider. The restructuring of a loan or other debt instrument (hereafter referred to collectively as a "loan") may include (1) the transfer from the borrower to the bank of real estate, receivables from third parties, other assets, or an equity interest in the borrower in full or partial satisfaction of the loan (see the Glossary entry for "foreclosed assets" for further information), (2) a modification of the loan terms, or (3) a combination of the above. A loan extended or renewed at a stated interest rate equal to the current interest rate for new debt with similar risk is not to be reported as a restructured loan.

The recorded amount of a loan is the loan balance adjusted for any unamortized premium or discount and unamortized loan fees or costs, less any amount previously charged off, plus recorded accrued interest.

In cases where the new terms of the restructured troubled debt provide for a reduction of either interest or principal (referred to as a modification of terms), the institution should measure any loss on the restructuring in accordance with the guidance concerning impaired loans set forth in the Glossary entry for "loan impairment," except that a troubled debt restructuring involving a modification of terms before the effective date of FASB Statement No. 114 may continue to be accounted for and disclosed in accordance with FASB Statement No. 15 as long as the restructured loan is not impaired based on the terms of the restructuring agreement. See the Glossary entry for "nonaccrual status" for a discussion of the conditions under which a nonaccrual asset which has undergone a troubled debt restructuring (including those that involve a multiple note structure) may be returned to accrual status.

A troubled debt restructuring in which a bank receives physical possession of the borrower's assets, regardless of whether formal foreclosure or repossession proceedings take place, should be accounted for in accordance with paragraph 34 of FASB Statement No. 15, as amended. Thus, in such situations, the loan should be treated as if assets have been received in satisfaction of the loan and reported as described in the Glossary entry for "foreclosed assets."

Troubled Debt Restructurings (cont.):

Despite the granting of some type of concession by a bank to a borrower, a troubled debt restructuring may still result in the recorded amount of the loan bearing a market yield, i.e., an effective interest rate that at the time of the restructuring is greater than or equal to the rate that the bank is willing to accept for a new extension of credit with comparable risk. This may arise as a result of reductions in the recorded amount of the loan prior to the restructuring (e.g., by charge-offs). All loans that have undergone troubled debt restructurings and that are in compliance with their modified terms must be reported as restructured loans in Schedule RC-C, part I, Memorandum item 1. However, a restructured loan that is in compliance with its modified terms and yields a market rate need not continue to be reported as a troubled debt restructuring in this memorandum item in calendar years after the year in which the restructuring took place.

A restructuring may include both a modification of terms and the acceptance of property in partial satisfaction of the loan. The accounting for such a restructuring is a two step process. First, the recorded amount of the loan is reduced by the fair value less cost to sell of the property received. Second, the institution should measure any impairment on the remaining recorded balance of the restructured loan in accordance with the guidance concerning impaired loans set forth in FASB Statement No. 114.

A restructuring may involve the substitution or addition of a new debtor for the original borrower. The treatment of these situations depends upon their substance. Restructurings in which the substitute or additional debtor controls, is controlled by, or is under common control with the original borrower, or performs the custodial function of collecting certain of the original borrower's funds, should be accounted for as modifications of terms. Restructurings in which the substitute or additional debtor does not have a control or custodial relationship with the original borrower should be accounted for as a receipt of a "new" loan in full or partial satisfaction of the original borrower's loan. The "new" loan should be recorded at its fair value.

A credit analysis should be performed for a restructured loan in conjunction with its restructuring to determine its collectibility and estimated credit loss. When available information confirms that a specific restructured loan, or a portion thereof, is uncollectible, the uncollectible amount should be charged off against the allowance for loan and lease losses at the time of the restructuring. As is the case for all loans, the credit quality of restructured loans should be regularly reviewed. The bank should periodically evaluate the collectibility of the restructured loan so as to determine whether any additional amounts should be charged to the allowance for loan and lease losses or, if the restructuring involved an asset other than a loan, to another appropriate account.

Trust Preferred Securities: As bank investments, trust preferred securities are hybrid instruments possessing characteristics typically associated with debt obligations. Although each issue of these securities may involve minor differences in terms, under the basic structure of trust preferred securities a corporate issuer, such as a bank holding company, first organizes a business trust or other special purpose entity. This trust issues two classes of securities: common securities, all of which are purchased and held by the corporate issuer, and trust preferred securities, which are sold to investors. The business trust's only assets are deeply subordinated debentures of the corporate issuer, which the trust purchases with the proceeds from the sale of its common and preferred securities. The corporate issuer makes periodic interest payments on the subordinated debentures to the business trust, which uses these payments to pay periodic dividends on the trust preferred securities to the investors. The subordinated debentures have a stated maturity and may also be redeemed under other circumstances. Most trust preferred securities are subject to mandatory redemption upon the repayment of the debentures.

Trust preferred securities meet the definition of a security in FASB Statement No. 115, "Accounting for Certain Investments in Debt and Equity Securities." Because of the mandatory redemption provision in the typical trust preferred security, investments in trust preferred securities would normally be

Trust Preferred Securities (cont.):
considered debt securities for financial accounting purposes. Accordingly, regardless of the authority under which a bank is permitted to invest in trust preferred securities, banks should report these investments as debt securities for purposes of these reports (unless, based on the specific facts and circumstances of a particular issue of trust preferred securities, the securities would be considered equity rather than debt securities under Statement No. 115). If not held for trading purposes, trust preferred securities issued by U.S. business trusts should be reported in Schedule RC-B, item 6.a, "Other domestic debt securities."

U.S. Banks: See "banks, U.S. and foreign."

U.S. Territories and Possessions: United States territories and possessions include American Samoa, Guam, the Northern Mariana Islands, the U.S. Virgin Islands, and the U.S. trust territories.

Valuation Allowance: In general, a valuation allowance is an account established against a specific asset category or to recognize a specific liability, with the intent of absorbing some element of estimated loss. Such allowances are created by charges to expense in the Report of Income and those established against asset accounts are netted from the accounts to which they relate for presentation in the Report of Condition. Provisions establishing or augmenting such allowances are to be reported as "Other noninterest expense" except for the provision for loan and lease losses which is reported in a separate, specifically designated income statement item on Schedule RI.

When-Issued Securities Transactions: Transactions involving securities described as "when-issued" or "when-as-and-if-issued" are, for the purposes of these reports, to be treated as conditional transactions in a security authorized for issuance but not yet actually issued. Purchases and sales of when-issued securities for which settlement date has not occurred as of the report date are not to be reflected in the balance sheet, Schedule RC, until settlement date. Banks should report as forward contracts in Schedule RC-L, item 12.b, commitments to purchase and sell when-issued securities that are not excluded from the requirements of FASB Statement No. 133 as a regular-way security trade. Such contracts should be reported on a gross basis (except that banks may net purchases and sales of the identical security with the same party). Commitments to purchase when-issued securities that are excluded from the requirements of Statement No. 133 should be reported as "Other off-balance sheet liabilities" in Schedule RC-L, item 9, and commitments to sell when-issued securities that are excluded from the requirements of Statement No. 133 should be reported as "Other off-balance sheet assets" in Schedule RC-L, item 10, subject to the existing reporting thresholds for these two items.

Trading in when-issued securities normally begins when the U.S. Treasury or some other issuer of securities announces a forthcoming issue. (In some cases, trading may begin in anticipation of such an announcement and should also be reported as described herein.) Such transactions are contingent upon the actual issuance of the security. Since the exact price and terms of the security are unknown before the auction date, trading prior to that date is on a "yield" basis. On the auction date the exact terms and price of the security become known and when-issued trading continues until settlement date, when the securities are delivered and the issuer paid. On settlement date, the securities purchased by the bank shall be reported as held-to-maturity securities in Schedule RC, item 2.a, as available-for-sale securities in Schedule RC, item 2.b, or as trading assets in Schedule RC, item 5, as appropriate.