**BANKING COMMISSION**
**P.O. Box 1408**
**Majuro, Marshall Islands 96960**
PHONE: (692) 625-6310 FAX: (692) 625-6309

# *INSTRUCTIONS AND REPORTING FORMS 2*

INTERIM PROFIT AND LOSS STATEMENT

## PURPOSE

The most sensitive indicator of durability of any business is its performance measured in terms of profitability. In the case of banks healthy profits are the first line of defense in protecting the interest of depositors. Profit performance viewed in context of balance sheet growth, liquidity and concentrations is accordingly essential for off-site supervisory analysis and surveillance.

The Interim Profit and Loss statement is being introduced for all banks operating in the Republic in order to improve supervisory monitoring of the factors influencing local operating results which, for a branch controlled abroad or a locally incorporate bank, is important for different reasons. It is also intended to emphasize the application of generally accepted accounting principles. The Balance Sheet instructions and format closely parallel the Profit and Loss instructions and format, and should be a useful back-up reference source.

## STATUTORY REFERENCE

Section 37 (1) of the Banking Act obliges the Commissioner of Banking to notify banks in writing of regulatory reporting requirements; it also requires the Commissioner to prescribe the content of such regulatory returns and the dates they are to be submitted.

The Interim Profit and Loss Statement is a quarterly report to provide operating results for the QUARTER and the PERIOD TO DATE at each calendar quarter-end and the comparables for the prior year. The attached instructions and reporting forms indicate the detail of the information required.

Banks that fail to submit timely and accurate Income Statements may be subject to fines under Section 37 (3).

## FREQUENCY/SUBMISSION DATE

All licensed banks are required to submit the quarterly Income Statements within 21 days after the last business day of each quarter-end.

## RECEIPIENT

Banking Commission, Capital Building, Floor 2 Room 268, Majuro.

Phone: (692) 625-6310; Fax (692) 625-6309; E-mail: bankcom@ntamar.com

## SIGNING AUTHORITY

The Senior RMI Officer of the institution concerned, or in his absence a designated officer must sign the completed return, to certify the accuracy of the information submitted.

# ***<u>INSTRUCTIONS 2</u>***
# ***<u>INTERIM PROFIT AND LOSS STATEMENT</u>***

Interim profit and loss statements are to be reported for the quarters ending in March, June, September and December. These interim reports are the responsibility of management, such that the results certified in the year-end report by the external auditor may differ, for example where loan loss provisions might be altered following the audit. If so, the next regulatory return is to be appropriately corrected and footnoted if the change is significant.

The Reporting Form is attached. It closely ties in with the Monthly Statement of Assets & Liabilities, where data can be averaged and hence used to develop "Average Balances and Rates" comparisons for off-site analysis.

The Reporting Format is presented to highlight the principle variables affecting profitability. It prominently displays NET INTEREST INCOME, PROVISIONS FOR LOAN LOSSES, NON-INTEREST INCOME, OVERHEAD EXPENSES (aggregate non-interest expense) and NET INCOME.

The ensuing instructions are to provide guidance for regulatory reporting of a bank's operating results, and thus to achieve conformity in accounting for the income and expense components. Please refer to the Reporting Format (attached), which determines the order of the ensuing text.

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## INTEREST INCOME

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Interest on DEPOSITS WITH BANKS and on LOANS or OVERDRAFTS is calculated on an accrual basis. Accordingly, when the interest payment on an individual credit has become overdue by more than a certain time, the total exposure is rendered **NON-ACCRUAL.** In North America, interest accrual is commonly discontinued on DEPOSITS WITH BANKS after 30 days and on LOANS after 90 days of interest being in arrears. When a loan or loan equivalent is placed in NON-ACCRUAL status, any interest previously recognized but uncollected must be reversed out of income in the current reporting timeframe.

In addition, when any such exposure is classified as being a NON-ACCRUAL loan, the bank must establish a SPECIFIC PROVISION by a charge against earnings and credit to the "PROVISION FOR LOAN LOSSES". A specific provision represents managements' estimate of the losses a bank could suffer on a non-accrual loan, determined in part by means of periodic portfolio reviews on a loan-by-loan basis.

**SUBSEQUENT PAYMENTS** on NON-ACCRUAL loans are accordingly applied against principal (cannot be taken into income), namely by reducing the specific provision, which in turn will frequently have arisen as a result of arrears of principal and/or interest. Only when a previously delinquent NON-ACCRUAL loan become fully current, on both interest and principal payments, would the loan become eligible for management to decide if it could revert to being a "**FULLY PERFORMING"** loan; only when the loan is a fully performing loan can the interest again be accrued to income. In short, subsequent interest on NON-ACCRUAL exposures may not be capitalized into income.

Another potential area of uncertainty about properly recording INTEREST INCOME is the correct reporting of **LOAN FEES**. LOAN FEES reported under INTEREST INCOME are fees that substitute for interest, such that the associated income is amortized over the life of the loan. Examples would be (a) where a commission has been charged on a loan, and there is no direct relation to the expense of booking the loan or (b) receipt of a loan participation fee, which by definition is an adjustment of the loan yield. In either case the interest income would be amortized over the remaining term to maturity of the loan.

Loan Fees that reimburse the bank for the cost of processing the loan, and/or fees for loan guarantees or commitments not booked for Balance Sheet reporting purposes are reported under "OTHER INCOME". The resulting dividing line for LOAN FEES, among other things, lessens the scope for distortations in loan yield comparisons. In other words, the fees reported as interest on loans will relate to loans and related assets actually booked for balance sheet reporting purposes. NOTE: Also see "OTHER INCOME".

DEPOSITS WITH BANKS - The breakdown for recording interest income is Head Office and Branches, Foreign Banks and Domestic Banks. A reporting bank seeking to optimize its return within the constraints of its liquidity management criteria on such placements will logically minimize holdings of non-interest bearing deposits.

LOANS AND ADVANCES, PUBLIC SECTOR, BUSINESSES AND INDIVIDUALS - Interest income on overdrafts is not being reported separately, and accordingly any interest income on fully performing overdrafts is an integral part of the sector interest income. Hence, (a) the four components of the Public Sector reported on the Balance Sheet have been combined in the Income Statement presentation, and (b) loans to Banks, Other Finance Companies and Nonprofit Institutions are combined under "Businesses" in the Income Statement.

FOREIGN INVESTMENT SECURITIES - Interest income on securities with fixed maturities in the investment account is to be reported on an accrual basis in accordance with generally accepted accounting principles. The main variation of the accrual principle occurs when a bank acquires an INVESTMENT SECURITY at a discount, in the RMI likely to be a U.S. Treasury Bills. Interest income on any investment acquired at a discount would require accretion of the discount so that carrying value would equal face value at maturity.

## INTEREST EXPENSE

The interest expense reflects interest paid or payable on an accrual basis. The sector subdivision follows from the Balance Sheet, although in most cases in less detail:

DEPOSITS BY BANKS - The sector breakdown for DEPOSITS WITH BANKS is per the interest income side. These liabilities are essentially operating balances, and arise on account of the reporting bank having more local assets than local deposits.

DEPOSIT BY OTHERS - Interest on local PRIVATE SECTOR DEPOSITS has been established for reporting purposes to be based on the category of interest-bearing deposit, namely CHECKABLE SAVINGS, TIME DEPOSITS and SAVINGS. LOCAL GOVERNMENT AND ALL GOVERNMENT CONTROLLED ENTERPRISES are likely lumped, on the same basis as for PRIVATE SECTOR. The remaining reporting requirements pertaining to interest expense is sector driven, rather than by deposit category.

The more detailed Balance Sheet reporting of deposits accordingly provides focus on the relative volatility of the reporting bank's deposit base, whereas the Income Statement is designed for monitoring the interest costs of deposits.

Borrowing Costs - Record the interest paid or payable on short and long term borrowings, referring to any form of borrowing other than deposits, as defined in the Balance Sheet Instructions.

## PROVISION FOR LOAN LOSSES

The provision for credit losses charged as an expense is credited to the "ALLOWANCE FOR LOAN LOSSES" (the reserve). Amounts charged against income in interim periods are frequently estimated based on projected losses for the year on loans, overdrafts, deposits with banks, letters of credit, guarantees and similar contingencies.

The estimated interim loss provision charged to income should be revised quarterly, or at a minimum semi-annually, based on a rigorous asset classification process in order to determine the adequacy of its reserve.

In effect the PROVISION FOR LOAN LOSSES is a transfer of income to the reserve. The resulting balance in the reserve reflects managements' estimate of the difference between the book value of the bank's loans and other credit exposures and expected recoverable value. In the event that security has been allowed minimal or no value, the reserve balance would tend to coincide with the amount by which the portfolio is impaired.

A tough loan review process by management for updating of reserve adequacy would accordingly result in the PROVISION FOR LOAN LOSSESS being closely in step with actual loss experience. A less demanding approach, where the credit review is infrequent, on the other hand, can thus be expected to exaggerate changes in the PROVISION FOR LOAN LOSSES in the reporting period immediately following the review.

## OTHER INCOME

Banking services generating non-interest income are not as directly tied with balance sheet accounts as the items previously covered by these instructions. The classification of service charges, fees and similar revenue sources from customer services accordingly require precise guidance per the guidelines below.

SERVICE CHARGES ON DEPOSITS - Include ledger fees on deposit transactions and similar charges, safekeeping charges, safety deposit box rentals and per item levies on checks.

LOAN FEE INCOME - Include LOAN FEES that reimburse the bank for the reasonable cost of setting up the loan, such as fees that recover direct expenses like those incurred to register security. Also include fees for guaranteeing credit accommodation for a stated period, where the loan may or may not be required. In the latter instance, stand-by loan fees and loan commitment fees for guaranteeing credit accommodation, where there is no asset booked, should be taken into "other income" rateably over the commitment period.

ACCEPTANCE, GUARANTEE AND LETTERS OF CREDIT FEES - Fees attributable to short-term, self liquidating trade related contingent liabilities arising from the movement of goods, including transaction related standby letters of credit, should be taken into income rateably over the commitment period.

MISCELLANEOUS OTHER INCOME - Include non-interest income attributable to services other than the above, if any. An item that could apply from time to time is profits (or losses) on disposal of premises or other fixed assets.

Note: Gains (losses) on disposition of assets held in "Loan Realization Account" or "Other Real Estate Owned" acquired through foreclosure proceedings are excluded, as proceeds represent recoveries on previous write-offs charged to the Reserve.

## SALARIES AND OTHER STAFF BENEFITS

The breakdown of staff expenses separates salaries and related staff benefits from pension and retirement allowances, as follows:

SALARIES, AND RELATED STAFF BENEFITS - Include salaries paid or payable in the accounting period, based on the agreed ANNUAL SALARY for all staff, even if they are on training abroad or on terminal leave prior to retirement. Salaries for support staff such as janitors and for part-time staff employed in peak periods or for one-off assignments are likewise included. RELATED STAFF BENEFITS refers to costs being subsidized by the bank and that benefit the staff such as medical insurance, housing costs, automobile or professional memberships. Exclude direct staff training costs, reported separately as a GENERAL EXPENSE.

PENSION AND RETIREMENT ALLOWANCES - Include contributions to pension funds, and ensure that any special contributions are amortized over a period of years considered reasonable in relation to the nature of the contributions. Also include retirement allowances paid other than from the pension fund, and like allowances to dependents of former employees.

## PREMISES AND EQUIPMENT EXPENSE

Expenses in this category generally relate to items included in the balance sheet under fixed assets. The Income Statement requires a three-way breakdown:

RENT ON PREMISES, OFFICE EQUIPMENT AND FURNISHINGS: - Include any rental applicable to bank premises, net of any amount received for sub-renting space to third parties. Also include rental and direct cost for computers, computer peripheral equipment terminals, regular office equipment and related software and service bureau costs, as well as rental of furniture and fixtures.

DEPRECIATION OF PREMISES, OFFICE EQUIPMENT AND FURNISHINGS: - Include depreciation of owned premises, amortization of leasehold improvements; plus depreciation on office equipment and furnishings, vehicles and any other tangible fixed assets.

UTILITY EXPENSES - Include electric utility expenses, water, vehicle fuel and maintenance expense and any other standard UTILITY EXPENSES paid by the bank. In the event that the bank carries insurance on its premises, include such property cost under this category. Telephone and related expenses are charged to COMMUNICATIONS EXPENSE (see GENERAL EXPENSE).

## GENERAL EXPENSES

These are all other expenses and importantly relate to staff training, communications, advertising, insurance policy costs and miscellaneous other as follows:

STAFF TRAINING EXPENSES - Include registration and course fees for enrolling employees in study programs of short duration, and instructor's fees if charged separately. Also include reimbursed per diem costs and any other direct expenses associated with staff training, except for (a) regular salaries accounted for under SALARIES & RELATED STAFF BENEFITS and (b) TRAVEL for training courses.

TRAVEL EXPENSE - Include travel expenses incurred by employees in the normal course of business and travel expense relating to training.

ADVERTIZING EXPENSES - Include costs attributable to advertising, business development and press announcements. In this regard, business development refers to costs of receptions, authorized expenses reimbursed to employees for hosting customers and so forth. Press announcements, on the other hand, will arise in connection with the requirement in Section 32 of the Act to annually publish the results of the bank and for staff vacancy advertisements.

PRINTING AND STATIONARY - Include costs of printing publications of the reporting institution such as staff magazines and annual reports. Also include all regular stationary expenses.

INSURANCE PREMIUMS - Include cost of all insurance policies except for property, already reported under "Premises & Equipment Expense". Other insurance is needed, for instance, (a) a "Bankers' Blanket Bond" policy to cover large fraud losses as well as (b) a policy to cover any losses resulting from negligence or dishonesty of directors or employees.

SHORTAGES AND LOSSES - Include the net of losses after any recoveries due insurance that are absorbed by the bank resulting from defalcations, thefts, forgeries, tellers' shortages, cash overages or branch errors.

LEGAL EXPENSES - Include all legal fees incurred by the bank for the reporting period(s) except such fees attributable to loan recovery and collection endeavors, which are accounted for in establishing loan losses charged to the "Allowance For Loan Losses", or the reserve.

## PROVISION FOR REVENUE TAXES

The government discontinued its net income tax law effective October 1, 1991 and in its place adopted a gross receipts tax. In the intervening years the gross receipts tax has been 3% of the revenues. Bank "revenue" for the revenue tax calculations, comprises of total INTEREST and NON-INTEREST INCOME with no allowable deductions.

## EXTRAORDINARY ITEMS (SPECIFY)

EXTRAORDINARY ITEMS can be associated with income, charges or profits and losses attributable to material events or transactions falling outside the ordinary activities of the reporting institution. Exceptional items arising from ordinary business like profits or losses on terminated activities can also be included under EXTRAORDINARY ITEMS, if regarded as material and/or abnormal. Recording of any such gain or loss, however, must be explained in a footnote.

## DOMESTIC VERSUS FOREIGN PROFITS

The definitions applicable in Instruction 1 for the Balance Sheet have been carried forward for purposes of the Income Statement. Hence, the only sources of (a) Foreign Interest Income would be on Deposits With Banks (Head Office/Branches plus other Foreign Banks), and likewise (b) Foreign Interest Expense would be on the same two deposit categories on the liability side (Deposits by Banks, HO/Branch and/or O. Foreign) plus interest on Deposits by NonResident NonBank customers, if any. FOREIGN NET INTEREST INCOME would thus be derived by deducting the above interest expense (b) from the above interest income (a). FOREIGN NET PROFITS would usually be the same amount, unless the bank runs into foreign costs. Hence, DOMESTIC PROFITS are derived after deducting total loan loss and overhead.

Banking Commission
April 30, 2001