should be reported as part of the general allowance, which is includible in Tier 2 capital subject to current limitations. In concluding that the FAS 114 allowance is general in nature, the FFIEC has also reaffirmed existing regulatory reporting policies that require banks to promptly charge-off identified losses. Similarly, savings associations are required to promptly charge-off identified losses, or create specific allowances which are reported separately from general allowances. With respect to impaired collateral-dependent loans, any portion of the loan balance that exceeds the amount that is adequately secured by the fair value of the collateral is generally classified as loss by examiners. Consequently, such losses on collateral-dependent loans are excluded from the general allowance and Tier 2 capital. Because of the conclusions on the treatment of FAS 114 allowances, no changes are required in the federal banking agencies' regulatory capital rules. In addition, the FFIEC has decided to maintain its existing regulatory nonaccrual standards.

EFFECTIVE DATE: For regulatory reports prepared as of March 31, 1995, unless an institution has elected to adopt FAS 114 and the guidance in this notice as of an earlier date.

FOR FURTHER INFORMATION CONTACT:
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At the FDIC: Doris L. Marsh, Examination Specialist, Accounting Section, Division of Supervision (202) 898–8905, or Robert F. Storch, Chief, Accounting Section, Division of Supervision (202) 898–8906.

At the OCC: Eugene W. Green, Deputy Chief Accountant, (202) 874–4933, or Frank Carbone, National Bank Examiner (202) 874–5170.

At the OTS: Timothy Stier, Deputy Chief Accountant (202) 906–5699.

SUPPLEMENTARY INFORMATION:

I. Background

A. Summary of FAS 114

FAS 114 was adopted in May 1993 by the Financial Accounting Standards Board (FASB). The statement applies to all creditors and to all loans that are identified for evaluation of collectibility, except: (1) large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment (such as credit card, residential mortgage, and consumer installment loans), (2) loans that are measured at fair value or at the lower of cost or fair value (such as loans held for sale), (3) leases, and (4) debt securities. FAS 114 does not specify how an institution should identify loans that are to be evaluated for collectibility. An institution should apply its normal loan review procedures in making that judgment.

Under FAS 114, a loan is impaired when it is probable that a creditor will be unable to collect all amounts due (including interest and principal) according to the contractual terms of the loan agreement. When a loan is impaired, a creditor must measure the extent of that impairment by determining the present value of expected future cash flows discounted at the loan's effective interest rate. However, as practical expedients, the creditor may measure impairment based on either the loan's observable market price, or the fair value of the collateral for the loan if the loan is collateral dependent. Although under FAS 114 a creditor is generally allowed to use any of these three measurement methods to determine the amount of impairment, a creditor must measure impairment based on the fair value of collateral when the creditor determines that foreclosure is probable.

FAS 114 does not address when a creditor should record a charge-off of an impaired loan. Furthermore, FAS 114, as amended by Statement of Financial Accounting Standards No. 118, ''Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures'' (FAS 118), in October 1994, does not address how a creditor should recognize interest income on an impaired loan.

B. FFIEC Guidance on FAS 114 Announced in May 1994

The May 17, 1994, **Federal Register** (59 FR 25656) stated that ''the FFIEC and the agencies are requiring institutions to adopt FAS 114 as of its effective date for purposes of reporting on the Call Report and TFR. Furthermore, the agencies will permit early adoption.'' This regulatory reporting treatment is consistent with the requirements of Section 37 of the Federal Deposit Insurance Act (12 U.S.C. 1831n).

While institutions are required to adopt FAS 114 for regulatory reporting purposes, the ''Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans,'' issued on November 7, 1991, will remain in effect. Therefore, impaired, collateral-dependent loans must be reported at the fair value of collateral in regulatory reports. This treatment is to be applied to all collateral-dependent loans, regardless of the type of collateral.

The FFIEC and the agencies also announced that they do not plan to automatically require additional allowances for credit losses on impaired loans over and above what is required on these loans under FAS 114.[2] However, an additional allowance on impaired loans may be necessary based on consideration of institution-specific factors, such as historical loss experience compared with estimates of such losses, concerns about the reliability of cash flow estimates, or the quality of an institution's loan review function and controls over its process for estimating its FAS 114 allowance.

C. Issues on Which the FFIEC Sought Public Comment

In the May 17, 1994, **Federal Register**, the FFIEC sought public comment on two primary reporting issues and certain other matters related to FAS 114.

1. The Character of the FAS 114 Allowance

Should that portion of an institution's allowance established pursuant to FAS 114 be reported and considered as a specific allowance and, thus, not be eligible for inclusion in Tier 2 capital under the agencies' current capital rules? Alternatively, should the FAS 114 allowance be regarded as a general allowance which would be eligible for inclusion in Tier 2 capital subject to existing limits?[3]

2. Maintenance of Nonaccrual Reporting Requirements

Should regulatory nonaccrual standards be maintained for loans subject to FAS 114?

3. Other Issues

a. Comment was sought on (i) how much the adoption of FAS 114 is expected to change overall allowance

[2] FAS 114 does not address the overall adequacy of the ALLL. However, in addition to requiring an allowance for credit losses on impaired loans, FAS 114 requires each institution to continue to maintain an overall allowance that complies with Statement of Financial Accounting Standards No. 5, ''Accounting for Contingencies.'' Thus, consistent with existing regulatory policy, the ALLL should be adequate to cover all estimated credit losses arising from the loan and lease portfolio, including losses on loans that do not meet FAS 114's impairment criterion.

[3] Under the agencies' risk-based capital rules, general allowances includible in Tier 2 capital are limited to 1.25 percent of gross risk-weighted assets and an institution's Tier 2 capital cannot exceed its Tier 1 capital.