Accounting Changes Affect Bank Regulatory Capital

SHUTTS & BOWEN LLP

100 Years of Service

April 2010

This article is complimentary for clients, friends and colleagues of Shutts & Bowen LLP. It provides timely and practical information and should not be considered legal advice on a specific matter or transaction.

For assistance or more information, please contact:

Robert C. Brighton, Jr.
rbrighton@shutts.com
954.847.3840

Fort Lauderdale
Suite 2100
200 East Broward Boulevard
Ft. Lauderdale, FL 33301
Phone: 954-524-5505

Miami
Suite 1500
201 S. Biscayne Boulevard
Miami, FL 33131
Phone: 305-358-6300

Orlando
Suite 1000
300 S. Orange Avenue
Orlando, FL 32801-5403
Phone: 407-423-3200

Tallahassee
Suite 804
215 South Monroe Street
Tallahassee, FL 32301
Phone: 850-521-0600

Tampa
Suite 1500
100 S. Ashley Drive
Tampa, FL 33602
Phone: 813-229-8900

West Palm Beach
1100 CityPlace Tower
525 Okeechobee Boulevard
West Palm Beach, FL 33401
Phone: 561-835-8500

Amsterdam
Europaboulevard 59
1083 AD Amsterdam, Netherlands
Phone: 011-3120-661-0969

By: Robert C. Brighton, Jr.

The Financial Accounting Board (FASB) adopted Statement of Financial Accounting Standards No. 166 and Statement of Financial Accounting Standards No. 167 (collectively, "FASB Changes") in June 2009. The FASB Changes limit the ability of banks to keep variable interest entities ("VIEs") and other special purpose entities ("SPEs") holding mortgages and other financial assets off their balance sheets and income statements. This change, when combined with the impact of mark-to-market accounting which requires assets to be valued at fair market, may adversely affect the regulatory capital leverage ratios of banks and require them to raise additional capital or curtail their lending activities.

Generally, the FASB Changes require banks to surrender additional control over the assets contributed to SPEs if their intent is to remove those assets from their financial statements of the bank.

The Office of the Comptroller of the Currency (OCC) has adopted new rules in response to the FASB Changes that further clarify their impact on the risk-based capital requirements of banks.

Mark-to-Market Accounting

Mark-to-market accounting as prescribed by FASB requires financial assets to be valued at fair market, often resulting in a significant write down for many loans given the current market for commercial and residential real estate properties, mortgages and real estate securities. Because of the capital requirements applicable to banks imposed by law and regulation, a write down in a loan's value may result in a reduction in regulatory capital, requiring banks to raise additional equity and/or curtail lending activities.

Transfers of Bank Loans to VIEs

Banks sometimes transfer mortgages and other financial assets to VIEs, in part to take the asset and related liabilities off their financial statements. Under FIN 46(R) ("Consolidation of Variable Interest Entities" interpreting Accounting Research Bulletin No. 51, *Consolidated Financial Statements*) as interpreted prior to June 2009, a transfer of assets to a VIE could be made and consolidation would not be required even though the bank held a controlling interest in the VIE provided that the bank did not have enough voting power to result in a majority of the voting power of the VIE.

© 2010 Shutts & Bowen LLP All rights reserved.

In Statement 167, FASB clarified the requirements of FIN 46(R) for contributions of assets to a VIE. Statement 167 requires surrender of control of the contributed asset and requires ongoing periodic testing of the criteria by which control is determined, not just at the time of the transfer.

Under GAAP, a company must consolidate any entity in which it has a "controlling interest." Prior to the issuance of Statement 167, FIN 46(R) required a quantitative measurement of indirect ownership of the contributed financial asset measured at the time of the contribution of the asset, focusing primarily on the voting control over the asset or the VIE maintained by the transferring company.

Under the revisions to FIN 46 effected by Statement 167, a company must perform a qualitative analysis when determining whether it must consolidate a VIE. Under these standards, if the company has an interest in a VIE that provides it with control over most of the significant activities of the entity (and the right to receive benefits or the obligation to absorb losses) the company must consolidate the VIE into its financial statements. Under the new standards, the quantitative analysis based on voting control which was previously determinative is no longer, by itself, determinative.

In addition, the new standards require banks and other companies to provide additional disclosure in their financial statements about their involvement with VIEs and any significant changes in risk exposure due to that involvement. Now banks are required to disclose how their involvement with a VIE affects the banks' financial statements. Banks and other companies that have transferred assets to a VIE will be required to disclose any significant judgments and assumptions made in determining whether to consolidate their financial statements with those of a VIE to which they have contributed assets.

Transfers of Financial Assets to SPEs

In addition, FASB has adopted Statement 166, revising Statement 140, "Accounting for Transfers and Servicing of Financial Assets," that eliminates the exemption from consolidation for "qualifying special purpose entities" (QSPEs), another technique by which banks which transfer to SPEs mortgages and other financial assets have kept those assets off their financial statements. Statement 166 also changes the requirements for derecognizing financial assets and requires additional disclosures about a transferor's involvement in transferred financial assets.

As originally conceived, a QSPE was an entity that would hold no assets that would require active management. In practice, this was an impossibility because of the variable nature of the markets and that of the underlying assets held by the QSPEs.

The revised standards on derecognition restrict when a company may transfer a portion of a financial asset and account for the transferred portion as being sold. Previous guidance permitted companies to report many transfers of portions or components of financial assets as sales. Under the new standards, a transfer of a portion of a financial asset may be reported as a sale only when (i) that transferred portion is a pro-rata portion of the entirety of the financial assets, (ii) no portion is subordinate to another and (iii) other restrictive criteria are met.

The revised standards clarify the legal isolation requirement for off-balance sheet arrangements and require that a company consider all of its involvement with the SPE or the transferred financial asset when determining whether the transfer may be accounted for as a sale.

The new standards require companies to provide additional disclosures about all of their continuing involvements with transferred financial assets. Continuing involvement may take many forms – for example, recourse or guarantee arrangements, servicing arrangements and providing certain derivative instruments. Companies will also need to provide additional information about transaction gains and losses resulting from the transfer of financial assets during a reporting period. These reporting requirements will continue for so long as the company has any continuing involvement in the transferred financial assets.

OCC Rule Changes

The OCC adopted a rule (the "OCC Rule") providing banks with the option to delay for two quarters any adjustments that might be required by the FASB Changes to the banks' (i) reported risk-weighted assets and (ii) tier 2 capital to the extent of any of the allowance for loan and lease losses (ALLL) required to be included in the banks' consolidated assets, followed by an optional two-quarter phase-in, but only for the effect of the inclusion of ALLL.

The OCC Rule reserved the authority of the banking agencies to treat entities that are not consolidated under GAAP as if they were consolidated for risk-based capital purposes, commensurate with the risk relationship. The delay and subsequent phase-in period applies only to the agencies' risk-based capital requirement, not the leverage ratio requirement applicable to banks.

In any event, the FASB Changes are required to be reflected on banks' risk-based capital requirements for periods beginning not later than July 1, 2010, and must be fully reflected not later than December 31, 2010.