



FEDERAL RESERVE BANK
OF DALLAS

ROBERT D. McTEER, JR.
PRESIDENT
AND CHIEF EXECUTIVE OFFICER

DALLAS, TEXAS
75265-5906

June 30, 1999

Notice 99-49

TO: The Chief Executive Officer of each
financial institution and others concerned
in the Eleventh Federal Reserve District

SUBJECT

Allowance for Loan Losses

DETAILS

The Board of Governors of the Federal Reserve System has issued guidance to supervisors and bankers regarding a Financial Accounting Standards Board (FASB) staff article on loan-loss allowance. The guidance includes emerging points of agreement between the Securities and Exchange Commission and the Federal Reserve on loan-loss accounting matters.

Consistent with generally accepted accounting principles (GAAP), the Federal Reserve expects institutions to consider the FASB guidance in maintaining conservative loan-loss allowances. In this regard, banks may record their loan-loss allowances at the high end of the range of estimated losses when it reflects management's best estimate.

Furthermore, determining the appropriate allowance involves a high degree of management judgment. Allowances designated as unallocated are not inconsistent with GAAP provided they reflect an estimate of inherent credit losses determined in accordance with GAAP.

It is expected that recent accounting developments discussed in the FASB article will have a limited impact on the level of the banking industry's loan-loss allowances. As the federal banking agencies and Securities and Exchange Commission noted in a March 10 joint letter, "We recognize that today instability in 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."

Looking ahead, given the fundamental changes that have taken place in credit-risk management in recent years, a broader reexamination of accounting standards for loan loss allowances would appear beneficial. The Federal Reserve intends to play an active role in promoting and participating in such an effort to ensure that allowance levels remain conservative and prudent, consistent with safety and soundness considerations.

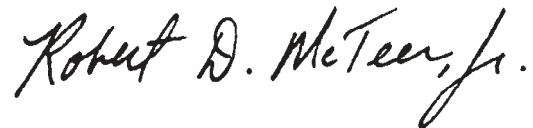
ATTACHMENT

A copy of the Board's SR letter 99-13 dated May 21, 1999, is attached.

MORE INFORMATION

For more information, please contact Lynn Black at (214) 922-6069. For additional copies of this Bank's notice, contact the Public Affairs Department at (214) 922-5254.

Sincerely yours,

A handwritten signature in black ink that reads "Robert D. McTeer, Jr." The signature is written in a cursive style with a prominent initial 'R' and a trailing flourish.



**BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551**

DIVISION OF BANKING
SUPERVISION AND REGULATION

**SR 99 - 13 (SUP)
May 21, 1999**

Recent Developments Regarding Loan Loss Allowances

Introduction

On March 10, 1999, the federal banking agencies and the Securities and Exchange Commission (SEC) issued a joint letter to financial institutions to announce new initiatives of the agencies and the accounting profession relating to the loan loss allowance. These projects are expected to result in enhanced guidance on loan loss allowance issues over a one- to two-year time horizon.

This letter addresses the allowance for loan losses in the context of existing accounting standards. As outlined in this letter and in view of the increased complexities and risks facing the banking industry in the last several years, it is expected that recent accounting developments will have only a limited impact on allowance levels in the industry. Indeed, as noted in the March 10th joint letter, the SEC and the federal banking agencies 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."

Last month, the Financial Accounting Standards Board (FASB) staff issued an article in the FASB's "Viewpoints" publication that provides guidance on certain issues regarding the allowance. Much of the guidance provided in the article is consistent with current practice and the banking agencies' policies on the allowance. The article does not purport to address comprehensively many key issues that relate to the allowance, such as what level of documentation is necessary to support allowance estimates or how to distinguish between inherent losses, the guidepost for reporting allowances under generally accepted accounting principles (GAAP), and future losses. The banking agencies, the SEC, and the American Institute of Certified Public Accountants (AICPA) intend to develop further guidance on important issues not addressed in the Viewpoints article. In addition, the article does not change certain fundamental concepts with respect to the allowance that are discussed in this letter, including the need for institutions to maintain conservative reserve levels within a reasonable range of probable credit losses, consistent with management's best estimate. This letter includes background information on such concepts that has emerged in discussions between the SEC and the Federal Reserve.

Institutions should consider the FASB guidance and this background information in developing their allowance estimates. Moreover, in view of the information in this letter and the work underway pursuant to the March 10th joint letter, it is expected that changes in allowance levels, if any, as a result of the Viewpoints article will be substantially limited.

Discussion and Background Information

Over the last year, the topic of loan loss allowances has been an increasingly important one to the banking industry and regulators. In light of increased volatility and banking risks in recent years, the banking industry has appropriately maintained robust reserving practices and levels. From a safety and soundness perspective, the Federal Reserve and other bank regulators have expected institutions to maintain strong loan loss reserves that are conservatively measured. In carrying out its responsibilities, the SEC has emphasized the need for financial statements and reported earnings to be transparent and, therefore, for allowances to be adequate but not excessive. Enhanced transparency has also been a critical objective of bank regulators, both domestically and internationally.

The SEC and the federal banking agencies agreed to work together to provide additional guidance to the banking industry, and to that end, issued a Joint Interagency Statement on loan loss allowances in November 1998. The statement outlined certain concepts in GAAP and in SEC and banking agency guidance that would provide a foundation for further joint projects in this area. Since January, the federal banking agencies have entered into high-level dialogue with the SEC on bank allowance policy issues. This has included meetings between the principals of the SEC and the banking agencies, and meetings of their chief accountants. This dialogue has helped the SEC and the banking agencies to achieve a better understanding of how to address these issues.

These discussions also led the SEC and the banking agencies to issue a joint interagency letter to financial institutions on March 10, which announced new initiatives relating to the loan loss allowance. The joint letter discussed the agencies' plans to gain a better understanding of sound bank allowance practices and use this knowledge to develop enhanced guidance on appropriate methodologies, disclosures, and supporting documentation for loan loss allowances. In addition, the agencies also stated that they would support and encourage the processes of the accounting standards setters as they seek to clarify key loan loss allowance accounting issues.¹ Most importantly, the letter indicated that the agencies will meet together periodically to discuss important matters that affect bank transparency and will focus on enhancing allowance practices going forward.

With the issuance of the March 10 letter, the banking agencies and the SEC formed a Joint Working Group (JWG) to oversee the interagency project to develop enhanced guidance on internal

¹ This includes providing input to the FASB on allowance issues and participation in the AICPA Loan Loss Allowance Task Force as the task force seeks to clarify such concepts as probable loss, future losses, and loss triggering events. The AICPA project is expected to result in final guidance in about two years. The AICPA was also asked to consider the impact of recently developed portfolio credit risk measurement and management techniques in the determination of the allowance.

documentation and public disclosures about the allowance. The target date for the issuance of this guidance is March 2000. A key aspect of all of these efforts will be input from the banking industry and the accounting profession on allowance policy issues. Should these efforts result in changes to current policies and practices, banking organizations will be provided a reasonable transition period prior to implementation.

There are already emerging points of agreement between the SEC and the Federal Reserve on important aspects of allowance practices. For example, there is agreement that:

- Arriving at an appropriate allowance involves a high degree of management judgment and results in a range of estimated losses.
- Institutions should maintain prudent, conservative, but not excessive, loan loss allowances that fall within an acceptable range of estimated losses. Consistent with GAAP, an institution should record its best estimate within the estimated range of credit losses, including when the best estimate is at the high end of the range.
- When determining the level for the allowance, management should always ensure that the overall allowance appropriately reflects a margin for the imprecision inherent in most estimates of expected credit losses.²
- Simply because a portion of the allowance is designated as “unallocated,” it is not thereby inconsistent with GAAP. The important consideration is whether the allowance reflects an estimate of probable losses, determined in accordance with GAAP, and is appropriately supported.
- Allowance estimates should be based on a comprehensive, well-documented, and consistently applied analysis of the loan portfolio.

FASB Viewpoints Article. Recently, in a Viewpoints article issued on April 12, 1999, the FASB staff provided guidance on certain issues regarding loan loss allowances. In particular, the article addresses the application of FASB Statements No. 5 and 114 (FAS 5 and FAS 114, respectively³) to a loan portfolio and how these statements interrelate. The article also provides a general overview of existing GAAP that relates to the allowance. The article is available on the FASB’s Internet website.⁴

² More guidance, including the level of support needed for this margin for imprecision, should be forthcoming from the JWG and AICPA projects. When reflecting the margin for imprecision and supporting such estimates, an institution should take into account all available information existing as of the balance sheet date, including credit quality, current trends, existing environmental factors (e.g., industry, geographical, economic, and political factors), and the range of estimated losses on loans.

³ FASB Statement No. 5, “Accounting for Contingencies,” and FASB Statement No. 114, “Accounting by Creditors for Impairment of a Loan.”

⁴ The FASB’s Internet web site can be accessed at www.fasb.org. The Viewpoints article is entitled, Application of FASB Statements 5 and 114 to a Loan Portfolio.

Banking organizations should consider the points noted above when evaluating the impact of the guidance in the article on their overall allowance levels. In addition, other important factors to consider in establishing appropriate allowance levels include the following:

- Most guidance that has preceded the recent FASB article has discussed the allowance in the context of a range of reasonable estimates of probable losses. The article, while not explicitly addressing this topic, is not intended to be inconsistent with this important concept.
- The article recognizes that some loans that are specifically identified for evaluation may be individually impaired, while other loans, that are not impaired individually pursuant to FAS 114, may have specific characteristics that indicate that there would be probable loss in a group of loans with those characteristics. Loans in the first category must be accounted for under FAS 114 and loans in the second category should be accounted for under FAS 5. Under FAS 5, a loss is accrued if characteristics of a loan indicate that it is probable that a group of similar loans includes some losses even though the loss could not be identified with a specific loan.⁵ When appropriate, this will permit institutions to use information derived from their internal grading systems and migration analyses in determining the inherent loss in loans in the second category.
- In assessing whether loans are fully collateralized and thus whether there is a need for an allowance on those loans, institutions should consider the reliability and timing of appraisals or other valuations to ensure that the values used for any allowance calculations are realistically and reliably measured. An institution should ensure that an appraisal of collateral reflects a realistic estimate of fair value, which takes into consideration the time it will take the institution to realize the value of the collateral and current market conditions for selling the collateral.
- The FASB article provides clarifying guidance on the interaction between FAS 5 and FAS 114. Allowance estimates under FAS 114 may be based on the expected future cash flows of an impaired loan, which are uncertain and involve significant judgment by an institution. Institutions should take into account all available information existing as of the measurement date (i.e., financial statement date), including credit quality, current trends, existing “environmental” factors (e.g., industry, geographical, economic, and political factors), and the range of estimated losses on such loans. Institutions may need to increase their FAS 114 allowance estimates if management's prior estimates have not appropriately taken into account all of the available information that affects the collectibility of such loans.⁶

⁵ Moreover, current GAAP and the FASB article emphasize that the loss does not have to be virtually certain in order to be recognized.

⁶ Banking organizations are also reminded that they should continue to classify and charge off loans in accordance with the policies of the federal banking agencies.

- Consistent with current guidance and the FASB article, if an institution has impaired loans with common risk characteristics that are individually impaired, the organization may measure impairment under FAS 114 on those loans on an aggregate basis (e.g., using average recovery periods, average amounts recovered, and a composite effective interest rate).

Other Matters

As mentioned above, this letter addresses the allowance for loan losses in the context of existing accounting standards. Looking ahead over the longer term, and given the fundamental changes that have taken place in credit risk management in recent years, a broader reexamination of accounting standards for loan loss allowances by the banking agencies and accounting standards setters would appear appropriate. The Federal Reserve intends to play an active role in promoting and participating in such an effort to ensure that allowance levels remain conservative and prudent, consistent with safety and soundness considerations.

Richard Spillenkothen
Director