

STATEMENT OF THE
FINANCIAL ACCOUNTING STANDARDS BOARD
TO THE
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS
COMMITTEE ON ENERGY AND COMMERCE
U.S. HOUSE OF REPRESENTATIVES

APRIL 24, 1986

The Financial Accounting Standards Board (FASB) appreciates this opportunity to submit this statement to the Subcommittee. The pronouncements of the FASB apply broadly to all business enterprises that prepare financial statements in accordance with generally accepted accounting principles, including financial institutions.

In response to requests from the Subcommittee staff, this submission addresses the following topics:

1. Accounting for regulatory assistance programs including the use of Income Capital Certificates and Permanent Income Capital Certificates
2. Accounting for troubled debt restructurings in accordance with FASB Statement No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings.

Accounting for Regulatory Assistance Programs

Financial institutions are required to maintain a minimum level of net worth or capital for regulatory purposes. The Federal Home Loan Bank Board (FHLBB) and the three banking regulators, the Federal Reserve Board, the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency, require institutions under their jurisdictions to follow generally accepted accounting principles when reporting to the regulatory agencies unless different regulatory accounting principles apply.

Faced with widespread weakness in financial institutions, regulators have on some occasions prescribed accounting practices that provide a means for institutions to meet minimum net worth requirements rather than to acknowledge directly that they are permitting exceptions to those requirements. The FASB has reviewed and commented on a number of those regulatory accounting proposals. In each case, the Board or its staff has acknowledged that a regulatory body may have specific needs or objectives that lead it to depart from generally accepted accounting principles. However, each response has emphasized the importance of following generally accepted accounting principles in general purpose financial statements provided to shareholders, depositors, and other users of that financial information. Our comments on those proposals were submitted to the Subcommittee as part of our November 7, 1985 testimony and are attached to the letters to the SEC included in this submission.

Actions taken by regulatory agencies to permit financial institutions to meet regulatory requirements have included lowering the regulatory net worth requirement and allowing special exceptions to generally accepted accounting

principles for reporting certain transactions in financial statements prepared for regulatory purposes. Some of these exceptions include deferring recognition of realized losses from sales of mortgage assets by spreading recognition of those losses over the remaining life of the mortgages sold and presenting certain fixed assets at appraised values if greater than amortized historical cost.

Regulatory agencies have also provided financial assistance to institutions. FASB Statement No. 72, Accounting for Certain Acquisitions of Banking or Thrift Institutions, specifies the accounting for financial assistance granted to an enterprise by a regulator in connection with an acquisition of a financial institution. Regulatory agencies have also designed assistance programs in which a regulatory insurer gives a promissory note to an institution in exchange for securities such as Net Worth Certificates (NWCs), Income Capital Certificates (ICCs), or Permanent Income Capital Certificates (PICCs) that are considered net worth of the institution for regulatory purposes.

Accounting for Income Capital and Permanent Income Capital Certificates

The PICC is the most recent development in the evolution of regulatory assistance programs. A PICC is a variation of the ICC, an assistance program first used by regulators in the early 1980's. The FASB understands that to date ICCs or PICCs have been issued by financial institutions in connection with the acquisition of failing savings institutions or the placement of institutions in the Management Consignment Program of the Federal Savings and Loan Insurance Corporation (FSLIC). When ICCs or PICCs are issued in connection with an acquisition, the FSLIC, as receiver of a

failed institution that is being acquired and as the insurer of a significant portion of that thrift's savings deposits, transfers the assets and liabilities of the failed thrift to the acquiring institution. The acquired institution's liabilities usually exceed the fair value of its assets. The acquirer is willing to assume the net liabilities for many reasons, including financial assistance granted by the regulator. That assistance can take a variety of forms. The form of assistance that generally accompanies the ICC/PICC arrangement is to include a promissory note from the FSLIC. The acquiring thrift issues an ICC or a PICC to the FSLIC with a face amount equal to the face amount of the FSLIC note.

The FASB recently considered the accounting by a savings and loan association for the proposed issue of an ICC or a PICC and receipt of a promissory note from the FSLIC. In a letter dated March 28, 1986 to Mr. A. Clarence Sampson, Chief Accountant of the SEC, James J. Leisenring, FASB Director of Research and Technical Activities, described the FASB staff's conclusion that the issuance of a PICC in return for an FSLIC promissory note should not cause the savings and loan association to report a net increase in liabilities or equity in general purpose financial statements until the FSLIC promissory note is sold. The promissory note and the PICC together comprise a package of regulatory assistance and should not be viewed in isolation from one another, but should be viewed as interrelated aspects of a single transaction. To focus only on the note or only on the PICC would overlook essential parts of the transaction.

That letter sets forth the specifics of the proposed PICC arrangement, the information supplied to the FASB, and the staff's conclusions on the appropriate accounting as well as reasons supporting the staff's

conclusions. The FASB staff's conclusion is equally applicable to the accounting by the issuer of an ICC. In another letter to Mr. Sampson dated March 28, 1986, Donald J. Kirk, FASB Chairman, indicated that the Board had discussed PICC accounting at a public Board meeting held on March 27, 1986, reviewed the conclusions expressed in the staff letter, and endorsed those views. Copies of those two letters are attached.

Accounting for Troubled Debt Restructurings

Recent testimony of banking regulators before committees of the U.S. Congress has focused attention on Statement 15 as the appropriate authoritative literature to be used by banks with loan concentrations in certain troubled industries in accounting for the restructuring of those loans. The accounting has been characterized by some as a means for banks to avoid recognizing losses on those loans.

The FASB issued Statement 15 in June 1977 to establish standards of financial accounting and reporting by the borrower and lender for a troubled debt restructuring. Statement 15 does not address accounting for allowances for estimated uncollectible amounts. The Board had previously addressed the accounting and disclosure for estimated losses on receivables in FASB Statement No. 5, Accounting for Contingencies, and the principle that a loss is recognized when full collection becomes doubtful existed long before that. The complete conclusions and rationale are included in Statement 15. The summary which follows is a general description of the issues and the conclusions in the standard.

A lender loans cash with the expectation that the future cash receipts, both those designated as interest and those designated as face amount, specified by the terms of the agreement will provide a return of the amount loaned as well as a return or yield on the loan. The difference between the amount a lender loans and the amount it receives from the borrower's payments of interest and face amount is the return on the investment for the entire period the receivable is held. A major accounting question is the attribution of this yield to the periods of time that the receivable is held.

Statement 15 defines a troubled debt restructuring as follows:

A restructuring of a debt constitutes a troubled debt restructuring . . . if the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider. That concession either stems from an agreement between the creditor and debtor or is imposed by law or a court. For example, a creditor may restructure the terms of a debt to alleviate the burden of the debtor's near-term cash requirements, and many troubled debt restructurings involve modifying terms to reduce or defer cash payments required of the debtor in the near future to help the debtor attempt to improve its financial condition and eventually be able to pay the creditor. Or, for example, the creditor may accept cash, other assets, or an equity interest in the debtor in satisfaction of the debt though the value received is less than the amount of the debt because the creditor concludes that step will maximize recovery of its investment.

A troubled debt restructuring can involve (a) a transfer from the borrower to the lender of receivables from third parties, real estate, or other assets in full or partial satisfaction of the debt; (b) issuance or other granting of an equity interest to the lender by the borrower in full or partial satisfaction of the debt; (c) a modification of the terms of the debt; or (d) some combination of the above. The modifications of the terms of a debt referred to in (c) above include (i) a reduction of the stated

interest rate, (ii) extension of the maturity date or dates at a stated interest rate lower than the current market rate for new debt with similar risk, (iii) reduction of the face amount of the debt, (iv) reduction of previously accrued interest, or (v) some combination of the above (i-iv).

Statement 15 distinguishes troubled debt restructurings based on their substance. The Board concluded that troubled debt restructurings could be considered as two types: (a) those that involve transfers of resources by the borrower to the lender in full settlement of the borrower's obligation and (b) those that involve a modification of terms whether or not the modification involves the transfer of resources by the borrower to the lender. In Statement 15, the Board concluded that a troubled debt restructuring that involves the transfer of receivables from third parties, real estate, or other assets or the issuance or other granting of equity interests to settle fully a loan requires accounting for the resources transferred at fair value and recognition of gain or loss. In contrast, if a troubled debt restructuring involves a modification of terms without the full settlement through a transfer of resources, the restructured debt is considered a continuation of the existing debt with modified terms.

The majority of the attention on Statement 15 in recent weeks has focused on the standards related to the lender's accounting in a troubled debt restructuring that involves a modification of terms. Accordingly, this submission concentrates on accounting by the lender that is set forth in Statement 15 for this type of restructuring.

Modification of Terms of a Loan

Modification of terms of debt is not unusual for financial institutions. In the comment letter received from the Federal Reserve System while the FASB was formulating Statement 15, then Chairman Dr. Arthur F. Burns noted that "in the ordinary course of business, commercial banks typically expect to encounter numerous situations in which the terms and conditions of particular credits need to be recast." Others in the banking community have also indicated that restructuring of debt is a normal and expected part of the banking business.

This Subcommittee has heard testimony that the accounting set forth in Statement 15 does not result in a lender reflecting a loss when a lender agrees to a troubled debt restructuring. Restructurings, whether considered troubled or not, affect the contractual cash flows between the borrower and the lender but may not require accounting recognition until other events occur.

In a troubled debt situation, the borrower is unable to perform under the terms of the existing loan agreement. In these circumstances, the lender evaluates the alternatives available to maximize its cash flows from the loan. In assessing its cash flow prospects, a lender may look either to collections from the borrower--the likely future cash receipts of interests and face amount--or to amounts recoverable from potential pursuit of specific collateral or other assets of the borrower. In order to maximize realization of future cash flows, the lender may grant a concession to the borrower, a concession not contemplated when the loan was made and one that would not otherwise be granted absent the borrower's financial

difficulties. In granting the concession, the lender unilaterally may forfeit its right to otherwise contractual cash flows. Whether granting the concession provides the basis for recognition of a loss requires analysis of the terms of the concession; a loss is not recognized merely because the loan is nonperforming and the original loan terms have been modified.

Whatever the form of the concession granted to the borrower, the lender's objective is to make the best of a difficult situation because the borrower has financial difficulties. The lender grants concessions to improve the prospects of collectibility or enhance the value of a nonperforming loan. Depending on the type of concession granted and whether that concession is granted in partial or full settlement of the borrower's obligation, different accounting issues arise.

Two major issues arise in accounting by a lender for a troubled debt restructuring that involves a modification of terms. The first issue involves whether to:

- a. make no change in the recorded investment for the receivable and recognize the effects of the modification in the future as reduced interest income over the term of the restructured debt, or
- b. recognize a loss by reducing the recorded investment and thereafter recognize higher interest income.

The interest method is used in both alternatives (a) and (b) to attribute interest income to periods between restructuring and the maturity date. The implicit annual interest rate will be higher and the resulting interest

income will be greater in each of the remaining periods if the lender recognizes a loss at the date of the restructuring rather than accounting in the future for the modified terms.

The second issue involves two related questions. The first question is whether the accounting alternative selected above should apply both to modifications in the timing of payments and to modifications in the amounts to be paid. The second question is whether the same accounting should apply both to modifications of amounts designated as interest and to modifications of amounts designated as face amount.

Statement 15 concluded that if a restructuring involves a modification of terms, the restructured loan continues an existing loan with changed terms. The effect on total cash flows is the issue, not whether the modifications apply to the cash flows designated as face amount or those designated as interest. The lender's primary objective is to enhance the prospects for recovery of its investment by reducing the effective interest rate from the restructuring to maturity. A lender would generally prefer to alleviate the borrower's cash difficulties by deferring payment of the amount designated as face amount rather than by reducing it because deferring payment may better preserve a lender's maximum claim in the event of the borrower's bankruptcy. Statement 15 requires that the accounting for that kind of modification be consistent with the accounting for other modifications of terms affecting future cash flows.

Statement 15 provides that accounting for the restructured debt should be based on the effect on cash flows--not on the labels used to designate those amounts. Statement 15 views the lender-borrower relationship as

encompassing all required cash flows under the agreement, not merely by the cash flows designated as repayment of the face amount. The recorded investment in a receivable represents the present value of all future cash receipts specified by the terms of the debt discounted at an effective interest rate. Whether an amount due at a particular time is described as face amount or interest does not affect either the present value of the receivable or its effective interest rate.

Statement 15 requires loss recognition to the extent that the restructured aggregate cash flows are less than the recorded investment of the receivable concluding that a troubled debt restructuring involving a modification of terms affects primarily the future effective interest rate. Accordingly, the effective interest rate implicit in the restructured receivable and the aggregate cash flows specified by the modified terms are used by the lender to recognize interest income between the date of restructuring and the maturity date. Appendix A illustrates accounting for a troubled debt restructuring under Statement 15 in a variety of circumstances.

Statement 15 also requires disclosures by lenders involved in troubled debt restructurings of the effects of those restructurings. They must disclose the aggregate recorded investment, the gross interest income that would have been recorded in the period on those receivables without the restructuring, and the amount of interest income that was included in net income for the period. Those required disclosures serve to inform users of the lender's financial statements about the concessions granted to the borrower.

The accounting set forth in Statement 15 is generally symmetrical for the lender and the borrower. Thus, in restructurings that involve a

modification of terms, the borrower recognizes no gain unless the carrying amount of the debt exceeds the total future cash payments specified by the new terms. The effects of the restructuring are reflected in future periods by the borrower as lower interest expense.

When the FASB solicited public comment on the accounting that is now set forth in Statement 15, some respondents argued that the lender should adjust the restructured loan to its fair value by discounting the modified cash flows at a current market rate or, alternatively, subject the modified terms to a present value calculation with the cash flows discounted at the pre-restructuring rate. Other respondents advocated loss recognition only by the lender in restructurings that involved a reduction of the amount designated as face amount. If either of those approaches had been adopted in Statement 15, lenders would generally recognize a loss at the date of restructuring followed by recognizing higher interest income on the modified loan. Many continue to advocate these alternative approaches, and the Subcommittee has heard testimony to that effect. The Board rejected both of those approaches for debt restructurings involving a modification of terms.

Evaluation of Collectibility

Restructured debt accounted for in accordance with Statement 15 does not relieve a financial institution of its obligation under Statement 5 and earlier generally accepted accounting principles to evaluate the collectibility of the amounts due under newly restructured terms. The fact that the loan arrangement needs to be restructured is evidence that ultimate collectibility is not assured. If careful assessment of a loan receivable shows that full collection is still questionable after a restructuring,

Statement 5 requires recognition of the loss if the loss has not already been recognized or if prior recognition was inadequate. Recognition of loss on a receivable is required if both of the following conditions are met:

- a. Information available prior to issuance of the financial statements indicates that it is probable that an asset has been impaired at the date of the financial statements. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of loss.
- b. The amount of the loss can be reasonably estimated.

FASB Technical Bulletin No. 79-6, Valuation Allowances Following Debt Restructuring, and footnotes 18 and 34 of Statement 15 provide that an assessment of the collectibility of a receivable with modified terms is necessary following a troubled debt restructuring. Collectibility may be assessed for individual receivables or for groups of similar types of receivables. Recognition of loss is required even though the particular receivables that are uncollectible may not be identifiable.

In issuing Statement 15, the FASB knew its provisions would be controversial. The standard resulted from the Board's normal procedures which involve extensive due process prior to the issuance of a final standard. In reaching the conclusions set forth in the standard, the Board considered and ultimately rejected a number of accounting alternatives. The reasons for the Board's acceptance or rejection of various views are summarized in the Basis for Conclusions portion of the standard. Copies of the Statement and the public record supporting it have been submitted under separate cover to the staff of the Subcommittee.

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The Financial Accounting Standards Board appreciates this opportunity to provide the Subcommittee with background for certain significant accounting issues the Board believes have implications for financial institutions. The Board and its staff continue to monitor developments that affect financial institutions. In addition, the FASB has for some time been considering the need for additional efforts to establish broad standards to improve disclosure of and reconsider the recognition and measurement of financial instruments. The staff of the FASB has developed a project proposal and will recommend that the Board add to its agenda a major project on that subject. The project would have significant implications for financial institutions as well as for commercial and industrial enterprises. The potential scope of that possible project is summarized in Appendix B.