REVISIONS TO THE REPORTS OF CONDITION AND INCOME (CALL REPORT) FOR 1999

Unless otherwise indicated, the revisions described below apply to all four versions of the Call Report (FFIEC 031, 032, 033, and 034). Where appropriate, samples of the schedules that are being revised, or portions thereof, are shown to illustrate the specific changes in reporting requirements. These samples are from the FFIEC 034 report forms. The Call Report revisions will take effect as of the March 31, 1999, report date. In the report for that date, banks may report a reasonable estimate for any new or revised item for which the requested information is not readily available. In addition, the wording of the instructions presented below should be regarded as preliminary. An update to the Call Report instruction book will be distributed with the March 31, 1999, Call Report materials.

Contents

Deletions of Items

Schedule RC-B -- Securities

In April 1998, the FFIEC and its member agencies rescinded their 1992 *Supervisory Policy Statement on Securities Activities* and approved in its place a new *Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities*. In adopting the new policy statement, the agencies removed the 1992 policy statement's specific constraints concerning investments in high-risk mortgage securities, including its "high risk" tests, and substituted broader guidance covering all investment securities, including the establishment by each institution of appropriate risk limits. As a result, the FFIEC has eliminated from the securities schedule Memorandum items 8.a and 8.b for the amortized cost and fair value, respectively, of "High-risk mortgage securities."

Schedule RC -- Balance Sheet (FFIEC 034 only)

Banks with less than $100 million in assets that participated in the banking agencies' agricultural loan loss deferral programs, which were mandated by statute (12 U.S.C. 1823(j)) in 1987, reported the unamortized amount of their deferred losses on the balance sheet of the FFIEC 034 report. Under these programs, participating banks had to fully amortize their deferred losses by December 31, 1998. Accordingly, the FFIEC is deleting the four items that pertained to deferred agricultural loan losses (items 12.b, 12.c, 28.b, and 28.c) from the FFIEC 034 version of Schedule RC.

New Items Relating to Accumulated Net Gains (Losses) on Cash Flow Hedges

The Financial Accounting Standards Board (FASB) issued Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FAS 133), on June 16, 1998. This statement takes effect for fiscal years beginning after June 15, 1999, with earlier application encouraged by the FASB. Banks must adopt FAS 133 for Call Report purposes upon the statement's effective date based on their fiscal year, with earlier application permitted consistent with the statement. Most banks have calendar year fiscal years and, therefore, will not need to apply this accounting standard until January 1, 2000. However, some banks have fiscal years that will require them to begin applying FAS 133 during 1999, e.g., beginning on July 1, 1999. Furthermore, other banks may choose to adopt this new accounting standard earlier in 1999 or may already have adopted FAS 133.

Under FAS 133, all derivatives must be reported as either assets or liabilities on the balance sheet and must be carried at fair value. If certain conditions are met, a derivative may be specifically designated as a "cash flow hedge." In a cash flow hedge, to the extent the hedge is effective, the gain or loss on the derivative is not initially reported in earnings, but instead in a separate component of equity capital (referred to as "accumulated other comprehensive income" in FAS 133). The gain or loss will subsequently be recognized in earnings in the period or periods when the transaction being hedged affects earnings. The ineffective portion of the cash flow hedge is reported in earnings immediately. [1]

As part of the disclosure requirements of FAS 133, an institution must disclose the accumulated net gains (losses) on cash flow hedges that are included in equity capital as of the balance sheet date. An institution also must disclose the related change in these accumulated net gains (losses) during the reporting period. Accordingly, the FFIEC is adding a new item to the balance sheet and to the changes in equity capital schedule of the Call Report. Banks that have adopted FAS 133 will report any accumulated net gains (losses) on cash flow hedges as of the report date in new item 26.c in the equity capital section of the balance sheet (Schedule RC). Banks also will report the year-to-date change in these accumulated net gains (losses) in new item 11.b of the changes in equity capital schedule (Schedule RI-A). Existing item 11 on Schedule RI-A will be renumbered as item 11.a. The instructions for each new item are presented below following the illustration of the schedule, or portion thereof, in which the new item appears.

When a bank adopts FAS 133, derivatives held for purposes other than trading must be reported at fair value on the balance sheet (Schedule RC) in item 11, "Other assets," or item 20, "Other liabilities," as appropriate. Derivatives held for trading will continue to be reported at fair value on the balance sheet in item 5, "Trading assets," or item 15.b, "Trading liabilities," as appropriate.

Schedule RC – Balance Sheet:

EQUITY CAPITAL						
23.		Perpetual preferred stock and related surplus				23.
24.		Common stock				24.
25.		Surplus (exclude all surplus related to preferred stock				25.
26.	a.	Undivided profits and capital reserves				26.a.
	b.	Net unrealized holding gains (losses) on available-for-sale securities				26.b.
	c.	**Accumulated net gains (losses) on cash flow hedges**				26.c.
27.		Cumulative foreign currency translation adjustments				
28.		Total equity capital (sum of items 23 through 27)				28.
29.		Total liabilities and equity capital (sum of items 21 and 28)				29.

Schedule RC, Item 26.c, Accumulated net gains (losses) on cash flow hedges.[2] Report the effective portion[3] of the accumulated change in fair value (gain or loss) on derivatives designated and qualifying as cash flow hedges in accordance with FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

Under Statement No. 133, a bank that elects to apply hedge accounting must exclude from net income the effective portion of the change in fair value of a derivative designated as a cash flow hedge and record it on the balance sheet in a separate component of equity capital (referred to as "accumulated other comprehensive income" in the accounting standard). The ineffective portion of the cash flow hedge must be reported in earnings. The equity capital component (i.e., the accumulated other comprehensive income) associated with a hedged transaction should be adjusted each reporting period to a balance that reflects the lesser (in absolute amounts) of:

(1) The cumulative gain or loss on the derivative from inception of the hedge, less (a) amounts excluded consistent with the bank's defined risk management strategy and (b) the derivative's gains or losses previously reclassified from accumulated other comprehensive income into earnings to offset the hedged transaction, or
(2) The portion of the cumulative gain or loss on the derivative necessary to offset the cumulative change in expected future cash flows on the hedged transaction from inception of the hedge less the derivative's gains or losses previously reclassified from accumulated other comprehensive income into earnings.

Accordingly, the amount reported in this item should reflect the sum of the adjusted balance (as described above) of the cumulative gain or loss for each derivative designated and qualifying as a cash flow hedge. These amounts will be reclassified into earnings in the same period or periods during which the hedged transaction affects earnings (for example, when a hedged variable-rate interest receipt on a loan is accrued or when a forecasted sale occurs.)

Schedule RI-A – Changes in Equity Capital:

1.		Total equity capital originally reported in the December 31, 1998, Reports				
		of Condition and Income				1.
2.		Equity capital adjustments from amended Reports of Income, net				2.
3.		Amended balance end of previous calendar year (sum of items 1 and 2)				3.
4.		Net income (loss) (must equal Schedule RI, item 12)				4.
5.		Sale, conversion, acquisition, or retirement of capital stock, net				5.
6.		Changes incident to business combinations, net				6.
7.		LESS: Cash dividends declared on preferred stock				7.
8.		LESS: Cash dividends declared on common stock				8.
9.		Cumulative effect of changes in accounting principles from prior years (see				
		instructions for this schedule)				9.
10.		Corrections of material accounting errors from prior years (see instructions				
		for this schedule)				10.
11.	a.	Change in net unrealized holding gains (losses) on available-for-sale				
		securities				11.a.
	b.	**Change in accumulated net gains (losses) on cash flow hedges**				11.b.
12.		Other transactions with parent holding company (not included in				
		items 5, 7, or 8 above)				12.
13.		Total equity capital end of current period (sum of items 3 through 12)				
		(must equal Schedule RC, item 28)				13.

Schedule RI-A, Item 11.b, Change in accumulated net gains (losses) on cash flow hedges. Report the change during the calendar year to date in Schedule RC, item 26.c, "Accumulated net gains (losses) on cash flow hedges." If the amount represents a reduction in the bank's equity capital, enclose it in parentheses.

Reporting of Nonmortgage Servicing Assets

In August 1998, the banking agencies amended their capital standards to revise the regulatory capital treatment of servicing assets. Under this amendment, nonmortgage servicing assets began to be recognized (rather than deducted) for regulatory capital purposes. However, nonmortgage servicing assets are subject to the 25 percent of Tier 1 capital sublimit that previously applied only to purchased credit card relationships. The overall limitation on the amount of servicing assets (when combined with purchased credit card relationships) that can be recognized for regulatory capital purposes increased to 100 percent of Tier 1 capital.

To date, banks have reported their nonmortgage servicing assets as part of "All other identifiable intangible assets" in item 6.b.(2) of Schedule RC-M -- Memoranda. This is because, prior to the August 1998 amendment, these identifiable intangibles generally were deducted in full from Tier 1 capital and from assets in regulatory capital calculations. On the other hand, banks have reported their purchased credit card relationships in item 6.b.(1) of Schedule RC-M. As a result of the revised regulatory capital treatment of nonmortgage servicing assets, the FFIEC is changing the item in which these assets are reported. The scope of item 6.b.(1) of Schedule RC-M will be expanded so that it includes both "Purchased credit card relationships and nonmortgage servicing assets." Distinguishing nonmortgage servicing assets from "All other identifiable intangible assets" in this manner will enable the agencies to verify the regulatory capital amounts that banks report in the Call Report and to calculate their regulatory capital ratios.

Schedule RC-M -- Memoranda:

6.	Intangible assets:				
	a.		Mortgage servicing assets		6.a
		(1)	Estimated fair value of mortgage servicing assets		6.a.(1)
	b.		Other identifiable intangible assets:		
		(1)	**Purchased credit card relationships and nonmortgage servicing assets**		6.b.(1)
		(2)	All other identifiable intangible assets		6.b.(2)
	c.		Goodwill		6.c.
	d.		Total (sum of items 6.a, 6.b.(1), 6.b.(2), and 6.c) (must equal Schedule RC, item 10)		6.d.
	e.		Amount of intangible assets (included in item 6.b.(2) above) that have been grandfathered or are otherwise qualifying for regulatory capital purposes		6.e.

The revised instructions for Schedule RC-M, items 6.b.(1) and 6.b.(2), are presented below. Revisions to the existing instructions (on page RC-M-5 of the Call Report instruction book) are shown in italics.

Item 6.b.(1), Purchased credit card relationships *and nonmortgage servicing assets*. *Report the carrying value of purchased credit card relationships plus the carrying value of nonmortgage servicing assets.*

Purchased credit card relationships represent the right to conduct ongoing credit card business dealings with the cardholders. In general, purchased credit card relationships are an amount paid in excess of the value of the purchased credit card receivables. *Such relationships arise* when the reporting bank purchases existing credit card receivables and also has the right to provide credit card services to those customers. *Purchased credit card relationships may also be acquired when the reporting bank purchases* an entire depository institution.

Purchased credit card relationships shall be carried at amortized cost, not in excess of the discounted amount of estimated future net cash flows. Management of the institution shall review the carrying value at least quarterly, adequately document this review, and adjust the carrying value as necessary. If unanticipated acceleration or deceleration of cardholder payments, account attrition, changes in fees or finance charges, or other events occur that reduce the amount of expected future net cash flows, a writedown of the book value of the purchased credit card relationships shall be made to the extent that the discounted amount of estimated future net cash flows is less than the asset's carrying amount.

The carrying value of nonmortgage servicing assets is the unamortized cost of acquiring contracts to service financial assets, other than loans secured by real estate (as defined for Schedule RC-C, part I, item 1), that have been securitized or are owned by another party, net of any related valuation allowances. For further information, see the Glossary entry for "servicing assets and liabilities."

Item 6.b.(2), All other identifiable intangibles. Report the unamortized amount (book value) of all other specifically identifiable intangible assets such as core deposit intangibles and favorable leasehold rights.

Instructional Changes

Computer Software Costs

In March 1998, the American Institute of Certified Public Accountants (AICPA) issued Statement of Position (SOP) 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*. SOP 98-1 provides guidance on whether costs of internal-use software should be capitalized (and then amortized) or expensed as incurred. This SOP is effective for fiscal years beginning after December 15, 1998. For Call Report purposes, banks must adopt this SOP upon its effective date based on their fiscal year with early application permitted in accordance with the transition guidance in the SOP. The Call Report instructions are being revised to conform with SOP 98-1, including replacing the current Glossary entry for "Internally Developed Computer Software" (located on page A-50 of the Call Report instruction book) with the following new Glossary entry for "Internal-Use Computer Software."

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 the 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.

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 computer 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, Lease, 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.

Costs of Start-Up Activities

In April 1998, the AICPA issued SOP 98-5, *Reporting on the Costs of Start-Up Activities*. SOP 98-5 requires costs of start-up activities, including organization costs, to be expensed as incurred. This SOP is effective for fiscal years beginning after December 15, 1998. Banks must adopt this SOP for Call Report purposes upon its effective date based on their fiscal year. Early application is permitted in accordance with the transition guidance in the SOP. The Call Report instructions are being revised to conform with SOP 98-5, including replacing the current Glossary entry for "Organization Costs" (located on pages A-64 and A-65 of the Call Report instruction book) with the following new Glossary entry for "Start-up Activities." Discussions of pre-opening income and expenses elsewhere in the instructions for the Report of Income would also be revised to conform with this new Glossary entry.

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.[4]

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 uses 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 through 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 through 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 9. 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.

Reporting of Investment Securities

In April 1998, the FFIEC and its member agencies rescinded their 1992 *Supervisory Policy Statement on Securities Activities* and approved in its place a *Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities*. The new policy statement does not retain the section of the 1992 policy statement addressing the reporting of securities activities, including a description of practices considered unsuitable when conducted in an institution's investment portfolio. When the FFIEC and the agencies published the *Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities*, they stated an intent to separately issue supervisory guidance on the reporting of investment securities. The FFIEC is adding the following new Glossary entry to the Call Report instructions to provide readily accessible guidance on this reporting matter to banks as they prepare their Call Reports.

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 purchaser 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 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.
(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 by 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.

Re-Booking Charged-Off Loans

"Re-booking" or "writing up" a loan or lease on which a full or partial direct write-down has previously been taken is not an acceptable practice under generally accepted accounting principles (GAAP) and, therefore, is not acceptable for Call Report purposes. To clarify this issue, the FFIEC is revising the Glossary entry for "Allowance for Loan and Lease Losses" through the addition of the following new fifth paragraph. The remainder of this Glossary entry (located on pages A-3 and A-4 of the Call Report instruction book) will not be changed.

Glossary entry for "Allowance for Loan and Lease Losses," new fifth paragraph -- 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.

Goodwill Transactions

Under GAAP, goodwill and similar intangible assets ordinarily cannot be disposed of apart from an enterprise as a whole. GAAP further states that an intangible asset such as goodwill should not be written off in the period of acquisition. To provide additional guidance on the proper accounting for goodwill, the FFIEC is revising the instructions for Schedule RC-M, item 6.c, "Goodwill," (found on page RC-M-6 of the Call Report instruction book) as well as a portion of the Glossary entry for "Business Combinations" that discusses "Purchase acquisitions" (found on page A-12 of the instruction book). These revisions are presented below and highlighted in italics.

Schedule RC-M, item 6.c, Goodwill. Report the amount (book value) of unamortized goodwill. Goodwill represents the excess of the cost of a company over the sum of the fair values of the tangible and identifiable intangible assets acquired less the fair value of liabilities assumed in a business combination accounted for as a purchase.

Goodwill and similar intangible assets ordinarily cannot be disposed of apart from an institution as a whole. Accordingly, a bank may not remove goodwill from its balance sheet by "selling" or "dividending" this asset to its parent holding company or another afFILiate. An exception to the rule precluding the disposal of goodwill is made when a large segment or separable group of assets of an acquired company or an entire acquired company is sold or otherwise liquidated. In that case, some or all of the unamortized goodwill recognized in the acquisition should be included in the cost of the assets sold.

The amount of goodwill reported in this item should not be reduced by any negative goodwill. Any negative goodwill arising from a business combination accounted for as a purchase must be reported in Schedule RC-G, item 4, "Other" liabilities, and in Schedule RC, item 20, "Other liabilities."

Glossary entry for "Business Combinations," revised second paragraph of the section on "Purchase acquisitions" -- Any excess of the cost of the acquisition over the net fair value of the identifiable assets and liabilities acquired or assumed is purchased goodwill. Identifiable and unidentifiable intangible assets (i.e., goodwill) are reportable in Schedule RC, item 10, "Intangible assets," and in Schedule RC-M, item 6. *An intangible asset such as goodwill should not be written off in the year of its acquisition.* Instead, consistent with Securities and Exchange Commission guidance, all intangible assets should be amortized over their estimated useful lives, generally not to exceed 25 years. The amortization expense of purchased goodwill and any other intangible assets shall be reported in Schedule RI, item 7.c, "Other noninterest expense," and in Schedule RI-E, item 2.a.

Reporting of Net Risk-Weighted Assets by Banks Subject to the Market Risk Capital Guidelines (FFIEC 031 and 032 only)

Banks that are subject to the market risk capital guidelines must report the amount of their "Market risk equivalent assets" in item 3.d.(2) of Schedule RC-R -- Regulatory Capital. These banks report their "Net risk-weighted assets" in item 3.d.(1) of this schedule, but the current instructions for this item specifically tell banks to exclude market risk equivalent assets. The sum of the amounts reported in items 3.d.(1) and 3.d.(2) is the denominator of the bank's total risk-based capital ratio.

In contrast, the instructions to the Federal Reserve Board's FR Y-9C bank holding company report direct these organizations to include market risk equivalent assets in "Net risk-weighted assets." In order to achieve greater consistency between the two reports, the FFIEC is revising the Call Report instructions for Schedule RC-R, item 3.d.(1), "Net risk-weighted assets," to include market risk equivalent assets. In addition, the caption for Schedule RC-R, item 3.d.(2), will be modified to read "Market risk equivalent assets included in net risk-weighted assets above."

The revised first paragraph of the instructions for Schedule RC-R, item 3.d.(1), is presented below. The second and third paragraphs of the instructions for this item will not be changed. Revisions to the existing instructions (located on page RC-R-13 of the Call Report instruction book) are shown in italics.

Schedule RC-R, item 3.d.(1), Net risk-weighted assets. Report the amount of the bank's risk-weighted assets net of all deductions. *The amount reported in this item is* the denominator of the bank's total risk-based capital ratio *and, thus, should include any amount reported in Schedule RC-R, item 3.d.(2), "Market risk equivalent assets."*

Determining the Tier 2 Capital Limit on the Allowance for Loan and Lease Losses for a Bank with Low Level Recourse Transactions

The instructions for reporting low level recourse transactions in Schedule RC-R -- Regulatory Capital give banks the option of using either the "gross-up method" or the "direct reduction method." However, the instructions do not explain how banks choosing the "direct reduction method" should calculate the amount of the allowance for loan and losses that can be included in Tier 2 capital. To clarify this matter, the FFIEC is adding guidance on the allowable allowance calculation to pages RC-R-5 and RC-R-6 of the instructions for Schedule RC-R.

Revised instructions on the "Treatment of Low Level Recourse Transactions" in the General Instructions to Schedule RC-R -- The first paragraph, the two bullet point paragraphs immediately following the first paragraph, and the second paragraph will not be changed. The remainder of this section of the General Instructions to Schedule RC-R would be revised as shown in italics:

- If the bank chooses to use the "direct reduction method," the "maximum contractual dollar amount of recourse exposure," as defined above, should be reported in Schedule RC-R, item 3.e. In addition, the bank should report as a credit equivalent amount in Schedule RC-R, item 7.b, column B, an "institution-specific add-on factor" for its low level recourse exposure. The amount of this factor also should be included in the "net risk-weighted assets" that the bank reports in Schedule RC-R, item 3.d.(1). The "institution-specific add-on factor," which is independent of the risk weight category of the assets to which the recourse applies, is calculated as follows:

$$F = \frac{C \times A}{C - R} - A$$

  where
  F = institution-specific add-on factor;
  C = total risk-based capital (as reported in Schedule RC-R, item 3.b);
  A = net risk-weighted assets excluding low level recourse exposures; and
  R = maximum contractual dollar amount of recourse exposure in low level recourse transactions (as reported in Schedule RC-R, item 3.e)

For purposes of calculating the amount of the bank's total risk-based capital to be used in the preceding formula (C in the formula) and to be reported in Schedule RC-R, item 3.b, the bank should determine the Tier 2 capital limit on the allowance for loan and lease losses by multiplying its "maximum contractual dollar amount of recourse exposure" (R in the preceding formula, as defined in these instructions) by 12.5 and adding this product to its gross risk-weighted assets excluding low level recourse exposures. This adjusted gross risk-weighted-assets figure multiplied by 1.25 percent is the bank's Tier 2 limit on the allowance for loan and lease losses. Once this limit on the allowance has been calculated, the limit is fixed at this amount. This limit should not be changed after the bank calculates the actual amount of its net risk-weighted assets excluding low level recourse exposures (A in the preceding formula) or its institution-specific add-on factor for low level recourse under the "direct reduction method" (F in the preceding formula). This means that a bank will measure its Tier 2 capital and its total risk-based capital prior to its application of the "direct reduction method" and will not recalculate these two amounts once the add-on factor is known.

- If the bank chooses to use the "gross-up method," the "maximum contractual dollar amount of recourse exposure" for a transaction, as defined above, should be multiplied by a factor of 12.5, 25, or 62.5 according to whether the assets sold would be assigned to the 100 percent, 50 percent, or 20 percent risk weight category, respectively. The resulting dollar amount should be reported as an off-balance sheet credit equivalent amount in column B of Schedule RC-R in the item (item 7.b, 6.b, or 5.b) appropriate to the risk weight category of the assets sold.

For example, a bank has sold $2 million in first lien residential mortgages subject to two percent recourse. The bank has removed the $2 million in mortgages from its Call Report balance sheet and, in accordance with GAAP, has also established a recourse liability account with a balance of $10,000. The maximum amount for which the bank is liable is $40,000. The mortgages qualify for a 50 percent risk weight and the bank's recourse exposure is less than the $80,000 minimum risk-based capital requirement for these assets sold with recourse. Thus, the low level recourse rule applies. The "maximum contractual dollar amount of recourse exposure" for this transaction is $30,000, the $40,000 maximum contractual amount of the bank's recourse exposure as of the report date, less the $10,000 balance of the recourse liability account for this transaction. *The bank has gross risk-weighted assets excluding low level recourse exposures of $100 million, Tier 1 capital of $8 million, an allowance for loan and lease losses of $1.1 million, and other qualifying Tier 2 capital components of $1.4 million.*

- If the bank chooses to use the "direct reduction method," the bank would report $30,000 -- its "maximum contractual dollar amount of recourse exposure" -- in Schedule RC-R, item 3.e, and would use this amount to calculate its institution-specific add-on factor using the formula provided above. *To determine the Tier 2 capital limit for the bank's allowance for loan and lease losses, the bank would first add $375,000 ($30,000 - its "maximum contractual recourse exposure" - multiplied by 12.5) to its $100 million of gross risk-weighted assets excluding low level recourse exposures. Its Tier 2 capital limit for the allowance would be $1,254,688 ($100,375,000 - its adjusted gross risk-weighted assets - multiplied by 1.25 percent limit -- the limit for the allowance). Since the bank's $1.1 million allowance is less than its Tier 2 capital limit for the allowance, the bank would report an "excess allowance for loan and lease losses" of $0 in Schedule RC-R, item 3.c. The bank's total risk-based capital is $10.5 million and its net risk-weighted assets excluding low level recourse exposures are $100 million.* Based on the facts in the example, the bank calculates that its institution-specific add-on factor is $286,533. The bank would report the amount of this add-on factor as a credit equivalent amount in Schedule RC-R, item 7.b, column B, and also include this amount in the "net risk-weighted assets" that it reports in Schedule RC-R, item 3.d.(1).

- If the bank chooses to use the "gross-up method," the bank would report $750,000 as a credit equivalent amount in Schedule RC-R, item 6.b, column B ($30,000 -- its "maximum contractual dollar amount of recourse exposure" -- multiplied by 25 -- the factor for assets that qualify for a 50 percent risk weight). Because the $2 million in mortgages sold have been removed from the balance sheet, the difference between the $750,000 credit equivalent amount and the $2 million is not reported in Schedule RC-R. In addition, because the $750,000 credit equivalent amount is assigned to the 50 percent risk category, the bank would include $375,000 ($750,000 multiplied by 50 percent) *in its gross risk-weighted assets for purposes of determining the Tier 2 capital limit for the allowance for loan and lease losses and* in the "net risk-weighted assets" that it reports in Schedule RC-R, item 3.d.(1).