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STATEMENT OF THE
FINANCIAL ACCOUNTING STANDARDS BOARD

TO THE

SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS
COMMITTEE ON ENERGY AND COMMERCE
U.S. HOUSE OF REPRESENTATIVES

JULY 12, 1985

Financial Accounting Standards Board
of the Financial Accounting Foundation
HIGH RIDGE PARK, P.O. BOX 3821, STAMFORD, CONNECTICUT 06905-0821

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The Financial Accounting Standards Board (FASB) appreciates this opportunity to submit this statement to the Subcommittee in response to Chairman Dingell's letter of July 9, 1985. The pronouncements of the FASB apply broadly to all business enterprises that prepare financial statements in accordance with generally accepted accounting principles (GAAP), including thrift institutions. Additional, industry specific, guidance is found in the American Institute of Certified Public Accountants (AICPA) Audit and Accounting Guide, Savings and Loan Institutions, FASB Statement No. 65, Accounting for Mortgage Banking Activities, and FASB Statement No. 72, Accounting for Certain Acquisitions of Banking or Thrift Institutions, and FASB Interpretation No. 9, Applying APB Opinions No. 16 and 17 When a Savings and Loan Association or a Similar Institution is Acquired in a Business Combination Accounted for by the Purchase Method.

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The term "GAAP" is a specialized term in the preparation of general purpose financial statements and in the practice of public accounting. The objective of general purpose financial statements is to provide useful, representationally faithful information to a wide group of investors, creditors, and other users. Although the objectives of regulatory reporting may parallel those for general purpose financial reporting, that is not always the case. The special needs of regulators may differ from those of the users of general purpose financial statements. The FASB acknowledges the resulting separation of regulatory and general purpose reporting requirements as a natural result of these differing needs and objectives. However, the Board has consistently maintained that accounting measurements should be neutral and unbiased. Revising financial statements, for example, so that certain institutions will meet regulatory net worth requirements does little for the credibility of financial reporting.

In accordance with the Subcommittee's request, this submission addresses the topics listed below. These topics were discussed at a meeting between the subcommittee staff (both majority and minority staff were present) and the staff of the FASB on June 7, 1985.

1. Economic and regulatory pressures on the thrift industry and the role of accounting information in the industry.

2. The accounting model based on historical cost as it is applied by thrift institutions.

3. Accounting for loan fees.

4. Accounting for real estate acquisition, development, and construction (ADC) loans.

5. Accounting for repurchase agreements.

The Thrift Industry and the Role of Accounting

Thrift institutions have historically borrowed short-term funds, through pass-book accounts, and loaned on a long term basis, for residential mortgages. This relationship caused few problems when interest rates were stable. The dramatic changes in interest rates during the 1970's and 1980's, coupled with increased competition for both deposits and mortgage loans, significantly changed the industry's historical borrowing/lending relationships. Institutions were faced with portfolios of long-term, fixed interest rate mortgages and liabilities made up largely of short-term, high interest rate deposits. As a result, in periods of rising interest rates, earnings on long-term assets tended to remain constant while interest costs of short-term borrowings tended to increase. If rates increased enough and the institution's asset mix did not change, net losses resulted.

Like other regulated financial institutions, thrifts must maintain a minimum level of net worth for regulatory purposes. As a result, thrifts are reluctant to liquidate portfolios of long term fixed-interest assets if doing so will cause them to incur a loss thereby reducing net worth. Thus, interest rate volatility and the need to meet regulatory net worth requirements have led the management of some institutions to enter into transactions that are, perhaps in part, designed either to avoid reduction of net worth by deferring recognition of losses or to increase net worth by accelerating recognition of income.

For example, institutions are often faced with the need to obtain cash either to lend or to meet regulatory liquidity requirements. One potential source of cash is the sale of assets. When assets are reported in the financial statements at a cost in excess of current market value, however, a sale of those assets would result in a loss and a corresponding decrease in net worth. When that reduction in net worth is unacceptable to an institution, management may transfer assets to others in exchange for cash but structure the transaction as a borrowing and thus avoid recognition of a loss. Such a transaction may often have many attributes similar to those of a sale of assets.

In addition, management may adopt accounting practices or structure transactions that permit recognition of income in the current period that might otherwise be reported in future periods. Such accounting practices alter only the timing of income recognition, not the amount of income earned from a transaction. Accelerated recognition of income is helpful in meeting current net worth requirements, but may be at variance from GAAP, which requires that income be recognized as it is earned.

The Federal Home Loan Bank Board (FHLBB) requires institutions under its jurisdiction to follow GAAP when reporting to the Board unless different regulatory accounting principles (RAP) apply. Faced with widespread weakness in the thrift industry regulators have, on some occasions, prescribed accounting practices that provide a means for institutions to meet minimum net worth requirements. The FASB or its staff has reviewed and commented on a number of such 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 GAAP. However, each response has emphasized the importance of following GAAP in general purpose financial statements provided to shareholders, depositors, and other users of financial information.

The following briefly summarized differences between RAP and GAAP have been addressed in correspondence between the FASB staff and various thrift industry regulatory and professional bodies.

1. Net worth certificates issued under provisions of the "Net Worth Certificate Act" are treated as assets by recipient institutions reporting financial information under RAP. The certificates do not meet the GAAP definition of an asset. (Letters attached; J.T. Ball, FASB Assistant Director of Research and Technical Activities, to Mr. James O. Sivon, Minority Staff Director of the House Committee on Banking, Finance and Urban Affairs, dated May 19, 1982, and to Roger Cason, Chairman of the AICPA Accounting Standards Executive Committee, dated November 23, 1983)

2. Appraised Equity Capital, the excess of the appraised value of certain fixed assets over their cost, is included in the RAP definition of net worth for institutions that participate in the Net Worth Certificate program. Other institutions may elect to use appraised equity capital for reporting under RAP. GAAP does not allow the use of appraised values to increase reported amounts of net worth. (Letter attached; J.T. Ball to the FHLBB Office of Communications, dated October 12, 1982. This letter was written in response to proposed regulations which the FASB staff understood would not include appraised equity capital in the body of financial statements. The staff's current understanding is that RAP financial statements prepared by some mutual thrift institutions do include appraised equity capital.)

3. Losses realized on the sale of certain interest bearing assets may be deferred in financial statements prepared in accordance with RAP. GAAP does not allow the deferral of realized losses. (Letter attached; J.T. Ball to the FHLBB Office of General Counsel, dated September 11, 1981)

The Accounting Model

The thrift industry uses the historical cost model of accounting, as do most businesses in the United States. Under this model, assets are generally stated in terms of their original dollar cost. For example, if a thrift institution loans $100, that is the amount used to record that loan in the thrift's accounts. As long as the loan is intended to be held until maturity, the recorded amount is not adjusted for interim fluctuations in value brought on by interest rate changes.

The historical cost model generally looks at assets such as mortgage loans on a "hold to maturity" basis. The current market value of some institution loan portfolios may be, at times, significantly less than the portfolio's historical cost because of changes in interest rates. However, evaluating an institution's financial condition solely on the current market value of its assets ignores the fact that the original costs will be recovered if the assets are held to maturity. The key question then becomes, "Can a thrift hold its long-term low-yielding assets to maturity?"

Accountants have distinguished assets that are held for sale in the normal course of business (inventory assets) from the investments that management intends to hold to maturity as described above. The historical cost accounting model values inventory at the lower of cost or market. Mortgage banking, the practice of originating loans for sale to investors rather than to hold to earn interest, is addressed by FASB Statement No. 65, <u>Accounting for Certain Mortgage Banking Activities</u>. Some have asserted that the character of business of some thrift institutions in today's market resembles more the activities of mortgage banking than of traditional thrift practice. If that is the case, the provisions of Statement 65 require that loans held for sale be valued at the lower of cost or market.

The liabilities of thrift institutions are generally short-term but are also subject to market fluctuations. The historical cost accounting model does not adjust the reported amount of liabilities based on changes in interest rates. Since deregulation, however, thrift institution deposits have become very rate sensitive. That is, depositors, (particularly large depositors) tend to move funds between institutions if interest rates offered are not competitive. As a result, significant portions of the deposit liabilities of thrift institutions are generally priced at or close to market rates of interest.

Accounting for Loan Fees

Although loan fees were charged in some parts of the country for many years, fees were generally 1% of the loan amount or less until recently. The practice of charging higher origination fees or, "points," began after the upward pressure on the cost of funds resulted in interest rates that could not be passed on in mortgage interest rates because of state usury laws. Charging higher loan origination fees provided a way to increase the return on loans without violating the usury limits.

As this practice developed, both the thrift industry regulators and the public accounting profession took the position that these fees were an adjustment of loan yield, or said another way, additional interest. However, both the regulators and the accounting profession allowed loan fees to be recognized in the current period to the extent costs were incurred in originating loans. The remainder, if any, was deferred and recognized as income over the life of the loan. The practical result of those conclusions was the immediate recognition of fees totaling approximately 1% of the loan balance with the remainder deferred and recognized over the expected life of the loan.

In 1979 the FHLBB revised its rule to allow immediate fee recognition of approximately double the amount originally provided. In response, the accounting profession reaffirmed the principle that the amount of fees to be recognized should be limited to costs incurred.

A task force formed in 1981 by the Accounting Standards Executive Committee (AcSEC) of the AICPA studied the issue of accounting for loan fees and costs and submitted its findings to AcSEC in 1983. The task force concluded that loan origination is integral to lending money and fees collected for origination should be recognized over the life of the loan as interest. The task force also concluded that loan costs should be deferred and amortized over the loan life as part of the cost associated with interest revenues and defined those costs more strictly that existing guidance. In September 1983, AcSEC referred the issues paper to the FASB for consideration.

The FASB placed a project on accounting for loan fees and costs on its technical agenda and a study of the subject was started in February 1984. In May 1985, after extensive analysis of comments received in response to an FASB Invitation to Comment issued in June 1984, the Board directed the staff to proceed with the development of an Exposure Draft of a Standard expressing its tentative conclusions on four basic issues.

First, the accounting for loan fees and origination and acquisition costs should be consistent for all types of lending.

Second, loan origination is integral to lending and related fees should be amortized as an adjustment to the yield of the related loan.

Third, a fee received for a loan commitment may be either integral to lending or for a separate service depending on the nature of the commitment.

Finally, the incremental direct origination and acquisition costs of a loan should be capitalized and amortized over the loan's life.

Thrift institutions have recently begun to charge fees for other services, not directly related to lending. In such transactions, often referred to as credit enhancements, an institution agrees to pay the debt of a third party should the third party fail to pay. Credit enhancements are, in many ways, similar to a bank's standby letter of credit or an insurance company's surety bond. Credit enhancement agreements, however, often require the institution to pledge specific assets to back the guarantee. The accounting implications of these transactions were recently discussed by the FASB Emerging Issues Task Force.

The FASB staff expects that the accounting for fees from credit enhancements and similar transactions will be addressed in the loan fees project. While the Board has yet to address credit enhancements, there are three possible approaches to the recognition of such fees. First, the fees might be included in income when received (a practice currently followed by some thrift institutions). Second, the fees might be included in income on a pro-rata basis over the life of the agreement (a practice currently followed by most banks). Finally, the fees might be included in income based on the release from risk on the guarantee (a practice similar to insurance company accounting).

Real Estate Acquisition, Development, and Construction (ADC) Loans

ADC loans made by thrift institutions have been a subject of recent interest though it should be recognized that other financial institutions make similar loans. Consequently the accounting issues involved are not limited to the thrift industry. At the heart of the issue is the question, "When does a transaction, characterized and structured as a loan, display more of the attributes of an investment in real estate rather than a loan?"

ADC Loans Generally

"ADC loan" is a generic term used to describe a variety of lending practices that are extensions of construction lending. The key features of an ADC loan are summarized below:

1. An ADC loan funds all, or substantially all, of the costs of acquiring undeveloped real estate, developing the real estate for construction, and construction of commercial or residential buildings.

2. The loan fees and interest accruing to the ADC loan are funded out of loan proceeds.

3. The ADC lender participates in the ultimate profitability of the real estate project. This participation may be an explicit sharing of sale proceeds. A similar result can be obtained if interest rates and fees are set at a level that produces the same payment to the lender, providing the project is sold for the expected amount. A financial institution making an ADC loan might also share in gross rents or operating cash flow from a commercial project or apartment building.

4. The ADC loan is usually secured only by the project being financed, with perhaps the personal guarantee of the borrower.

5. ADC loans do not typically require that the developer make any repayment before completion of the project.

Characterization of the Transaction

The ADC loan shares a number of attributes in common with transactions that are accounted for as investments. For example, partnerships in which one party provides financial resources and another party provides development skills are common in the real estate industry. The financing partner is typically entitled to a return of contributed capital with an agreed rate of return and some share of any ultimate profit. The financing partner is at risk for at least the funds provided and reaps the reward of the investment through successful completion and sale of the project. The similarity between the risks and rewards of an ADC loan and those of the investment described above have led some to contend that ADC loans should be characterized as real estate investments, following the fundamental principle that accounting should reflect the economic substance of a transaction rather than the form of the transaction.

This position was taken in report of the House Committee of Government Operations entitled "Federal Home Loan Bank Board Supervision and Failure of Empire Savings and Loan Association of Mesquite, Texas".

> [M]any of Empire's "loans" for real estate acquisition and development were in fact investments, with the borrower taking few risks and Empire bearing the major risk of an equity participant. Nevertheless, Empire treated the "income" from the points and fees charged on these "loans" as income up-front rather than, as required in the case of an investment, when the property is sold or otherwise disposed of.

The characterization of an ADC transaction as an investment in real estate could have implications beyond those alluded to in the quotation above. FHLBB regulations can place a thrift institution under increased regulatory supervision if the amount of direct investment in real estate exceeds certain limits. Some institutions could exceed those direct investment levels if their ADC transactions were considered to be real estate investments.

Others contend that a loan, legally made and properly structured as such, should not be reconstrued by accountants. They argue that the making of ADC loans is within the Congressionally mandated powers of a savings and loan institution. They further maintain that the lending institution has rights and powers as a lender that are not typically held by investors. In addition, they point out that ADC lending shares many attributes with long established construction lending practice.

Recognition of Income

If an ADC loan is considered to be an investment, recognition of income from interest and loan fees is inappropriate. The institution would recognize income only when the property was sold in accordance with FASB Statement No. 66, Accounting for Sales of Real Estate. Prior to sale, the institution would capitalize interest costs, based on the institution's cost of funds, as described in FASB Statement No. 34, Capitalization of Interest, and would reduce the amount of the investment for any fees and interest received.

If the ADC loan is treated as a loan, interest and loan fees would be included in income, subject to consideration of the loan's overall recoverability. The current and proposed accounting for loan fees is described in a separate section of this submission.

Collectibility

Whether or not a loan will ultimately be repaid is a major issue in the accounting for any loan. The amount of risk accepted by a lender in an ADC transaction increases the attention that must be given to collectibility. It is difficult for management, auditors, and regulators to judge the ultimate collectibility of an ADC loan while development is progressing. Since the loan typically funds its own interest and requires no payment before completion of the project, it is almost impossible for the loan to be in default during the development period.

Some have contended that the ADC loan accounting problem is a question of collectibility. To the extent that collectibility is in question, the current accounting guidance is applied to ADC transactions in the same fashion as it is to other lending. There does not seem to be a need for new guidance, dealing specifically with collectibility of ADC transactions.

Guidance on ADC Loan Accounting Issues

The accounting profession first addressed ADC transactions in November 1983 when AcSEC issued a Notice to Practitioners entitled, "Certain Real Estate Lending Activities of Financial Institutions." The Notice provided criteria that should be used to determine whether an ADC transaction should be reported as a loan or as an investment. That Notice became the basis for FHLBB rules proposed in October 1984 and finalized in FHLBB rule 85-291 on April 18, 1985. A second AcSEC Notice to Practitioners entitled, "Notice to Practitioners on ADC Loans," was issued in November 1984, providing additional guidance.

The members of the FASB Emerging Issues Task Force have discussed ADC Loan accounting issues at a number of Task Force meetings and have recently agreed that guidance is needed beyond the two Notices. Following meetings between the FASB staff and AICPA representatives a third Notice to Practitioners was drafted for consideration at AcSEC's July 30 meeting. The FASB staff expects that the third Notice will address circumstances in which personal guarantees and other factors should be considered in meeting the criteria listed in earlier notices. At the same time, the FASB staff understands that AcSEC plans to form a task force to study broader accounting issues raised by real estate lending that provides substantially all of the cost of a project and funds interest and loan fees from the loan proceeds.

In summary, the three principal issues in accounting for ADC transactions are being addressed as follows:

Characterization of the transaction is being addressed through AcSEC Notices to Practitioners and FHLBB rulemaking.

Recognition of income should be resolved when appropriate characterization of the transaction is determined. ADC transactions characterized as loans are included in the scope of the FASB project on accounting for loan fees.

The evaluation of collectibility and accounting when an ADC loan is deemed not fully recoverable is addressed by the accounting guidance that applies to all lending.

Repurchase Agreements

The accounting for repurchase agreements has also been the subject of recent study and concern. In the summer of 1984, the Financial Corporation of America restated earnings for the first half of that year as the result of an SEC objection to its accounting practice involving certain repurchase agreements. More recently, the failures of ESM Government Securities, Inc. and Bevill, Bresler & Schulman Asset Management Corporation resulted in large losses for many of their repurchase agreement customers.

In a repurchase agreement an entity with a short-term cash shortage and securities it doesn't presently need contacts a broker and exchanges the securities for cash. Simultaneously, the entity agrees to repurchase the securities from the broker at a specific time in the future for the original exchange amount plus additional compensation (interest) for allowing the use of cash. Although structured as a sale and repurchase of the securities[1], the substance of the transaction is a collateralized borrowing by the "seller" and a loan by the "buyer." The accounting follows this substance.

Various organizations, including the AICPA, the SEC, and the Governmental Accounting Standards Board have moved to investigate and address the financial reporting implications of those losses and of repurchase

[1] The sale and repurchase structure was originally conceived to provide the purchaser/lender access to collateral without the difficulty of perfecting a security interest.

agreements in general. The staff of the FASB is monitoring the activities of these organizations. The proposals that have resulted from consideration of repurchase agreements call for increased disclosure, rather than for a change in the accounting of the transactions themselves. Most of the problems surrounding the recent losses incurred by thrift institutions from repurchase transactions are not accounting issues, as such. Institutions that sustained losses in the much publicized failures of government securities dealers seem to have done so through 1) a failure to understand or protect against the risks involved or 2) alleged fraud committed by the dealers involved.

While not directly related to the recent losses described above, there is one issue in the accounting for repurchase transactions that could have implications for the thrift industry. Some repurchase transactions call for the repurchase of exactly the same security as that delivered while others allow the repurchase of securities that are different. Borrowing/lending accounting is allowed for the later transactions as long as the securities returned are substantially the same even though not exactly the same. (For example, repurchase transactions involving U.S. Treasury securities of the same type with the same coupon and maturity) The characterization of a repurchase agreement as a borrowing/lending is not considered appropriate when the securities returned are not substantially the same as those held prior to the transaction. In that case, the transaction is accounted for as a sale and a gain or loss is recorded.

Accounting guidance indicates that mortgage backed securities can be used in repurchase transactions involving the return of different but substantially the same securities. Some, however, have questioned the appropriateness of that accounting. They point out that each group of mortgage loans set aside (a loan pool) to back the securities is unique in the way the underlying loans will repay. As a result, they maintain that other pools cannot be considered to be substantially the same.

Resolution of this issue could have significant implications for thrift industry accounting. If pools of mortgages and mortgage-backed securities are not considered to be substantially the same as other pools, then the repurchase transactions in those pools would no longer justify accounting treatment as a borrowing. Absent that treatment, many institutions might elect not to be participants in the repurchase marketplace for mortgage backed securities.

The issue of "substantially the same" has been addressed in an AICPA proposed Statement of Position. The AICPA is scheduled to send this proposal to the FASB for review in the very near future.

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The Financial Accounting Standards Board appreciates this opportunity to provide the Subcommittee with a background of accounting issues in the thrift industry. The Board and its staff continue to monitor developments in this area through the Board's Emerging Issues Task Force. The preceding submission discussed what the Board believes to be significant issues with broad implications for the thrift industry. In addition, the Emerging Issues Task Force has addressed a number of narrower issues that relate to thrift institutions and to financial institutions generally. The subcommittee staff has previously been provided with Task Force materials on those issues. The staff of the FASB is analyzing the issues raised by the Task Force and other questions concerning various financial instruments and accounting by financial institutions. The staff expects to report the results of that analysis to the Board in the coming months.