INTERIM GUIDANCE ON THE REGULATORY REPORTING AND CAPITAL TREATMENT FOR DERIVATIVES, DECEMBER 1998

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In June 1998, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities" (FAS 133). FAS 133 provides comprehensive guidance on accounting for derivative instruments, including certain derivatives that are embedded in other contracts, and hedging activities.

Under FAS 133, banks, bank holding companies, and savings associations (collectively, banking organizations) must recognize all derivatives as either assets or liabilities on the balance sheet at fair value. If certain conditions are met, a derivative may be specifically designated as a "fair value hedge," a "cash flow hedge," or a "foreign currency hedge." The accounting for changes in the fair value of a derivative (that is, gains and losses) depends on the intended use of the derivative and the resulting designation. Derivatives used for trading or not qualifying as a hedge will continue to be marked to fair value, with changes in fair value recognized in current net income.

FAS 133 defines the three types of hedges as follows:

- A **fair value hedge** seeks to offset the exposure to changes in the fair value of a recorded asset or liability or firm commitment (the hedged item). The change in fair value (gain or loss) on the derivative (the hedging instrument) is recognized in net income together with any offsetting change in the fair value of the hedged item. The effect is that changes in fair value on both the hedged item and hedging instrument are recognized in the same period and any ineffectiveness of the hedge strategy is reflected in net income.

- A **cash flow hedge** seeks to offset the exposure to variable cash flows of a forecasted transaction or an existing floating rate asset or liability or pool of floating rate assets or liabilities. Under FAS 133, all hedges of anticipated transactions are considered cash flow hedges. The change in fair value (gain or loss) on the derivative that offsets the change in the hedged cash flow (the "effective portion") is recognized on the balance sheet in a separate component of equity (referred to in FAS 133 as "accumulated other comprehensive income"). The amount reflected in equity is recognized in net income when the hedged cash flow affects net income. The ineffective portion of the hedge is recognized immediately in net

income.

- A **foreign currency hedge** offsets the risk resulting from changes in foreign currency values. If specified criteria are met, an institution can use a derivative in a foreign currency fair value hedge, a foreign currency cash flow hedge, or a hedge of a net investment in a foreign operation. The accounting for a foreign currency hedge depends on the transaction, but generally will be treated like a fair value hedge or a cash flow hedge.

In addition to the accounting designation for hedges, FAS 133 requires that institutions separately account for certain types of embedded derivatives. Specifically, embedded derivatives that are not "clearly and closely related" to the economic characteristics and risks of the instruments in which they reside must be separated from the host instrument and reported separately on the balance sheet as a derivative. FAS 133 provides guidance on determining whether an embedded derivative is "clearly and closely related."

FAS 133 raises several important regulatory issues. This interim guidance explains the appropriate regulatory reporting and capital treatment of derivatives after a banking organization adopts this new accounting standard.

Interim Regulatory Reporting Treatment

For purposes of the bank Reports of Condition and Income (Call Report), the Consolidated Financial Statements for Bank Holding Companies (FR Y-9C), and Thrift Financial Report (TFR), all banking organizations must adopt FAS 133 for fiscal years beginning after June 15, 1999. Early adoption is also permitted to the extent allowable under FAS 133. Banking organizations must adopt FAS 133 for regulatory reporting purposes at the same time they adopt it for other financial reporting purposes. For banking organizations with a calendar year fiscal year that do not elect early adoption, the March 31, 2000, Call Report, FR Y-9C, or TFR will be the first report to be completed in accordance with FAS 133.

Under FAS 133, changes in the fair value of most derivatives will be reflected in net income. However, for derivatives that qualify as cash flow hedges, the accumulated gains (losses) on these derivatives, to the extent the hedges are effective, initially will be recorded in a separate component of equity capital (accumulated other comprehensive income).

The Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency have proposed a modification of the Call Report and FR Y-9C forms in March of 1999 to capture the amount of accumulated net gains (losses) on cash flow hedges in a separate line item on the balance sheet. In the interim, however, banks and bank holding companies that adopt FAS 133 should report any accumulated net gains (losses) on cash flow hedges on the same balance sheet line item that is currently used to report "Net

unrealized holding gains (losses) on available-for-sale securities" (Schedule RC, item 26.a, for banks and Schedule HC, item 27.e, for bank holding companies). In addition, any year-to-date changes in the accumulated net gains (losses) on cash flow hedges should be reported on the same line item that is currently used to report the "Change in net holding gains (losses) on available-for-sale securities" (Schedule RI-A - Changes in Equity Capital, item 11, for banks and Schedule HI-A, item 13, for bank holding companies).

In September 1998, the Office of Thrift Supervision changed the instructions to its TFR to accommodate reporting consistent with FAS 133, for 1998 and beyond. Pursuant to those instructions, savings associations that have adopted FAS 133 should report any accumulated gains (losses) on cash flow hedges on the same balance sheet line that is currently used to report "Other components of equity capital" (Schedule SC, line SC890). In addition, any quarter-to-date changes in the accumulated gains (losses) on cash flow hedges should be reported on the same supplemental information line that is currently used to report "Other adjustments" (Schedule SI, line SI670).

Interim Guidance on the Regulatory Capital Treatment

This interim guidance explains how derivatives and any gains or losses on derivatives are to be treated under the agencies' current regulatory capital standards after a banking organization adopts FAS 133. This treatment may have an effect on a banking organization's leverage and risk-based capital ratios. For example, since FAS 133 requires all derivatives to be reported at fair value on the balance sheet, banking organizations with derivatives may report higher total assets than they would have before adopting FAS 133. Additionally, the ineffective portion of any hedge is recorded directly in earnings and included in undivided profits (or retained earnings) and, therefore, included in Tier 1 capital.

The different accounting treatment for fair value hedges and cash flow hedges may also have an effect on regulatory capital ratios as described below.

Fair Value Hedges

For fair value hedges under FAS 133, an institution must recognize in earnings any change in the fair value of the derivative, as well as any offsetting changes in the fair value of the hedged asset or liability. The resulting change in the carrying value of a hedged asset could change reported total assets and risk-weighted assets, thereby affecting the denominator of both the leverage and risk-based capital ratios.

Cash Flow Hedges

To the degree a cash flow hedge is effective, changes in the fair value of the derivative are recorded directly in a separate component of equity. At present, the

accumulated net gains (losses) on cash flow hedges in this separate component of equity should not be included in (i.e., should be excluded from) regulatory capital. This approach is consistent with existing risk-based capital guidelines that exclude from regulatory capital the separate equity capital component for unrealized gains and losses on available-for-sale debt securities. However, the ineffective portion of the gains (losses) on cash flow hedges is immediately reported in net income, thereby affecting Tier 1 capital (i.e., the numerator) for both the leverage and risk-based capital ratios.

Risk-weights for Derivative Instruments

Under current accounting practice, many derivatives that are used for risk management purposes are kept off-balance sheet. Because these contracts may represent significant credit exposures, the risk-based capital standards require banking organizations to allocate capital for derivatives that pose these risks. The risk-based capital standards outline a two step process for calculating the amount to be included in risk-weighted assets for a derivative. First, the derivative must be converted to an on-balance-sheet credit equivalent amount.[1] Then, the credit equivalent amount is multiplied by a risk weight[2] and included in risk-weighted assets.

The existing risk-based capital treatment for derivatives remains in effect. In other words, the fact that an institution records a derivative on its balance sheet under FAS 133 will not change the way in which that derivative is risk-weighted for regulatory capital purposes. The amount to be included in risk-weighted assets for a derivative will continue to be based on the credit equivalent amount of the derivative, not the on-balance-sheet fair value.

Embedded Derivatives

If FAS 133 requires a banking organization to record a financial instrument and its embedded derivative separately, then the two components should be treated separately for both leverage and risk-based capital purposes. Banking organizations should calculate the credit equivalent amount of the derivative component and determine its appropriate risk weight according to the existing risk-based capital standards. The nonderivative component should be assigned a risk weight based on its characteristics as a separate instrument.

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[1] The credit equivalent amount of a derivative equals the fair value of the derivative (if it is positive) plus an additional amount for the potential future credit exposure. The potential future credit exposure additional amount is the notional amount of the derivative multiplied by a credit conversion factor which depends on the remaining maturity and type of contract, e.g., interest rate, foreign exchange, or equity.

[2] The risk weight is determined by criteria listed in each agency's risk-based standards and depends, in part, on the type of counterparty.