Board of Governors of the Federal Reserve System

Supplemental Instructions June 2003

FASB Statement No. 149 and Loan Commitments That Must Be Accounted for as Derivatives

FASB Statement No. 133 Implementation Issue No. C13 provides guidance on the circumstances in which a loan commitment must be accounted for as derivative. This guidance applies to commitments issued before July 1, 2003. **Commitments issued after June 30, 2003, are addressed by FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities.*** Bank holding companies must follow the guidance in Issue No. C13 and Statement No. 149 for FR Y-9 reporting purposes.

According to Issue No. C13, loan commitments that relate to the origination or purchase of mortgage loans that will be held for sale must be accounted for as derivative instruments in accordance with Statement No. 133. However, loan commitments that relate to the origination or purchase of mortgage loans that will be held for investment, i.e., loans for which the BHC or its subsidiaries has the intent and ability to hold for the foreseeable future or until maturity or payoff, are not considered derivatives. In addition, commitments that relate to the origination of other types of loans (that is, other than mortgage loans) are not considered derivatives.

FASB Statement No. 149 differs somewhat from Issue No. C13. Under Statement No. 149, loan commitments that relate to the origination of mortgage loans that will be held for sale must be accounted for as derivatives by the issuer of the commitment. Commitments to originate mortgage loans that will be held for investment purposes and other types of loans are not considered derivatives. However, for commitments to purchase or sell existing loans, the definition of a derivative in Statement No. 133 (see page GL-20 of the Glossary section of the FR Y-9C instructions) should be applied to these commitments to determine whether they meet this definition and are subject to the provisions of Statement No. 133.

Mortgage loan commitments that must be accounted for as derivatives are considered over-the-counter written interest rate options. Therefore, because they are derivatives, these commitments should not be reported as unused commitments in item 1 of Schedule HC-L, Derivative and Off-Balance Sheet Items. Instead, mortgage loan commitments that are derivatives must be reported on the balance sheet (Schedule HC) at fair value. In addition, the par value of the mortgage loans to be acquired under these commitments must be reported in Schedule HC-L, item 11.d.(1), column A, and in Schedule HC-L, item 13, column A. The fair value of these mortgage loan commitments must be reported in the appropriate subitem of Schedule HC-L, item 14.b. As written options, mortgage loan commitments that are derivatives are not covered by the Federal Reserve's risk-based capital standards. However, if the fair value of these mortgage loan commitments is positive and therefore reported as an asset, this positive fair value is subject to the risk-based capital standards and must be risk weighted as an on-balance sheet asset.

The unused portion of loan commitments that are not considered derivatives should continue to be reported in Schedule HC-L, item 1. Unused commitments with an original maturity exceeding one year are subject to the risk-based capital standards and must be reported in

Schedule HC-R, item 53.

FASB Interpretation No. 45

In November 2002, the FASB issued Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*. This interpretation clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. Among the types of guarantee contracts to which the provisions of Interpretation No. 45 apply are:

- financial standby letters of credit, which are irrevocable undertakings, typically by a financial institution, to guarantee payment of a specified financial obligation, and
- performance standby letters of credit, which are irrevocable undertakings by a guarantor to make payments in the event a specified third party fails to perform under a nonfinancial contractual obligation.

Commercial letters of credit and other loan commitments, as well as subordinated interests in securitizations, are not considered guarantees under Interpretation No. 45 and, therefore, are not subject to the interpretation. Bank holding companies (BHCs) should refer to Interpretation No. 45 for further information on the types of guarantee contracts to which the interpretation's initial recognition and measurement provisions do and do not apply.

For financial and performance standby letters of credit and other types of guarantees subject to the interpretation, when a BHC or its subsidiary issues the guarantee, it must recognize on its balance sheet a liability for that guarantee. In general, the initial measurement of the liability is the fair value of the guarantee at its inception. When a BHC or its subsidiary issues a guarantee in a standalone arm's length transaction with a party outside the consolidated BHC, which would typically be the case for a standby letter of credit, the liability recognized at the inception of the guarantee should be the premium or fee received or receivable by the guarantor. However, if the BHC or its subsidiary issues a guarantee for no consideration on a standalone basis, the liability recognized at inception should be an estimate of the guarantee's fair value. In the unusual circumstance where, at the inception of a guarantee, it is probable that a loss has been incurred and its amount can be reasonably estimated, the liability to be initially recognized for that guarantee should be the greater of the premium or fee received or receivable by the guarantor or the estimated loss from the loss contingency that must be accrued under FASB Statement No. 5, *Accounting for Contingencies*.

Interpretation No. 45 does not prescribe a specific account for the guarantor's offsetting entry when it recognizes the liability at the inception of a guarantee because that offsetting entry depends on the circumstances. If a BHC or its subsidiary issued a standby letter of credit or other guarantee in a standalone transaction for a premium or fee, the offsetting entry would reflect the consideration the BHC or its subsidiary received, such as cash, a receivable, or a reduction of a deposit liability. In contrast, if the BHC or its subsidiary received no consideration for issuing the guarantee, the offsetting entry would be to expense.

The interpretation does not describe in detail how a BHC's or its subsidiary's liability for its obligations under its guarantees should be measured subsequent to initial recognition. However, the accounting for fees received for issuing standby letters of credit has been, and should continue to be, governed by FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*. Under Statement No. 91, such fees are termed "commitment fees."

For FR Y-9C purposes, BHCs should apply the initial recognition and measurement provisions of Interpretation No. 45 on a prospective basis to guarantees issued or modified after December 31, 2002, irrespective of the BHC's fiscal year-end. A BHC's previous accounting for guarantees issued prior to January 1, 2003, should not be revised.

FASB Interpretation No. 46

The FASB issued Interpretation No. 46, *Consolidation of Variable Interest Entities*, in January 2003. This interpretation explains how to identify a "variable interest entity" (previously referred to as a "special purpose entity") and how an organization should assess its interests in a variable interest entity to decide whether to consolidate that entity. Variable interest entities often are created for a single specified purpose, for example, to facilitate securitization, leasing, hedging, research and development, and reinsurance. Most small BHCs are unlikely to have any "variable interests" in variable interest entities.

In general, a variable interest entity is an entity in which either the controlling financial interests are not voting interests or the equity investors do not bear the entity's residual economic risks. A variable interest is a contractual or ownership interest in an entity that changes when the value of the entity's net assets changes. An organization that has a variable interest (or a combination of variable interests) that will absorb a majority of a variable interest entity's expected losses if they occur, receive a majority of the entity's expected residual returns if they occur, or both, is the "primary beneficiary" of the variable interest entity and must consolidate it.

For FR Y-9C purposes, BHCs with variable interests in variable interest entities created after January 31, 2003, must apply the provisions of Interpretation No. 46 to those entities immediately. A BHC that is a public company and has a variable interest in a variable interest entity created before February 1, 2003, must apply the provisions of Interpretation No. 46 to that entity no later than the beginning of the first interim or annual reporting period beginning after June 15, 2003. A BHC that is not a public company but has a variable interest in a variable interest entity created before February 15, 2003, must apply the provisions of Interpretation No. 46 to that entity no later than the end of the first annual reporting period beginning after June 15, 2003.

Allocated Transfer Risk Reserves

For BHCs that have allocated transfer risk reserves (ATRRs) related to loans and leases held for investment, the way in which the ATRR and related provisions should be reported on the FR Y-9C balance sheet and income statement changed effective with the March 31, 2003, reporting date. Any ATRRs related to loans and leases held for investment should be included on the balance sheet in Schedule HC, item 4.c, "Allowance for loan and lease losses." This means that these ATRRs should no longer be deducted directly from the individual loans to which they relate in the FR Y-9C loan schedule (Schedule HC-C). The amount of any ATRRs related to loans and leases held for investment should be disclosed in new Memorandum item 1 of Schedule HI-B, part II. In addition, provisions for allocated transfer risk related to loans and leases should be included in Schedule HI, item 4, "Provision for loan and lease losses." Any ATRRs for assets other than loans and leases held for investment should continue to be deducted directly from the individual assets for FR Y-9C balance sheet purposes.

ATRRs are not eligible for inclusion in either Tier 1 or Tier 2 capital. Therefore, because the allowance for loan and lease losses will include any ATTRs related to loans and leases held for investment, BHCs should ensure that they deduct these ATRRs from the amount of the loan loss allowance reported on the FR Y-9C balance sheet when determining the "Allowance for loan and lease losses includible in Tier 2 capital" and the "Excess allowance for loan and lease losses" to be reported in Schedule HC-R, items 14 and 60, respectively. The entire amount of a bank's ATRR should be reported in Schedule HC-R, item 61.

Equity-Indexed Certificates of Deposit

Under FASB Statement No. 133, a certificate of deposit (CD) that pays "interest" based on changes in an equity securities index is a hybrid instrument with an embedded derivative that must be accounted for separately from the host contract, i.e., the CD. **Examples of equity-indexed CDs include the "Index Powered CD" and the "Dow Jones Industrials Indexed Certificate of Deposit."**

At the maturity date of a typical equity-indexed CD, the holder of the CD receives the original amount invested in the CD plus some or all of the appreciation, if any, in an index of stock prices over the term of the CD. Thus, the equity-indexed CD contains an embedded equity call option. To manage the market risk of its equity-indexed CDs, a bank that issues these CDs normally enters into one or more separate freestanding equity derivative contracts with an overall term that matches the term of the CDs. At maturity, these separate derivatives are expected to provide the bank with a cash payment in an amount equal to the amount of appreciation, if any, in the same stock price index that is embedded in the CDs, thereby providing the bank with the funds to pay the "interest" on the equity-indexed CDs. During the term of the separate freestanding equity derivative contracts, the bank will periodically make either fixed or variable payments to the counterparty on these contracts.

When a subsidiary bank of a BHC issues an equity-indexed CD, it must account for the written equity call option embedded in the CD separately from the CD host contract. The fair value of

this embedded derivative on the date the CD is issued must be deducted from the amount the purchaser invested in the CD, creating a discount on the CD that must be amortized to interest expense over the term of the CD using the effective interest method. This interest expense should be reported in the income statement, of the FR Y-9C, in the appropriate subitem of Schedule HI, item 2.a, "Interest on deposits." The equity call option must be "marked to market" at least quarterly with any changes in the fair value of the option recognized in earnings. On the balance sheet, the carrying value of the CD host contract and the fair value of the embedded equity derivative may be combined and reported together as deposit liabilities on the balance sheet (Schedule HC). As for the separate freestanding derivative contracts the bank enters into to manage its market risk, these derivatives must be carried on the balance sheet as assets or liabilities at fair value and "marked to market" at least quarterly with changes in their fair value recognized in earnings. The fair value of the freestanding derivatives should not be netted against the fair value of the embedded equity derivatives for FR Y-9C balance sheet purposes because these two derivatives have different counterparties. The periodic payments to the counterparty on these freestanding derivatives must be accrued with the expense reported in earnings along with the change in the derivative's fair value. In the FR Y-9C income statement (Schedule HI), the changes in the fair value of the embedded and freestanding derivatives, including the effect of the accruals for the payments to the counterparty on the freestanding derivatives, should be netted and reported consistently in either "Other noninterest income" (item 5.l) or "Other noninterest expense" (item 7.d).

The notional amounts of the embedded and freestanding equity derivatives must be reported in column C of Schedule HC-L, items 11.d.(1) and 11.e, respectively. The notional amounts of both derivatives must also be included in Schedule HC-L, item 13, column C. The fair values of these two derivative contracts must be included in the appropriate subitems of Schedule HC-L, item 14.b, column C. The equity derivative embedded in the indexed CD is a written option, which is not covered by the Federal Reserve's risk-based capital standards. However, the freestanding equity derivative is covered by these standards.

A BHC or its subsidiary that purchases an equity-indexed CD for investment purposes must account for the embedded purchased equity call option separately from the CD host contract. The fair value of this embedded derivative on the date of purchase must be deducted from the purchase price of the CD, creating a discount on the CD that must be accreted into income over the term of the CD using the effective interest method. This accretion should be reported in the FR Y-9C income statement in Schedule HI, item 1.c. The embedded equity derivative must be "marked to market" at least quarterly with any changes in its fair value recognized in earnings. These fair value changes should be reported consistently in either "Other noninterest income" (item 5.l) or "Other noninterest expense" (item 7.d). The carrying value of the CD host contract and the fair value of the embedded equity derivative may be combined and reported together as interest-bearing balances due from depository institutions on the balance sheet in Schedule HC, item 1.b. The notional amount of the embedded derivative must be reported in Schedule HC-L, item 11.d.(2), column C, and item 13, column C, and, if appropriate, its fair value (which will always be positive or zero, but not negative) must be reported in Schedule HC-L, item 14.b.(1), column C. The embedded equity derivative in the indexed CD is a purchased option, which is subject to the Federal Reserve’s risk-based capital standards.

FASB Statements Nos. 141 and 142

In July 2001, the FASB issued Statement No. 141, *Business Combinations*, and Statement No. 142, *Goodwill and Other Intangible Assets*. In October 2002, the FASB issued a related accounting standard, Statement No. 147, *Acquisitions of Certain Financial Institutions*, which is discussed in the following section. BHCs must follow each of these three accounting standards for FR Y-9C purposes.

Statement No. 141 requires all business combinations (i.e., mergers and acquisitions), except for combinations between two or more mutual enterprises, to be accounted for by the purchase method. The use of the pooling-of-interests method is prohibited. Statement No. 141 also changes the requirements for recognizing intangible assets as assets apart from goodwill in business combinations accounted for by the purchase method. The statement specifically identifies core deposit intangibles as one type of intangible that must be recognized as an asset separate from goodwill.

Statement No. 142 addresses how intangible assets that are acquired individually or with a group of other assets (but not in a business combination) should be accounted for upon their acquisition. It also explains how goodwill and other intangible assets should be accounted for after they have been acquired. In this regard, under Statement No. 142, goodwill should not be amortized, but should be tested for impairment in accordance with the provisions of this accounting standard. In addition, core deposit intangibles have a finite useful life and must be amortized over this period using a method that reflects the pattern in which the economic benefit of the asset is consumed. For core deposit intangibles, this results in the use of an accelerated method of amortization.

Although the accounting rules for goodwill and other intangible assets have changed, there has been no change in the regulatory capital treatment of these assets. The existing regulatory capital limits on servicing assets and purchased credit card relationships remain in effect, and goodwill and other intangible assets continue to be deducted from capital and assets in determining a BHC's capital ratios.

Reporting of Funds Invested Through Bentley Financial Services, Inc.

On October 30, 2001, the banking regulatory agencies issued a joint release advising depository institutions that the Securities and Exchange Commission (SEC) had filed suit against Robert L. Bentley, Entrust Group, and Bentley Financial Services, Inc. Specifically, the SEC alleged that the defendants were representing to investors that they were selling federally-insured certificates of deposit when, in fact, they were selling uninsured securities issued by the defendants. In addition, a temporary restraining order was issued against the defendants, freezing the defendants' accounts and appointing a receiver to exercise control over the defendants' assets. In light of these events, bank holding companies that have invested funds through Bentley Financial Services should report these funds as "Other" assets in Schedule HC-F, item 5, ***not*** as "Interest-bearing balances" due from depository institutions in Schedule HC, item 1.b. In addition, these Bently-related assets should be placed in nonaccrual status and reported as nonaccrual assets in Schedule HC-N, item 9, column C. Previously accrued but uncollected interest on these funds should be reversed through a charge to interest income (for any amounts

accrued in 2002) and a charge to other noninterest expense (for amounts accrued prior to 2002) in Schedule HI, Income Statement. Any write-downs of Bently-related assets and changes to establish valuation allowances against these assets should be reported as other noninterest expense. In addition, these funds should be risk-weighted at 100 percent in item 42, column F, in Schedule HC-R, Regulatory Capital.

Accelerated Filing Deadline

The Board approved the acceleration of the filing deadline for top-tier FR Y-9C filers and will follow the SEC's phased-in approach by implementing a 40-day deadline in June 2004 and a 35-day deadline in June 2005. The new filing deadlines apply for the March, June, and September report dates. The December filing deadline for top-tier FR Y-9C filers will remain at 45 days after the report date.

The 35-day deadline is defined as "5 business days after the 30th day after the report date" to allow time for integration of bank data in the event that the 30th day falls on a weekend.

The FR Y-9LP, FR Y-9SP, FR Y-9ES and all lower-tier BHCs that file the FR Y-9C are not subject to the accelerated deadline. The deadline for these reports will remain at 45 days after the report date.

Listing of Revisions

Significant Revisions to the FR Y-9C for June 2003:

Instructions

(1) *General Instructions.* The General Instructions section was modified to reflect required electronic filing.
(2) *Schedule HI, item M14.* Clarified to include employee stock options expensed, whether calculated using the intrinsic value method or fair value method.
(3) *Schedule HI-A, item 14.* Clarified instruction that opening equity capital for bank holding companies opened since January 1 of the year-to-date reporting period should be reported in Schedule HI-A, item 1.
(4) *Schedule HC-E, General Instructions.* Clarified that nonrefundable stock subscription payments should be reported as other liabilities.
(5) *Schedule HC-F, item 3.* Added footnote providing guidance regarding interest-only strips receivable not in the form of a security.
(6) *Schedule HC-S, General Instructions.* Clarified reference to interest-only strips as credit-enhancing interest-only strips.
(7) *Schedule HC-S, item 6(a).* Added guidance regarding interest-only strips receivable not in the form of a security.
(8) *Glossary.* Clarified "Premiums and Discounts" entry regarding the amortization of premiums and accretion of discounts.

Significant Revisions to the FR Y-9LP for June 2003:

Instructions

General Instructions. The General Instructions section was entirely reorganized. Existing information was slotted into four main topics: Who Must Report, Where to Submit the Reports, When to Submit the Reports, and How to Prepare the Reports. Existing language was also modified to reflect required electronic filing.

Significant Revisions to the FR Y-9SP for June 2003

Reporting Form and Corresponding Instructions

Balance Sheet, items 17.b and 17.c. Added two new subitems to Memorandum item 17 to collect additional information on top-tier BHC nonbank subsidiaries, item 17.b, "Total combined loans and leases of nonbank subsidiaries," and 17.c, "Total aggregate operating revenue of nonbank subsidiaries." Old items 17.b through 17.d would be renumbered accordingly. Operating revenue would be defined as the sum of total interest income and total noninterest income (before deduction of expenses and extraordinary items.)

Income Statement, Memoranda item 2; Balance Sheet, Memoranda items 14, 18, 19, 20. Modified "no" response to "0."

Instructions only

General Instructions. The General Instructions section was entirely reorganized. Existing information was slotted into four main topics: Who Must Report, Where to Submit the Reports, When to Submit the Reports, and How to Prepare the Reports.

Revisions to the FR Y-11 for June 2003:

Report Form

Updated reporting date to June 30, 2003. No other changes for this quarter.