Comptroller General
of the United States

Washington, D.C. 20548

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April 3, 1991

The Honorable Robert L. Clark
Comptroller, Office of the
Comptroller of the Currency

The Honorable Alan Greenspan
Chairman, Board of Governors of
the Federal Reserve System

The Honorable T. Timothy Ryan, Jr.
Director, Office of Thrift
Supervision

The Honorable L. William Seidman
Chairman, Federal Deposit Insurance
Corporation

This letter expresses our views and concerns over your recently issued joint statement and the related Request for Public Comment on "Returning a Loan With a Partial Charge-off to Accrual Status," dated March 14, 1991, issued by the Examination Council. These announcements were intended to clarify certain regulatory and accounting policies and to solicit public comment on the proposed "loan-splitting" treatment for nonperforming loans.

We have previously reported[1] that current generally accepted accounting principles (GAAP) allow management too much leeway in accounting for troubled loans and related reserves resulting in failure to recognize losses in a timely manner and misleading financial reports. We will soon report on how these accounting rules have contributed to hiding significant losses in banks that eventually failed. Therefore, we will be recommending that the Financial Accounting Standards Board and the American Institute of Certified Public Accountants tighten up these accounting rules.

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[1]Additional Reserves and Reforms are Needed to Strengthen the Bank Insurance Fund (GAO/T-AFMD-90-28, September 11, 1990).

As further set forth in this letter, we are concerned that your loan-splitting proposal could compound the problem with current accounting principles for nonperforming loans and will open the door for additional abuses. We are also concerned that your joint statement creates the impression that examiners have been directed to "lighten up" on the application of the accounting principles. We believe they should be tightened.

Loan-Splitting Could Lead to Additional Accounting Abuses

Under the proposed concept of loan-splitting, a nonperforming loan returns to an accrual status by writing off the uncollectible part of the loan and allowing the remaining portion of the loan to be treated as a performing loan with interest income being recorded. We have the following specific concerns about the proposed loan-splitting treatment.

-- The basic premise for loan-splitting is that the collectible portion of the loan can be identified and separated from the uncollectible portion. This determination would be subjective and depend heavily on judgments of institution management. The proposal does not provide sufficient guidance to ensure that adequate loss reserves will be established for the portions of split loans not written off. A nonperforming loan, whether partially written off or not, represents a high level of risk to an institution and this risk must be adequately factored into the determination of loan loss reserves. Since existing accounting principles provide only general guidance for establishing loss reserves for nonperforming loans, the loan-splitting proposal could lead to more confusion and further understatement of loan loss reserves.

-- Loan-splitting could give the impression that loans with demonstrated weaknesses have somehow improved. In reality, the borrower is in the same position as before and the so-called performing position of the loan is still tainted. Under the proposal, the borrower would not be notified that the lending institution has written off part of the loan. Therefore, the lender is not making any concession to the borrower and the debt has not been restructured. However, under the proposal, the portion of the loan remaining on the institution's books is reclassified as a fully performing loan. It is not clear that accounting for loan-splitting as proposed is in conformity with GAAP and could lead to a new form of regulatory accounting principles (RAP). Previous regulatory accounting forbearances for the savings and loan industry resulted in a false picture of the health of thrifts and contributed to the major financial crisis facing the taxpayers.

-- Key financial indicators such as nonperforming loan ratios, loan loss reserves, earnings and capital could be seriously distorted if loan-splitting is implemented. In the year of change, and until a new history is built, trend analysis will be difficult, if not impossible, and the impression of an improving situation may be given at a time when the opposite way may be the case. In addition, if the use of loan-splitting is optional, there will be a lack of comparability between years of an institution's financial statements and within the industry. Finally, and of critical importance, such distortions of financial information could jeopardize the effectiveness of regulatory off-site monitoring and the ability of other financial statements users to effectively analyze financial data of institutions.

Optimistic Valuation of Real Estate Loans Will Result in Hidden Losses

Your joint statement indicates that future expectations of the property's performance over time should be considered in valuing real estate. We were advised by a regulatory official that this concept does not represent a change from current regulatory guidance. However, we are concerned that the tone of the statement will send a signal to bank management and regulators that will open the door for optimistic assessments of the future performance of real estate. We are extremely troubled by this implied change in focus from current to future market conditions, especially considering the length of time it may take for the real estate market to recover.

A recent study indicated that it may take up to ten years for full absorption of existing commercial real estate. The primary focus for real estate valuations must be that of current market conditions in order to avoid an accumulation of hidden losses on an institution's balance sheet. As recognized in your loan-splitting proposal's "qualifying criteria," any consideration of real estate value based on future performance should be supported by verifiable evidence such as signed leases or letters of intent. This evidence, along with other factors that go into the appraisal process, must be carefully scrutinized due to the risk of estimating future performance.

Among the most important of the factors used in the appraisal process is the discount rate. The discount rate, in effect, serves to adjust future projected values to today's dollars due to the uncertainties of future markets and the probability of recovering the investment. Theoretically, discounting of projected future values should equate to current market values. This often does not occur in current practice, especially in depressed real estate markets, because the expected impact of improved property performance outweighs the impact of discounting.

We believe that the discounting process could result in property values comparable to current market conditions, if properly performed. This would require the use of "risk adjusted" discount rates. Further regulatory and accounting guidance is needed which requires the use of risk adjusted discount rates in the valuation of real estate loans and foreclosed property in uncertain market environments. We believe this approach will help avoid overly optimistic real estate loan valuations and therefore serve as a basis for realistic loan loss reserve levels.

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The solution to current issues facing depository institutions is not accounting gimmicks. The purpose of accounting is to provide evenhanded, neutral, and unbiased information for making business and economic decisions, and not to determine what those decisions should be. Altering accounting rules as suggested should not increase nor decrease a depository institution's willingness to make new loans. Lending decisions should be based on prudent underwriting standards which are applied on a consistent basis. Further, adopting the proposed loan-splitting concept, long-term, is likely to result in more problem loans and larger bank failure losses because of the potential to hide the true financial condition of a depository institution. If banks analysts need more information on nonperforming loans, we believe that additional disclosures about the status of these loans, such as their current cash flows, is a more prudent alternative than loan-splitting. If there is concern that accounting rules may be unfairly affecting the classification of problem loans and accounting for their cash flows, the standard setting bodies should consider these concerns in the overall review of accounting rules for troubled loans.

At this time, the implied loosening up on valuation of real estate loans will only serve to temporarily gloss over existing problems. We believe stronger, not weaker, guidelines need to be provided by the regulators and the accounting profession to ensure realistic real estate valuations are used as a basis for determining adequate loan loss reserves. If the result of your announcement is in fact a loosening of accounting rules it will have a serious adverse effect on regulators' ability to identify and react to troubled institutions and to protect the insurance funds and the taxpayers. The consequences are extremely serious considering the Bank Insurance Fund's condition and the continuing high number of bank and thrift failures.

The Department of Treasury Under Secretary for Finance's March 11, 1991 letter to me stated that the long-term success of any plan to recapitalize the Fund depends on correcting the underlying structural flaws in our banking system. Further, he stated the plan should use GAAP. We do not believe that the loan-splitting proposal meets the Under Secretary's well-founded objectives. The proposal may result in accounting rules that are considered GAAP but in reality are a form of RAP that as thrift industry experience has shown could have disastrous consequences.

Charles A. Bowsher

Charles A. Bowsher
Comptroller General
of the United States

cc: The Honorable Nicholas F. Brady
The Secretary of the Treasury

The Honorable Richard C. Breeden
Chairman, Securities and Exchange Commission

Mr. Robert J. Lawrence, Executive Secretary
Federal Financial Institutions Examination Council

Mr. Dennis R. Beresford
Chairman, Financial Accounting Standards Board

Mr. Philip B. Chenok
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