



BANKING ISSUANCE

Comptroller of the Currency
Administrator of National Banks

Type: Banking Circular

Subject: **Accounting for Loan Swaps**

TO: Chief Executive Officers of All National Banks, Deputy Comptrollers, Regional Administrators and All Examining Personnel

PURPOSE

The purpose of this Banking Circular is to provide guidance in accounting for loan swaps, principally of foreign borrowers.

BACKGROUND

With increased frequency, banks are exchanging public and/or private sector loans of borrowers in financially troubled countries. While these "swaps" are recordable events for accounting purposes, valuing the elements of an individual exchange has been difficult because there does not currently exist any established secondary market for these loans. This Circular addresses the problem of exchange valuation and discusses related accounting issues.

ACCOUNTING

General Principles

A swap of loans to different debtors represents an exchange of monetary assets which should be accounted for at current fair value. Normally, when monetary assets are exchanged, with or without additional cash payments, and the parties have no remaining obligations to each other, the earnings process is complete. The transaction may result in recognition of a gain or loss for either or both parties. The gain or loss is measured on the date of agreement to the exchange as the difference between (1) the amount of the recorded investment in the loan plus any cash or other consideration paid and (2) the current fair value of the loan plus any cash or other consideration received.



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Application of General Principles to Foreign Loan Swaps

The estimated fair value of the consideration given and received in a loan swap must be determined. Certain foreign countries are currently experiencing financial difficulties. These difficulties are a significant factor in determining estimated fair values of consideration given and received. For exchanges involving loans to debtors of such countries, it is presumed the estimated fair values will be less than the respective face values of the loans and other consideration. Assuming the general presumption is not overcome, this would result in a loss on the swap.

Establishing fair values usually will be difficult and subjective because of significant uncertainties in the timing and amount of cash flows. Further, there is presently no established market for such loans. These problems, however, do not preclude a bank from making reasonable estimates and judgments. Indeed, it must be assumed that any swap decision is predicated on the ability of a bank to estimate reasonably the value of the consideration to be received from the exchange.

The determination of fair value should, among other things, consider the following:

- Ⓐ similar transactions for cash;
- Ⓑ secondary market values, if any, of similar financial instruments;
- Ⓒ the credit standing of the debtor and/or guarantor (including prospects for re-entry into the voluntary lending markets in the foreseeable future);
- Ⓓ prevailing interest rates;
- Ⓔ pricing options available (e.g., prime-based vs. LIBOR-based loans);
- Ⓕ anticipated delays in receipt of payment; and
- Ⓖ tax consequences, including the effect of foreign withholding taxes on after-tax yields.



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Because of the highly judgmental nature of the valuation process in swap transactions, it would not be uncommon for two banks involved in a swap to reach a different conclusion on the value of the consideration (foreign loans) paid and received.

Classification of Losses and Valuation of Remaining Loans to a Troubled Debtor

If the current fair value of the proceeds of the swap is less than the recorded investment in the loan and other consideration paid, a loss should be recognized and recorded at the date the transaction is agreed to by both parties. The following guidelines should be followed in determining whether the swap loss should be recorded as a direct charge to income or as a loan write-off:

- ⓐ A loss resulting from a change in the interest rate environment for similar loans (e.g., sovereign loans) during the period of time the loan was held in the bank's loan portfolio should be recorded as a direct charge to income.
- ⓑ A loss resulting from a major concern as to collectibility of the loan should be charged to the allowance for loan losses (whether or not specifically reflected in an allocation of such allowance).
- ⓒ A loss which is not identified solely with either of the aforementioned factors should be recorded as a direct charge to income.

If a loss from a swap transaction is attributable to a major concern as to collectibility, then there should generally be a presumption that a reserve for losses on other loans to that debtor is warranted.

Gains and Loss Recoveries

In rare cases, gains or loss recoveries might be indicated as a result of the valuation process. However, due to the subjective nature of the valuation process and the troubled financial condition of certain of the foreign debtors, gains or loss recoveries should not be recognized until the acquired loan is repaid in cash by the borrower.



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Discounts on Loans Received

Unless timely collection in accordance with current terms is assured, any difference between the carrying value and face value of the loan received in the swap should not be accreted to income over the remaining life of the loan but rather should be reported as income when the loan is collected or when collection has become assured.

Fees and Transaction Costs

All fees and transaction costs involved in a loan swap should be expensed when the loan transaction is complete. The new loan received in the exchange is initially recorded at its current fair value. Deferring recognition in income of any fees paid or transaction costs incurred would cause the new loan to be carried at an amount greater than its current fair value.

Domestic Loan Swaps

The principles set forth in this policy are equally applicable to swaps of domestic loans in which the borrower is financially troubled.

ORIGINATING OFFICE

Questions regarding this Banking Circular may be directed to the Chief National Bank Examiner's Office, Bank Accounting Division (202) 874-5180.

Michael Patriarca
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