

**Testimony Of
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Allowances For Loan And Lease Losses
Before The
Subcommittee On Financial Institutions And Consumer Credit
Committee On Banking And Financial Services
U.S. House Of Representatives
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Room 2128, Rayburn House Office Building**

Good morning, Madame Chairwoman and Members of the Subcommittee. I appreciate this opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) regarding recent developments affecting the accounting for the allowance for loan and lease losses (loan loss reserves) by financial institutions. The banking and thrift agencies and the Securities and Exchange Commission (SEC) have been engaged in an ongoing dialogue on this issue. Our current work consists of a number of interagency projects dealing with the appropriate methodologies and procedures for establishing loan loss reserves, consistent with generally accepted accounting principles (GAAP). Our objective in undertaking this work is to improve the transparency of financial information and improve market discipline, consistent with safety and soundness.

Your letter of invitation asked that we discuss the coordination of, and progress made by, the SEC and the banking and thrift agencies on establishing clear guidance for financial institution loan loss reserves under GAAP. As you are aware, I joined with Comptroller Hawke and Director Seidman in sending a letter to the House and Senate Banking Committees indicating our concerns regarding this issue, specifically on a recent Financial Accounting Standards Board (FASB) article published in Viewpoints. The FDIC was concerned that financial institutions would interpret this Viewpoints article in isolation from other guidance on loan loss reserves and would take this guidance as a signal to make unwarranted reductions in loan loss reserves that could threaten bank safety and soundness.

In my testimony today, I will discuss why adequate reserves remain a regulatory priority. Next, I will address the ongoing dialogue between banking regulators and the SEC on providing guidance to financial institutions ensuring that the level of reserves is consistent with GAAP. Finally, I will outline the FDIC's concerns regarding the Viewpoints article. Responses to the specific questions raised in your letter of invitation are attached to this statement in Appendix 1.

The Importance of Adequate Loan Loss Reserves

Banking and thrift regulators must ensure that financial institutions maintain appropriate resources to absorb losses arising from the business of banking. Equity capital, which consists of accumulated retained earnings and funds paid-in by shareholders, serves as the last line of defense for the deposit insurance funds and is the primary means by which we can ensure that the insurance funds will not be depleted, necessitating a call for taxpayer dollars. After the problems experienced by the industry during the 1980s, the Congress recognized the importance of adequate capitalization by enacting legislation on such issues as risk-based capital and prompt corrective action standards.

Banking and thrift regulators must also ensure that the accounting principles used by financial institutions adequately reflect prudent and realistic measurements of assets among other items. Any losses imbedded in the asset portfolio should be accurately presented in order to reflect properly the amount of an institution's equity capital. Probably the most important adjustment in reflecting the carrying value of the loan portfolio, and the focus of the hearing today, is loan loss reserves. Loan loss reserves are created as a result of losses incurred from one of the principal risk areas in banking -- credit risk arising from lending activities.

To determine an appropriate allowance, financial institutions must periodically evaluate the loans held in their portfolios to determine the likelihood of collection. In cases where it is probable that a loan or group of loans will be not fully collected and the impairment is reasonably estimable, institutions are required to establish a reserve and recognize a loss against current earnings. When a loan is identified as uncollectible, the amount is charged against the allowance account. However, if the institution then suffers additional credit losses and must increase its reserves, this will be an expense to current earnings and, therefore, a reduction in equity capital. Thus, establishing the appropriate level for the allowance account is of great concern to banking and thrift regulators. Conceptually, loan loss reserves should represent credit losses inherent in an institution's loan portfolio given the facts and circumstances as of the evaluation date. Protection against credit losses that have not yet been incurred should be provided through the institution's equity capital.

The FDIC, primarily through its examination process, emphasizes the need for banks to maintain prudent and conservative, but not excessive, loan loss reserves that fall within an acceptable range of estimated losses determined in accordance with GAAP. Establishing appropriate levels for loan loss reserves is an art, not a science. Trying to clarify the precise methodology for setting reserves, which I will address below, is also a difficult and judgmental task. Both the banking and thrift agencies and the SEC agree that the process for determining reserves must be based on a comprehensive, adequately documented, and consistently applied analysis of the loan portfolio. We agree wholeheartedly with the SEC that the process must not be misused to manipulate earnings or mislead users of financial statements.

Recent developments in the current economic climate suggest that some institutions may need to review the loss assumptions built into their loan loss reserve calculations. Such developments include the economic difficulties in Asia and Brazil, weaknesses in

the agricultural, energy and other commodity-dependent sectors of the U.S. economy, and high consumer bankruptcy rates. All of these factors are identifiable adverse events that may affect the degree of loss imbedded in loan portfolios. Whether estimable and probable losses have been incurred because of these factors depends on the characteristics of each institution's individual loans. Accordingly, each bank must use its judgment in applying established accounting guidance.

Established Guidance on Accounting for Loan Loss Allowances

The following provides a summary of the primary sources that financial institutions have looked to for guidance on the accounting for loan loss allowances under GAAP. A more detailed discussion of these resources is included in Appendix 2, which is attached to this statement.

At the highest level in the hierarchy of GAAP, the Financial Accounting Standards Board (FASB) has two pronouncements relevant to establishing loan loss reserves. Statement of Financial Accounting Standards No. 5 (FAS 5) details the process governing the accounting for and reporting of "loss contingencies." The collectibility of loans -- that is, credit losses -- is only one of the types of loss contingencies addressed in FAS 5. Statement of Financial Accounting Standards No. 114 (FAS 114) specifically addresses the accounting by creditors for the impairment of loans that are evaluated individually. Both statements emphasize that the amount of an institution's loan loss reserves should be based on past events and must reflect current economic conditions.

In 1986, the SEC issued Financial Reporting Release 28 that public companies must follow when they account for loan losses. This guidance emphasized that the management judgment that is involved in determining the appropriate amount for an allowance must be exercised in a disciplined manner, reflect a detailed analysis of the loan portfolio, and be adequately documented. For SEC registrants, SEC rules and interpretive releases have the same level of authority as FASB statements in the hierarchy of GAAP.

The FDIC and the other banking and thrift agencies expect depository institutions to report loan loss allowances in their regulatory reports in accordance with GAAP. The banking and thrift agencies described their views on this subject in a 1993 Interagency Policy Statement on the Allowance for Loan and Lease Losses. The banking and thrift agencies consulted with the SEC and the FASB during the development of this statement. When an institution establishes a loan loss allowance in accordance with the interagency policy, the amount of the allowance should fall within the range of reasonable estimates for an allowance under GAAP.

The interagency statement also discusses the examiner's responsibility for assessing the adequacy of an institution's allowance. For example, we expect our examiners to evaluate the quality of the institution's loan review system and its ability to identify loan problems, the process management follows to estimate the amount needed in the loan loss allowance, the assumptions and other significant factors considered in this process,

and the adequacy of the documentation that supports management's calculation of the allowance. Reviews of the loan loss allowances of banks and thrifts have generally shown that institutions' processes for establishing allowances are acceptable.satisfactory.

Review of Interagency Efforts to Clarify Loan Loss Reserve Accounting Guidance

In September 1998, SEC Chairman Levitt announced a nine-point action plan to combat earnings management practices in all of its possible forms, including the use of unrealistic assumptions to estimate loan losses. In October and November, discussions between the banking and thrift agencies' principals and staffs and those of the SEC led to the release on November 24, 1998, of a Joint Interagency Statement on the allowance for loan losses of depository institutions.

The November interagency statement reminded institutions about existing guidance on the establishment and maintenance of an allowance consistent with GAAP. The statement also recognized the importance of depository institutions having prudent, conservative, but not excessive, loan loss allowances that fall within an acceptable range of estimated losses. The five agencies agreed to work together with the accounting profession and the banking and thrift industries to develop further guidance on accounting for loan loss allowances.

AfterDespite the release of the November interagency statement, insured institutions and their accountants continued to have questions about the SEC's stance on the appropriate amount, disclosure, and documentation of the allowance compared to the position of the banking and thrift agencies on these matters. In order to address these concerns, the SEC and the banking and thrift agencies began discussing the need for a second written statement to the banking and thrift industries and released the resultant Joint Interagency Letter to Financial Institutions on March 10, 1999.

This interagency letter reiterated the need for institutions to follow GAAP in determining an adequate loan loss allowance and described four specific initiatives designed to provide additional guidance on allowance issues to alleviate uncertainty on the part of bank and thrift institutions and their accountants. Two of the initiatives involve joint banking and thrift agency-SEC projects to develop parallel guidance. The first project involves developing the appropriate methodologies and supporting documentation for determining the allowance to be reported in financial statements. The second project will address enhanced disclosures regarding allowances and loan credit quality. As a third initiative, the agencies stated that they will encourage and support the FASB's process for providing additional guidance on the accounting for allowances. The fourth initiative calls upon the agencies to provide support for and to participate in a task force of the American Institute of Certified Public Accountants (AICPA) that is developing guidance on specific allowance issues, such as how to distinguish inherent losses from future losses and how to identify loss-triggering events. These projects are intended to provide enhanced guidance on loan loss allowance issues over a one- to two-year time horizon.

On April 12, the FASB issued its guidance in the form of an article by its staff in the Viewpoints publication. (Viewpoints is an official publication of the FASB in which staff or Board members express their views on accounting issues. Although these views do not represent official positions of the FASB, the views nonetheless are part of the hierarchy of GAAP.) Much of the guidance provided in the Viewpoints article is consistent with the policies of the banking and thrift agencies on the allowance and current industry practice. However, it is our view that the article does not address comprehensively many key issues, including the level of documentation necessary to support allowance estimates and how to distinguish inherent losses from future losses. This point is worth emphasizing because it should remind banking and thrift institutions and their accountants, as well as the banking and thrift agencies and the SEC, not to consider the Viewpoints article in isolation. In addition, guidance that has been issued in the past on other aspects of the accounting for loan loss allowances should not now simply be ignored. Moreover, as the March 10 Joint Interagency Letter indicates, further guidance on several significant loan loss accounting issues that are not addressed in the Viewpoints article will be forthcoming from the projects currently being undertaken by the banking and thrift agencies, the SEC, and the AICPA.

Another missing element in the Viewpoints article is the concept that the allowance should fall within an acceptable range of estimated losses. Discussions with the FASB staff have indicated to us that the absence of this concept from the article does not represent a difference of opinion between the FASB and the banking and thrift agencies, but simply reflects a decision on the part of the article's authors not to emphasize this point.

Thus, our view, and one which we believe the FASB would support, is that the allowance estimation process necessarily involves a high degree of management judgment. Management should record its best estimate within the acceptable range, including when the best estimate is at the high end of the range. In addition, management should always ensure that the overall allowance appropriately reflects a margin for the imprecision inherent in most estimates of expected credit losses. Despite the judgmental nature of the allowance estimation process, the process must not be used to manipulate earnings or mislead the various users of institutions' financial statements and regulatory reports.

Following the publication of the Viewpoints article, some bankers asked the FDIC how they should factor the guidance in the article into their existing allowance methodologies. Because banking organizations should follow GAAP for both regulatory reporting and other financial reporting, we believe institutions should evaluate the effect of the guidance in the article on their overall allowance practices and levels. However, as I noted earlier, I want to emphasize again that the Viewpoints article represents the result of only one of the four initiatives that the banking and thrift agencies and the SEC described in their March 10 letter to financial institutions. Thus, as the three remaining projects -- the joint banking and thrift agencies-SEC documentation and disclosure projects and the activities of the AICPA Loan Loss Allowance Task Force -- result in

enhanced guidance on allowance issues over the next one to two years, institutions will also need to evaluate the effect of this guidance on their practices and allowance levels going forward. This may mean that some institutions will need to modify their processes for determining allowances. However, should the guidance result in material changes to current policies and practices, we believe that institutions should be provided a reasonable transition period before implementation.

After the publication of the Viewpoints article, the SEC staff indicated that it planned to issue a statement at the May 20 meeting of FASB's Emerging Issues Task Force (EITF). This statement would alert lending institutions and their accountants to the article's conclusions about the loan loss allowance and explain how any adjustments an SEC registrant would need to make in order to comply with the article should be reported and disclosed. The SEC staff shared a draft of its announcement with the banking and thrift agencies and did respond favorably to a number of our comments concerning the content of the announcement. However, we remained concerned about the release of the announcement. Our key concern was whether banking and thrift institutions, particularly SEC registrants, would read into the announcement that they were expected to make fundamental changes in their allowance methodologies that would result in unwarranted reductions in allowance levels. To the extent that an institution responded to this announcement by recording a material downward adjustment, are concerned that one or more shareholders might seize upon this transition adjustment as a basis for bringing suit against the organization for manipulative or deceptive an inadequate loan loss reserve might result.

Where do these developments leave the FDIC today? At this point, we remain committed to continuing to work with the SEC and the other banking and thrift agencies on the projects announced in the March 10 Joint Interagency Letter. In these projects, we plan to develop parallel guidance on the documentation that should support an institution's reported allowance and on enhanced public disclosures about the allowance. The target date for this guidance is March 2000.

A key aspect of these efforts is input from the banking and thrift industries and the accounting profession on allowance policy issues. In addition, through the banking and thrift agencies' participation in the activities of the AICPA Loan Loss Allowance Task Force, we continue to support and encourage the task force as it seeks to develop more specific guidance on key allowance accounting issues.

Concluding Remarks

Given the importance of loan loss reserves to both bank safety and soundness and transparent financial reporting, the FDIC will continue to work with the other banking and thrift agencies and the SEC to develop further guidance in this area. Our mutual objective is to ensure that allowances for loan losses are properly determined and that earnings are not improperly managed, in order to improve the transparency of financial information and improve market discipline. Madame Chairwoman and Members of the Subcommittee, your hearing today provides us with an opportunity to provide further

clarification on this important accounting issue. This hearing will provide valuable support as we work toward the completion of the projects announced in the March 10 Joint Interagency Letter.

APPENDIX 1

FDIC Responses to Questions Raised in Subcommittee Letter of Invitation

1. Federal Law requires that financial statements to be filed by banks with the Federal bank agencies must be in compliance with GAAP. Some have suggested that in the area of loan loss reserves the Federal banking agencies apply regulatory accounting principles ("RAP") to banks and thrifts which are less stringent than GAAP. Please discuss what accounting standards the Federal banking agencies apply to financial institutions, and if it is GAAP, the process by which the federal banking agencies interpret and apply GAAP.

Under the auspices of the Federal Financial Institutions Examination Council (FFIEC), the FDIC, the Federal Reserve Board (FRB), and the Office of the Comptroller of the Currency (OCC) have developed uniform Reports of Condition and Income (Call Reports), which serve as the regulatory reports for all insured commercial banks and FDIC-supervised savings banks. The Office of Thrift Supervision requires each savings association to file the Thrift Financial Report (TFR) as its regulatory report. The FDIC and the other Federal banking agencies expect the institutions under their supervision to follow GAAP when completing their respective regulatory reports.

The Call Report instructions issued by the FFIEC are intended to be consistent with GAAP. In particular, the Glossary section of these instructions summarizes many of the accounting standards most relevant to banks. In six areas, the Call Report instructions contain specific reporting guidance that falls within the range of acceptable practice under GAAP. One of these areas is the Glossary entry for the "Allowance for Loan and Lease Losses" which references the 1993 Interagency Policy Statement on this subject. Before adopting specific GAAP guidance for regulatory reporting purposes, the FFIEC normally consults with the staffs of the FASB and the SEC on the issue.

2. Please discuss how frequently examiners review a financial institution's loan loss reserves. Please describe the guidance to examiners regarding review and evaluation of such reserves. Does this guidance require examiners to review allowances to determine if they are in accordance with GAAP? In reviewing loan loss reserves, do the Federal banking agencies compare loan loss reserves to financial institutions in the same peer group as well as local and regional economic trends?

Examiners review a bank's loan loss reserves at each examination which occurs every 12 or 18 months depending on the size and health of the institution. The Federal banking agencies' 1993 Interagency Policy Statement on the Allowance for Loan and Lease Losses discusses the examiner's responsibility for assessing the adequacy of an

institution's reserves. In general, we expect our examiners to evaluate the quality of the institution's loan review system and its ability to identify loan problems, the process management follows to estimate the amount needed in loan loss reserves, the assumptions and other significant factors considered in this process, and the adequacy of the documentation that supports management's calculation of the allowance.

When assessing management's process and the factors considered therein, examiners should determine whether the range of management's loss estimates takes reasonable account of changes in national and local economic and business conditions and developments. Examiners also perform a quantitative analysis to check the reasonableness of the loan loss reserve. This includes comparisons with the institution's peer group to identify any divergent trends in various ratios involving the allowance. Loan loss reserves that have been established in accordance with the interagency policy statement should fall within the range of reasonable estimates for a reserve under GAAP.

3. Some have suggested that the Federal Banking agencies always encourage institutions to increase their reserves, whether warranted or not, due to safety and soundness concerns. Please discuss whether this is consistent with existing examiner guidance.

The FDIC has, on occasion, told banks that its allowances were excessive and should be reduced. More frequently, however, banks have concluded based on their own allowance methodology that they needed to reduce their allowance through a negative provision for loan losses (i.e., a credit to expense). When bank management's conclusion is adequately documented and supported, examiners do not take exception to these reductions in allowances.

Existing examiner guidance---the 1993 Interagency Policy Statement on the Allowance for Loan and Lease Losses---calls for examiners to generally accept management's estimates of credit losses when they assess the adequacy of an institution's loan loss reserve when management has (i) maintained effective systems and controls for identifying, monitoring, and addressing asset quality problems in a timely manner, (ii) analyzed all significant factors that affect the collectibility of the portfolio in a reasonable manner, and (iii) established an acceptable allowance evaluation process that meets the objectives for an adequate allowance. However, when an institution's loan loss reserve does not meet those objectives, the institution is required to restore its reserve to an adequate level through an increase in its provision for loan and lease losses expense.

4. Please discuss whether the SEC has consulted with and coordinated its comments on loan loss reserves with the Federal Reserve and other federal banking regulators. Please discuss whether you believe consultation between the SEC and the federal banking regulators prior to the SEC issuing loan loss reserve comments would be workable and whether prior consultation would promote a more consistent approach to GAAP.

The SEC does not consult with nor coordinate its comments on loan loss reserves with the FDIC when it reviews filings by SEC registrants. However, for registrants whose loans are primarily held by FDIC-insured institutions, consultation with the federal banking agencies would enable the agencies to advise the SEC as to whether the registrant's allowance level and related credit risk disclosures are consistent with examiners' most recent examination findings. To make such a consultation process workable, we believe that the banking agencies would need to establish guidelines for their staffs concerning the information to be reviewed in SEC filings, the comparisons that should be made with examination data, and the nature of the comments and other information to be provided to the SEC. Prior consultation with the banking agencies might provide the SEC with sufficient additional information when considering if a registrant's reported allowance level falls within an acceptable range of estimated losses and therefore is neither excessive nor inadequate. It may also help to identify where a registrant's credit risk disclosures need to be improved so that they are consistent with the reported amount of the allowance.

5. Please discuss whether you believe there is a widespread problem with financial institutions inflating their loan loss reserves outside of what is permitted under GAAP.

We do not believe that there is a widespread problem with FDIC-supervised banks maintaining loan loss reserves in excess of what is acceptable under GAAP. Our examiners' reviews of loan loss reserves have generally shown that institutions' processes for establishing reserves are satisfactory. Moreover, for those depository institutions and holding companies whose financial statements are audited, auditors' opinions have not taken exception to reported reserves as being inflated or otherwise in excess of the acceptable range of estimated losses.

6. In the early 1990s several bank holding companies were sued for securities fraud with respect to arguably inadequate loan loss reserves. Did you take action against any of the banks or bank holding companies involved?

The FDIC was not a party in any of the suits referred to in this question. However, the FDIC and the Resolution Trust Corporation (RTC) as receivers sued the auditors of failed institutions including situations where the FDIC or RTC determined that the auditor had opined that its client institution's financial statements were fairly presented in accordance with GAAP when available information indicated that the institution's loan loss reserves were not adequate. During that time period, the FDIC also included provisions in formal and informal enforcement actions that required institutions under its supervision, when necessary, to increase reserves that were inadequate and thereafter maintain them at acceptable levels.

7. In response to the problems of the early 1990s, did the SEC meet and work with the Federal banking agencies on loan loss reserves?

The federal banking agencies and SEC have worked together since the early 1990s as detailed below.

7a. Did the SEC review or have input into the 1993 Interagency Statement on loan loss reserves? Please comment generally on how bank loan loss reserve practices have changed since 1993.

Yes. The Federal banking agencies provided a nearly final draft of the 1993 interagency policy to the SEC staff for its review and comment. Certain aspects of the draft were clarified in response to the SEC staff's comments.

Since 1993, loan loss reserve practices have changed in response to the provisions of Financial Accounting Standards Board Statement No. 114, Accounting by Creditors for Impairment of a Loan (FAS 114), as amended by Statement No. 118. For most institutions, these statements required them to change their methodology for determining the amounts to be included in the overall allowance for loan losses. FAS 114 made it clear that a creditor must evaluate the collectibility of both contractual interest and principal of all loans when assessing the need for a loss accrual for loan losses. In addition, FAS 114 specifically addresses the accounting by creditors for the impairment of those loans within the overall portfolio that are individually evaluated for impairment. In general, individually evaluated loans are impaired when, on the basis of current information and events, it is probable that a creditor will be unable to collect all amounts due (both principal and interest) according to the contractual terms of the loan agreement. When an individually evaluated loan is impaired, it must be measured based on the present value of its expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, based on the loan's observable market price or the fair value of the collateral if the loan is collateral dependent.

7b: Please describe how the SEC and Federal banking agencies communicated and coordinated on the loan loss reserve and other accounting issues between 1993 and November of 1998.

In general, the staffs of the SEC and the banking agencies communicated and coordinated on accounting issues through occasional interagency meetings to discuss either a single topic or a number of current issues of mutual interest. In addition, when the banking agencies were considering issuing joint guidance on an accounting matter, the banking agencies would provide a draft to the SEC staff for its review and comment. When reviewing an individual institution's accounting for a specific unusual or complicated transaction to determine whether it had been properly accounted for in accordance with GAAP, banking agency staff members commonly discuss the transaction informally with the SEC staff (and others outside the banking agencies) to gain the benefit of their insights on the appropriate accounting for the transaction.

7c: In November of 1998 and March of 1999 the agencies issued interagency statements on the loan loss reserve issue. Please discuss these statements and how the coordination provided for in these statements is working.

The November 1998 interagency statement reminded institutions about existing guidance on the establishment and maintenance of a reserve consistent with GAAP. The statement also recognized the importance of depository institutions having prudent, conservative, but not excessive, loan loss reserves that fall within an acceptable range of estimated losses. It also indicated that the SEC and the banking agencies agreed to work together with the accounting profession and the banking and thrift industries to develop further guidance on accounting for loan loss allowances.

The March 1999 interagency letter reiterated the need for institutions to follow GAAP in determining an adequate loan loss reserve and described four specific initiatives designed to provide additional guidance on allowance issues. Two of the initiatives involve joint banking agency-SEC projects to develop parallel guidance. The first project involves developing the appropriate methodologies and supporting documentation for determining the reserve to be reported in financial statements; the second would address enhanced disclosures regarding reserves and loan credit quality. As a third initiative, the agencies stated that they would encourage and support the FASB's process for providing additional guidance on the accounting for reserves. The fourth initiative calls upon the agencies to provide support for and to participate in a task force of the American Institute of Certified Public Accountants (AICPA) that is developing guidance on specific reserve issues, such as how to distinguish inherent losses from future losses and how to identify loss-triggering events. These projects are intended to provide enhanced guidance on loan loss reserve issues over a one- to two-year time horizon.

For the joint banking agency-SEC documentation and disclosure projects described in the March letter, the agencies have established working groups consisting of staff from each of the five agencies. The working groups have developed a proposed plan for developing the guidance envisioned in that letter, which the agencies chief accountants are currently reviewing. Both projects will study best practices and gather information from the banking industry, accounting profession, and others. For example, this includes a review of information gathered during regular bank and thrift examinations about institutions' methods, processes, and procedures for establishing the allowance for credit losses and the related documentation practices. The working groups are meeting regularly and, at this point, the projects are progressing within the timetables that have been presented to the chief accountants for their review. The target date for completing these projects is March 2000.

8. FASB issued Statement No. 114 in 1993. This statement was supposed to supplement FASB Statement No. 5. Did the SEC, Federal banking agencies and FASB work on Statement No. 114 together?

In May 1992, the FASB provided the SEC, the banking agencies, and the U.S. General Accounting Office copies of the summary and standards sections of the Exposure Draft of a proposed accounting standard, Accounting by Creditors for Impairment of a Loan, and invited comments on whether the Exposure Draft was clearly stated and

understandable and whether it contained any "fatal flaws." The FDIC submitted written comments describing its preliminary views on the proposal in June 1992. The FASB published the Exposure Draft of this proposed standard that same month. The FDIC staff provided written comments on this proposal to the FASB in November 1992.

As the FASB neared the completion of this accounting standard in April 1993, representatives of the federal banking agencies met with the FASB to discuss the agencies' concerns and recommendations with respect to the standard. Later that month, the banking agencies wrote to the FASB reiterating the agencies' more significant concerns. The FASB ultimately addressed several areas of concern raised by the banking regulators when it issued Statement No. 114 in May 1993.

9. Please discuss your understanding of the issues which the AICPA Task Force on Loan Loss Reserves is intended to address.

The Task Force's primary objective is to provide additional guidance on the application of GAAP as it relates to the allowance for loan losses. The guidance would likely be published in the form of a Statement of Position, which would first be issued for public comment as an Exposure Draft. However, before the Task Force can begin work on the Statement of Position itself, it has had to prepare a prospectus identifying the potential issues to be addressed and the recommended scope of the project. The prospectus must be approved by the Planning Subcommittee of the AICPA's Accounting Standards Executive Committee and then must be cleared by the FASB.

The Task Force is considering developing guidance on such issues as how to differentiate a current loss from a future loss, when a creditor should record a direct write-down (charge-off) of an impaired loan, how a creditor should determine that it is probable that it will be unable to collect all amounts due according to the contractual terms of a loan, how and to what extent various credit risk models used in practice to measure credit loss comply with GAAP, and clarify whether and how institutions should incorporate a margin for imprecision in their estimation of credit losses. The guidance may also discuss how current trends, future trends, and economic conditions should be considered in the measurement of loan losses. In addition, it may address appropriate measurement techniques and methodologies, disclosure requirements, and documentation standards.

10. The Federal banking agencies closely monitor economic trends on a regional, national and international basis. Please discuss whether you believe that financial institutions should be permitted to establish loan loss reserves for expected future losses based on local or regional market conditions or expected trends.

Under the current accounting standards governing the accounting for loan loss reserves, the overall reserve allowance should be adequate to cover probable credit losses related to specifically identified loans as well as probable credit losses inherent in the remainder of the loan portfolio that have been incurred as of the balance sheet date.

This is based on the fundamental concepts for the accrual of a loss contingency set forth in FASB Statement No. 5, Accounting for Contingencies, which was issued in 1975. Protection against credit losses that have not yet been incurred should be provided through the institution's equity capital.

11. In connection with the Viewpoints article, the SEC indicated that "transition adjustments" for loan loss reserves should be made prior to the end of the 2nd quarter. Please discuss whether you expect many financial institutions to take advantage of this one time opportunity.

The FDIC would have preferred and requested that the FASB expose any changes to GAAP to public comment. This is a process followed by the agencies when changing its rules, and we believe a healthy and worthwhile part of the process. That notwithstanding, because banking organizations should follow GAAP for both regulatory reporting and other financial reporting, institutions should evaluate the effect of the guidance in the Viewpoints article on their overall reserve practices and levels. We believe that much, but not all, of the guidance provided in the Viewpoints article is consistent with current practice and the banking regulators' policies on loan loss reserves. However, the article does not address comprehensively many key issues, including the level of documentation necessary to support allowance estimates and how to distinguish inherent losses from future losses. This point is worth emphasizing because it should remind institutions and their accountants, as well as the banking agencies and the SEC, not to consider the Viewpoints article in isolation. In addition, guidance that has been issued in the past on other aspects of the accounting for loan loss reserves should not now be ignored. Consequently, the article does not change certain fundamental concepts with respect to the reserve. Moreover, as the March 1999 Joint Interagency Letter indicates, further guidance on several significant loan loss accounting issues that are not addressed in the Viewpoints article will be forthcoming from the projects currently being undertaken by the banking and thrift agencies, the SEC, and the AICPA.

Going forward, we expect that institutions will continue to maintain prudent and conservative allowances within a reasonable range of probable credit losses. In this regard, in their March 1999 interagency letter, the banking agencies and the SEC stated, "We recognize that today instability in certain global markets, for example, is likely to increase loss inherent in affected institutions' portfolios and consequently require higher allowances for credit losses than were appropriate in more stable times." Current weaknesses in the agricultural, energy, and other commodity-dependent sectors of the U.S. economy and high consumer bankruptcy rates are likely to have a similar impact on affected institutions. In addition, on May 19, 1999, SEC Chairman Levitt stated that suggestions "that the SEC thinks [loan loss] reserves are too high and should be lowered . . . couldn't be further from the truth." He further emphasized that "it is not our policy that institutions artificially lower reserves or ever have inadequate reserves."

Thus, when institutions consider the FASB staff's conclusions in the Viewpoints article within the broader context of the other available guidance on the allowance, we do not expect that many institutions will report a "transition adjustment" in the second quarter.

APPENDIX 2

Previous Guidance on Accounting for Loan Loss Allowances

This appendix provides a summary of the primary sources that financial institutions used for guidance on the accounting for loan loss allowances under GAAP before 1999. At the highest level in the hierarchy of GAAP, there are two pronouncements issued by the FASB:

- Statement of Financial Accounting Standards No. 5, Accounting for Contingencies (FAS 5), which was issued in 1975, and
- Statement No. 114, Accounting by Creditors for Impairment of a Loan (FAS 114), issued in 1993 and amended by Statement No. 118 in 1994.

The Audit and Accounting Guide: Banks and Savings Institutions (Audit Guide), which was originally published by the AICPA in 1996, provides guidance on implementing these two accounting statements.

FAS 5 sets forth the standards governing the accounting for and reporting of "loss contingencies." The collectibility of loans, that is, credit losses, is one of the types of loss contingencies addressed in FAS 5. This accounting standard requires that a creditor evaluate the collectibility of both contractual interest and principal of all receivables (loans) when assessing the need for a loss accrual for loan losses. FAS 5 requires that institutions record a loss from a loss contingency when it is probable a loss has been incurred and the amount of the loss is reasonably estimable.

FAS 114 addresses the accounting by creditors for the impairment of those loans within the overall portfolio that are individually evaluated for impairment. In general, individually evaluated loans are impaired when, on the basis of current information and events, it is probable that a creditor will be unable to collect all amounts due (both principal and interest) according to the contractual terms of the loan agreement. When a loan is impaired, it must be measured on the basis of the present value of its expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loan's observable market price, or the fair value of the collateral if the loan is collateral-dependent. If this amount is less than the loan's recorded investment, the creditor must maintain a loan loss allowance for this shortfall.

In estimating the amount of loan losses to be recognized under FAS 5 and FAS 114, the AICPA's Audit Guide explains that the overall allowance for loan losses at each reporting date should be adequate to cover probable credit losses related to specifically identified loans as well as probable credit losses inherent in the remainder of the loan portfolio that have been incurred as of the balance sheet date. Thus, the amount of a

bank's loan loss reserves should be based on past events and current economic conditions.

In 1986, the SEC issued guidance that registrants (public companies) must follow when they account for loan losses. In Financial Reporting Release (FRR) 28, the SEC observed that determining the appropriate amount for the allowance necessarily involves a high degree of management judgment. That judgment must be exercised in a disciplined manner, reflect a detailed analysis of the loan portfolio, and be adequately documented.

The FDIC and the other banking and thrift agencies expect depository institutions to report loan loss allowances in their regulatory reports in accordance with GAAP. The agencies described their views on this subject in a 1993 Interagency Policy Statement on the Allowance for Loan and Lease Losses. This policy statement directs each institution to maintain an allowance for loan losses at a level that is adequate to absorb estimated credit losses associated with the loan portfolio. It then explains that these estimated credit losses should meet the criteria set forth in GAAP for accruing a loss contingency. Thus, when an institution establishes a loan loss allowance in accordance with the interagency policy, the amount of the allowance should fall within the range of reasonable estimates for an allowance under GAAP.

The interagency allowance policy also discusses the examiner's responsibility for assessing the adequacy of an institution's allowance. For example, we expect our examiners to evaluate the following items: (1) the quality of the institution's loan review system and its ability to identify loan problems, (2) the process management follows to estimate the amount needed in the loan loss allowance and the assumptions and other significant factors considered in this process, and (3) the adequacy of the documentation that supports management's calculation of the allowance. These reviews of institutions' loan loss allowances have generally shown that their processes for establishing allowances are satisfactory.

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