levels, and (ii) what portion of total overall allowances are expected to be related to impaired loans evaluated pursuant to FAS 114.

b. Comment was sought on implementation issues arising from FAS 114 to the extent they relate to U.S. branches and agencies of foreign banks. These entities are required to file quarterly the Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks (002 Report), which in many respects is similar to the bank Call Report. The 002 Report requires U.S. branches and agencies of foreign banks to report the amount of nonaccrual loans (see issue 2, ''Maintenance of Nonaccrual Reporting Requirements'').

c. Comment was sought on how FAS 114 might affect an institution's internal loan review process and its internal loan classification system for loans subject to FAS 114. In this regard, the FFIEC noted that, according to the December 21, 1993, Interagency Policy Statement on the Allowance for Loan and Lease Losses, each institution should ensure that it has a formal credit grading system that can be reconciled with the classification framework used by the agencies.

II. Public Comments

The FFIEC received 85 comment letters concerning the regulatory implementation issues arising from FAS 114. Seventy letters came from banking and thrift institutions. Eight financial institution trade associations, one professional association for accountants, three state banking departments, a state banking supervisors' conference, and two accounting firms also offered comments.

A. The Character of the FAS 114 Allowance

58 of the 70 commenters who addressed this issue indicated that an institution's allowance established pursuant to FAS 114 should be reported as a general allowance and be eligible for inclusion in Tier 2 capital. Many commenters stated that they believe that the FAS 114 allowance is a general allowance because of its availability to absorb any losses in the loan portfolio. Others noted that the banking agencies' current policy of requiring prompt charge-offs supports the idea that an institution's allowance for loan and lease losses (ALLL) does not contain identified losses and that any FAS 114 allowances included in the ALLL would be general. Respondents also indicated that the methodology required by FAS 114 is similar to that recommended in the agencies' current policies for determining an adequate ALLL and that other allocations of the ALLL for analytical purposes are currently disclosed in documents filed with the Securities and Exchange Commission without implying that they are specific allowances.

12 of the commenters recommended that the FAS 114 allowance be considered a ''specific allowance'' and not be eligible for inclusion in Tier 2 capital. These commenters indicated that they believe that FAS 114 relates to identified losses of particular loans and groups of loans. One commenter stated that, because of the current limit on the amount of the ALLL that may be included in Tier 2 capital (i.e., 1.25 percent of gross risk-weighted assets), the current impact on institutions of a decision to treat the FAS 114 allowance as a specific allowance would be minimal. At the same time, this commenter noted that considering the FAS 114 allowance to be specific would promote consistency in the application and analysis of financial accounting, regulatory reporting, and capital standards. In addition, the commenter suggested that viewing the FAS 114 allowance as specific would add discipline to the loan review process.

B. Maintenance of Nonaccrual Reporting Requirements

51 of the 60 commenters addressing this reporting issue agreed that the agencies should maintain existing nonaccrual policies for regulatory reporting purposes. Many respondents stated that, since nonaccrual policies are widely recognized, used, and understood, no change in these policies was needed. Some respondents indicated that institutions should not be required to modify their accounting systems until a change in income recognition methods for loans, if any, is made by FASB.

9 of the commenters did not believe the agencies should retain existing nonaccrual policies. One respondent stated that the agencies' nonaccrual policies did not improve the safety and soundness of institutions, but rather forced the cost recovery method of accounting for all funds collected on these loans. Some commenters suggested modifications to the current nonaccrual policies.

C. Specific Questions Raised by the Agencies

1. Allowance Levels

Commenters were asked how much the adoption of FAS 114 was expected to change overall allowance levels. Of the 41 commenters who responded, almost all stated that there would be little change in their allowance level. Other respondents indicated that they had not yet studied the impact of FAS 114.

Thirteen respondents answered the question about what portion of the overall ALLL is expected to be related to impaired loans evaluated pursuant to FAS 114. Several commenters simply indicated that they expected the FAS 114 portion of their ALLL to be small, while three provided separate specific estimates of less than 25 percent, 10 percent, and 5 percent. One stated that the FAS 114 allowance would be less than its existing ALLL and another indicated that its size would depend on the types of loans in portfolio. One commenter suggested that the FAS 114 allowance would be larger if assessed during an economic downturn.

2. U.S. Branches and Agencies of Foreign Banks

Four of nine commenters on this subject suggested that nonaccrual standards should be maintained for these branches and agencies. Three suggested that the same rules should apply to all institutions operating in the U.S. so that institutions chartered in the U.S. are not placed at a competitive disadvantage. Two commenters stated that branches and agencies of foreign banks should not have to record an ALLL at the branch. One commenter also requested that the agencies make no changes to the 002 Report.

3. Internal Review Systems

About half of the 55 institutions commenting on how FAS 114 might affect an institution's internal loan review process and its internal loan classification system said that FAS 114 will have little or no effect. Another third indicated that it will cause some operating and reporting changes with accompanying cost, but little or no perceived benefit. Changes that may be needed include more analysis and monitoring of loans, more time estimating cash flows and reviewing cash flow estimates, and more time estimating cash flows and reviewing cash flow estimates, and more documentation of the work performed.

III. Decisions on FAS 114 Implementation Issues

After review of the comments received and further consideration of the issues involved, the FFIEC has made the following decision on implementation issues arising from FAS 114.