Interoffice Memorandum

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Subject: RTHM Impairment Analysis

Department: Transaction Support

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The purpose of this memorandum is ascertain the effect of SFAS No. 114 (SFAS 114), *Accounting by Creditors for Impairment of a Loan*, and a recent DIG issue regarding collectibility of hedge gains in determining the appropriate accounting treatment of the RTHM's option basket at December 31, 1999.

<u>Scope (Paragraphs 4-6)</u>

SFAS 114 applies only to creditors and addresses the **recognition of impairment** and **measurement of impairment** for all loans (collateralized or uncollateralized) except for the following

- Small balance homogenous loans
- Loans carried at fair value
- Leases
- Debt securities within the scope of SFAS No. 115, *Accounting for Certain Investment in Debt and Equity Securities*

<u>Recognition of Impairment (Paragraphs 8-10)</u>

SFAS 114 applies a SFAS No. 5 *Accounting for Contingencies*, approach to evaluating whether or not a loan is impaired. That is, a measurement event does not occur until a creditor determines that a loan is impaired. Recognition of impairment is determined when it is **probable** that the creditor will be unable to collect all amounts due according to the contractual terms of the agreement. The term **probable** has the same meaning in SFAS 5 and SFAS 114. SFAS 5 requires recognition of a loss when **both** (a) information available prior to the issuance of the financial statements indicates that an asset has been impaired at the date of the financial statements **and** (b) the amount of loss can be reasonably estimated (paragraph 8). The Board clarified that the term probable means a higher level of likelihood than "more likely than not." The Board also clarified that the term probable does not mean "virtually certain."

Question 9 to the FASB Staff Implementation Guidance, *Application of FASB Statements 5 and 114 to a Loan Portfolio* addresses the issue of determining the method utilized to determine collectibility and states:

> How should a creditor determine it is probable that it will be unable to collect all amounts due according to the contractual terms of a loan under Statement 114?
>
> The Board decided not to specify how a creditor should determine that it is probable that it will be unable to collect all amounts due according to a loan's contractual terms. A creditor should apply its normal loan review procedures in making that determination.

AALLP's interpretation of SFAS 114 addresses the issue of loans that do not have stated payment dates and that accrue interest at the contractual rate. This concept is similar to a financial instrument that does not settle until a future period or has the ability to settle at future dates (i.e. option contracts). Question 7 addresses this issue by stating:

> For some creditors, it is not unusual to have cash flow loans whose payments are based solely on the actual property cash flow (e.g., real estate loans). Given the lack of scheduled payment amounts, how should a creditor evaluate and measure impairment on the loan?
>
> Since most cash flow loans do not become past due prior to maturity and they continue accruing interest at the contractual rate, the loans would be treated similar to demand loans as discussed in the last

sentence of paragraph 8 For such loans, the creditor must have a process in place to determine whether it will collect all amounts due Assuming there are no concerns regarding collectibility of all principal AND INTEREST, a loan would not be classified as impaired. If a cash flow loan does become impaired, its impairment would be measured similar to all loans. The lack of an established payment schedule should not impact the measurement

Measurement

When a loan is impaired, as determined in the previous recognition section, a creditor shall measure the impairment based on one of the following methodologies:

- Present value of expected future cash flows discounted at the effective interest rate
- Loan's observable market price
- Fair value of the collateral if the loan is collateral dependant

Current DIG Issue

The DIG is currently addressing the issue of financial instrument impairment in conjunction with the highly effective criteria between the hedge underlying and the hedging instrument. The DIG has determined that

> when the derivative is in an asset position, the entity must be aware of the counterparty's creditworthiness (and changes therein) in determining the fair value of the derivative. Although a change in the counterparty's creditworthiness would not necessarily indicate that the counterparty would default on its obligations, such a change would warrant further evaluation. If the likelihood that the counterparty will not default ceases to be probable, an entity would be unable to conclude that the hedging relationship is expected to be highly effective in achieving offsetting cash flows.

Conclusion

SFAS 5, SFAS 114 and the current DIG issue all begin the impairment assessment based upon the probability of collectibility by the creditor. As such, a creditor that can objectively demonstrate the ability to recover its investment should not have a reason to measure an impairment.

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