APPENDIX D

PROPOSED SUPERVISORY GUIDELINES FOR ACCOUNTING FOR FEES ON SYNDICATED INTERNATIONAL CREDITS

A. Description of types of fees and recent practices

In addition to the stated interest on international syndicated[1/] loans (including stated interest adjustments for late payments), banks often require payment of certain fees in connection with these credits. These fees are identified by a variety of terms, and are intended for a variety of purposes: for example, a flat fee added specifically to increase the yield of the loan; a fee designed to cover costs associated with syndicating a loan (e.g., for structuring and negotiating a loan package, underwriting a syndicated loan, advising the borrower); a fee to cover the costs of committing funds on the prescribed terms for a fixed period of time; or a fee for serving as agent in administering a syndicated credit. In addition, banks frequently provide in the loan agreement that the managing bank(s) is to be reimbursed for all out-of-pocket expenses incidental to the arrangement of a credit facility, as well as collection or enforcement costs. (A glossary of terminology and description of the principal fees associated with the extension of international credits by commercial banks is attached.)

A survey of a sample of international syndicated loan agreements, concluded between 1978 and 1983, for borrowers in those countries recently experiencing balance of payments difficulties indicates the following:

1/ "Syndication" is the process of arranging a Multi-bank Credit Facility and is characterized by the formation of a Management Group, assumption of "Underwriting Commitments" and participation of various Lending Banks.

-- Over this period, commitment fees have ranged generally between 1/4 to 1/2 percent on the undrawn amounts of the loan during the availability period. Agency fees have varied for example from $7,500 per year to $300,000, with the variations perhaps related to the size and complexity of the loans. Practically all the agreements surveyed had detailed provisions relating to reimbursement of expenses.

-- The stated interest rates on the loans surveyed by-and-large ranged around 1% to 1-5/8% above LIBOR, with only a few notable exceptions.

-- Management and other front-end fees were unstated in the loan documents in the majority of cases, with the fees established by a side agreement. It is not clear the extent to which these fees are disclosed to other participants in the syndicate. Where the front-end fees were stated, they ranged from 3/4% to 1-1/2%.

B. <u>Current accounting rules and practices applicable to nonrefundable fees</u>

We understand that there are differences in the manner in which banks account for the nonrefundable fees associated with international loans. The major difference is the extent to which the fees are amortized over the life of the loan, as an adjustment to the interest yield on the loan, or instead are taken into income at the time the fees are received. Currently, neither generally accepted accounting principles nor regulatory policy definitively specify the manner in which fee income to the bank should be recognized.

Existing guidance on the timing of recognition of revenues is provided in Accounting Principles Board (APB) Statement No. 4, Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises that states the following realization principle:

> Revenue from services rendered is recognized under this principle when services have been performed and are billable. Revenue from permitting others to use enterprise resources, such as interest, rent, and royalties is also governed by the realization principle. Revenue of this type is recognized as time passes or as the resources are used.

Thus, under these accounting principles, each activity for which nonrefundable fees are received must be analyzed to consider whether the activity provides services and constitutes a separate earning process or is an integral part of the entity's central operations.

The American Institute of Certified Public Accountants (AICPA) Industry Audit Guide, Audits of Banks ("Bank Audit Guide") (1983) at pages 52-55, provides very general guidance as to accounting recognition of fees. As to commitment fees, the Bank Audit Guide in part states:

> "Banks have recorded income from commitment fees in a variety of ways including recognition:
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> (a) in full when received.
> (b) when the commitment period has expired or the loan has been drawn down.
> (c) ratably over the commitment period.
> (d) ratably over the combined commitment and loan period.
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> "The accounting for recognition of income from commitment fees should be based on the nature and substance of the transactions. However, a bank's method of accounting should ensure that any income that represents an adjustment to the interest yield is deferred until the loan is drawn down and then amortized over the expected life of the loan in relation to the outstanding balance.
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> "Fees representing compensation for a binding commitment or for rendering a service in issuing the commitment should be deferred and amortized over the commitment period using the straight-line method."

The Guide does not directly address questions of front-end fees in syndicated international credits, but discusses "origination fees" as follows:

> "Banks also receive fees for originating loans in-house. The normal origination fee (generally referred to as points) is essentially a reimbursement for the expenses of the underwriting process, that is, processing the loan application, reviewing legal title to the collateral, obtaining appraisals, and other procedures. Origination fees, to the extent they are a reimbursement for such costs, should be recognized as income at the time of loan closing. Loan origination fees that are not reimbursements of such costs should be amortized to income over the expected loan period by application of the interest method."

Thus, existing accounting principles allow for a substantial exercise of discretion and so disparity in practice for accounting for front-end and other fees associated with syndicated international credits. Indeed, the accounting profession has recognized that clearer guidance is needed with respect to accounting for nonrefundable fees by financial institutions on all forms of credits. The AICPA has, for this reason, formed a task force to prepare an issues paper addressing the diversity in accounting practice. The study has been underway for several months and no recommendations have as yet been made.

C. Proposed supervisory guidelines for accounting for fees on syndicated international credits

There has developed an increased use of fees to cover a number of different purposes including additions to the yield of international syndicated credits. In view of the present diversity in accounting practice as to those fees among banks, and paucity of definitive guidance as to the appropriate accounting for the wide range of fees that has developed, the federal bank regulatory agencies consider that to achieve conformity and uniformity in accounting for fees the following guidelines should be established.

PROPOSED GUIDELINES

1. Front-end fees in most instances represent an adjustment to the interest yield and shall be deferred until the loan is issued, and then amortized over the expected life of the loan in relation to the outstanding loan balance using the interest method. Front-end fees, or the portion thereof, that are identifiable as reimbursement of direct costs shall be recognized as income at the time of the loan closing or restructuring.

2. Fees for guaranteeing the funding of a loan (i.e., commitment fees) shall be recognized as revenue over the combined commitment and loan period. Reimbursement of any direct loan processing costs will be recognized as income at closing. Then the straight line method, based on the combined life of the commitment and loan period, shall be applied to the remaining fee to recognize income during the commitment period. When the loan is disbursed, the interest method shall be applied to the balance of the fee to recognize income over the life of the loan. If the loan in fact is not funded, unamortized commitment fees will be recognized as income at the end of the commitment period.

3. Agency fees and advisory fees should be recorded as income when received to the extent they represent reimbursements for identifiable, direct costs, otherwise they should be amortized over the expected period of the loan.

COMMENTARY

A. In a syndicated credit, it is often difficult to determine what share of the front-end fees represent a reimbursement of direct costs of the Managing Bank(s) and what share represents an adjustment to the interest

yield. A reasonable presumption is that a Managing Bank should recognize a portion of the fee as an adjustment to interest yield based upon the other Participating Banks' share of the fee. Hence, it may be appropriate to consider the portion equal to the largest of any Participating Bank's*/ share of the front-end fee as an interest yield adjustment. The balance of a Managing Bank's share of a front-end fee, or some portion thereof, may be considered as reimbursement of direct costs if such costs are identifiable.

B. Proposed Guideline #2 reflects a presumption that commitment fees often embody three elements -- reimbursement of direct processing costs, remuneration from services in making commitments (such as assumption of risk of adverse changes in market interest rates over the commitment period), and a component that represents a yield adjustment. Determining the amount of each component may be difficult. When the separate components of the fees cannot reasonably be identified, the foregoing guideline provides a reasonable solution for recognizing the total fees over the combined commitment and expected loan period, and is the approach currently recommended in the Bank Audit Guide. The guideline also presumes that it is difficult to determine at the outset of a loan whether the loan in fact will need to be funded. Accordingly, a commitment fee should be accounted for over the combined life unless the loan is not actually funded.

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*/ A "Participating Bank" is not included in the Management Group for the credit nor does it assume any underwriting risk, i.e., the bank does not commit to lending obligations in excess of the amount it intends to lend in the transaction.

Glossary of Fees

1. Front End Fee: A flat fee paid by the Borrower to the Lending Bank(s). The fee is generally expressed as a percentage of the amount of the Credit Facility and is paid on the signing or disbursement dates of the Credit Facility. This fee is also sometimes referred to as a commission, financing fee, or flat fee.

a. Management Fee: The portion of the Front End Fee which is distributed to Lending Banks (in a Multi-bank Credit Facility) in differing amounts depending on their roles in the transaction (i.e. Managing Bank, "Underwriting Bank," Participant, etc.) and participation amount. Managing Banks normally receive a larger share of the Front End Fee than do Participants. There are numerous alternatives for payment of the Management Fee to accomplish different structure and pricing objectives. The Management Fee normally represents an interest yield paid in fee form and, in the case of Multi-bank Credit facilities, frequently includes an element of compensation for additional service provided or "underwriting risk" assumed.

b. Praecipuum: The portion of the Front End Fee which is distributed to one or more of the Lending Banks (generally Managing Banks) in a Multi-bank Credit Facility. This allocation of the Front End Fee serves as compensation for handling a disproportioniate share of the responsibility for arranging a Credit Facility or assuming an underwriting risk.

c. Pool: The residual amount resulting from the payment of Participating Banks in Multi-bank Credit Facilities of a less than full share of the Front End Fee. The Pool amount, which may or may not exceed the Praecipuum, is normally apportioned among Managing Banks on some preagreed upon formula and represents a form of compensation for the additional service provided by the Managing Bank(s) during the arrangement of the transaction.

2. Agency Fee: An annual fee paid to the Agent Bank by the Borrower and is normally intended to reimburse the Agent Bank for out-of-pocket expenses incurred in the performance of its administrative duties. Such expenses normally include telex, telephone, postage, printing, and travel. The amount of Agency Fee is generally fixed at the time of the signing of the Credit Agreement and varies in amount depending upon the number of Lending Banks participating in the Credit Facility, the complexity of the transaction and the frequency of communication with the Lending Banks.

3. Commitment Fee: This fee is paid by the Borrower and compensates Lending Banks for legally committing to lend to a Borrower at agreed upon terms and conditions at some future time. This fee is sometimes referred to as a Reservation Fee. This annual fee is customarily expressed as a percentage of the unused commitment from the Lending Bank and is normally paid quarterly in arrears.

4. Advisory Fee: A fee paid by a Borrower to compensate a bank(s) for a specific advisory service provided in relation to a transaction, such as a complex project loan. The advice may relate to the structure of the transaction or its arrangement and execution. This fee often is not listed in the loan agreement.

5. Expense Reimbursement: It is customary for a Borrower to reimburse banks active in arranging multi-bank or direct (i.e. one-bank) Credit Facilities for out-of-pocket expenses incidental to the arrangement of such facility. Normally these expenses include legal, telecommunications, travel and other expenses incurred during the arrangement of the Credit Facility and collection or enforcement costs.