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Divergent Loan Loss Methods Undermine Usefulness of Financial Reports

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The Honorable Donald W. Riegle, Jr.
Chairman
The Honorable Alfonse M. D'Amato
Ranking Minority Member
Committee on Banking, Housing, and
Urban Affairs
United States Senate

The Honorable Henry B. Gonzalez
Chairman
The Honorable Jim Leach
Ranking Minority Member
Committee on Banking, Finance and
Urban Affairs
House of Representatives

As the largest single component of most depository institution's assets, loans represent a significant potential for loss. Estimated losses on uncollectible loans are reflected in financial reports of the institutions in the form of loan loss reserves. This report presents the results of our review of the methods used by federally insured depository institutions to establish loss reserves for loans which are likely to be uncollectible. Neither authoritative accounting standards nor regulatory guidance provide sufficiently detailed direction to depository institutions for establishment of loan loss reserves. As a result, institutions used widely diverse methods that produced reserves which could not be meaningfully compared among such institutions and may not have reflected the true loss exposure in the institutions' loan portfolios.

We are sending copies of this report to the Secretary of the Treasury; Director, Office of Management and Budget; Chairman, Financial Accounting Standards Board; heads of federal regulatory agencies for banking and thrift institutions; and other interested parties. Copies will be made available to others on request.

Please call me at (202) 512-9406 if you or your offices have any questions. Other major contributors to this report are listed in appendix VI.

Robert W. Gramling
Director, Corporate Financial
Audits

Executive Summary

Purpose

Loan loss reserves are a major indicator of a depository institution's loss exposure from problem loans and are critical to understanding the entity's financial condition. From 1980 to 1992, approximately 2,700 federally insured institutions failed, at a substantial cost to the insurance funds and taxpayers. Loan losses were the major cause of many of these failures. Previously issued GAO reports have shown that institutions have made inadequate estimates of loan losses prior to failure, and that regulatory examiners have lacked a consistent framework to quantify loan portfolio risks and assess reserve adequacy.

In the last 2 years, the condition of the banking and thrift industry improved dramatically. To determine current loan loss reserving practices, GAO conducted case studies of 12 institutions, each with assets over $1 billion. GAO assessed the reliability and comparability of their loan loss reserves by focusing on the methods the institutions used to estimate loss exposure and make allocations to reserves. GAO also focused on the adequacy of accounting standards and regulatory guidance for establishment of loan loss reserves.

Background

Financial reports of depository institutions affect the decisions made by investors, creditors, depositors, regulators, and others who rely on the accuracy of the accounting information presented in the reports. To be useful, the information must be accumulated and presented in accordance with accepted standards that are intended to ensure that reports are fairly stated and can be meaningfully compared among institutions.

As the largest single component of most depository institutions' assets, loans represent a significant potential for loss. Likely losses should be reflected in institutions' financial reports in the form of loan loss reserves. The depository institution's management is responsible for establishing loan loss reserves in accordance with generally accepted accounting principles (GAAP) and regulatory guidance. It does this by making periodic provisions or charges to operating expenses. The reserves adjust the institution's loans receivable to reflect amounts that management estimates will not be recovered. The loan loss reserve must be sufficient to cover both specifically identified loss exposures as well as other inherent loss exposures in the institution's portfolio which have not yet been specifically identified.

Results in Brief

Contrary to the recent past when GAO found problems with understated loan loss reserves, the case studies GAO conducted for this report generally showed that institutions maintained significant amounts of unsupported reserves. Both situations are symptomatic of the lack of definitive guidance for establishing and maintaining appropriate levels of loan loss reserves.

GAO found that significant portions of most of the 12 depository institutions' loan loss reserves were not justified by supporting analysis and were not comparable among the institutions. The reserves were developed using reserving methods that varied greatly regarding (1) the use of individual loan assessment results, (2) determination and application of historical loss experience, and (3) the inclusion of supplemental reserves. Most of the supplemental reserves were not clearly linked to likely losses.

As a result, investors, creditors, depositors, regulators, or other financial report users would not be able to meaningfully compare the institutions' reserves in judging their adequacy and the quality of the institutions' loan portfolio. Further, unjustified supplemental reserves can be used as cushions to absorb changes in the condition of the loan portfolio and thus to control reported earnings and capital. Such practices mask an entity's true financial condition and can mislead investors and impede regulators' ability to protect the deposit insurance funds.

Neither authoritative accounting standards nor regulatory guidance provide sufficiently detailed direction to depository institutions for establishment of loan loss reserves. The lack of detailed authoritative and regulatory guidance provided excessive flexibility to institutions in establishing loss reserves. Such flexibility resulted in the use of widely diverse reserving methods that produced reserves which could not be meaningfully compared and may not have reflected the true loss exposure in the institutions' loan portfolios.

Principal Findings

Results of Individual Loan Assessments Often Not Used to Establish Reserves

Specific assessment of the collectibility of individual loans is the most accurate means to identify and measure loss exposure for larger-balance impaired loans. However, to establish reserves, most of the institutions

regularly applied their own loss history or loss factors that closely resembled industry averages in lieu of or in addition to results of specific assessments of impaired loans. These practices may have distorted the loss exposure in individual loans and established reserves that could not be meaningfully compared among institutions.

For example, the loss exposure for one problem loan from an institution in the sample was $21.2 million based on an individual assessment of collateral value versus outstanding loan balance. The institution used loss factors which were similar to industry averages to establish a reserve for this loan of $8.1 million. GAO believes this $13.1 million difference represented a material understatement of the institution's loss exposure on this loan. Applying the reserve approach of another institution in our sample to the same loan, however, would have resulted in a reserve of $23.6 million. The difference in reserve amounts of $15.5 million exemplifies the lack of comparability in reserve approaches for individual problem loans.

Historical Loss Rates Determined and Applied Inconsistently

Loss exposures on unimpaired and smaller-balance loans are generally best estimated on a group basis using historical loss experience from similar loan groups. Most of the institutions used their own loss experience to establish a large portion of their reserves. GAO found the methods used to determine historical loss rates from past experience varied markedly and resulted in incomparable reserves. Institutions used widely different time periods of past experience to develop historical loss rates. In some cases, the time periods reflected only the institution's most recent experience, such as the last 12 months. However, in other cases, time periods included several years of past experience, thus helping to mitigate the effects of a particularly good or bad year on the historical loss rates. Further, some of the institutions applied historical loss rates so as to reflect losses expected over the lives of their current loan portfolios. Others, however, applied rates to reflect losses expected only for the coming year.

The 12 institutions in our sample used loss history to establish from about 11 percent to 87 percent of their total reserves. Nine of the institutions relied on loss history to determine 40 percent or more of their reserves. These large percentages of reserves based on historical loss rates, combined with the widely different methods used to determine and apply those rates, are likely to result in significant incomparabilities in reserves.

Such incomparability hampers financial report users' ability to assess the true financial condition and relative health of depository institutions.

Large Supplemental Reserves Not Adequately Justified

Most of the institutions' reserves included large supplemental reserves that generally were not clearly linked to an analysis of loss exposure or supported by evidence which showed that losses were likely and reasonably estimated. Supplemental reserves comprised over 30 percent of the total loan loss reserves for 7 of the 12 institutions reviewed. For example, one institution in the sample continued to build its loan loss reserve for several quarters even though its detailed analysis of the loan portfolio indicated that it had sufficient reserves. At the time of GAO's review, the institution's reserve was about $612 million over what was justified by its own portfolio analysis. This amounted to 15 percent of capital and exceeded the previous year's earnings by over 80 percent. In some cases, supplemental reserves acted as cushions which could be used to absorb changes in the estimated loan loss exposure of the institution. Such supplemental reserves could allow bank management to avoid recording loss provisions or recoveries to reflect these changes in loss exposure.

Such use of unjustified supplemental reserves can conceal critical changes in the quality of an institution's loan portfolio and undermine the credibility of financial reports. Further, the use of reserve cushions which have been built up over time to absorb subsequent loan quality deterioration could impede regulators' ability to identify, between examinations, a decline in the financial condition of an institution early enough to take timely corrective action.

Accounting and Regulatory Guidance for Establishment of Reserves Is Inadequate

Accounting standards and regulatory guidance for the establishment of loan loss reserves do not provide sufficient detail regarding the appropriateness of using loan loss history to establish reserves for large impaired loans, the development and application of historical loss factors, and the maintenance of supplemental reserves. This has given institutions excessive flexibility in establishing loan loss reserves. A recently issued accounting standard for impaired loans and a joint regulatory policy statement on loan loss reserves have provided some additional guidance, but do not resolve the problems GAO identified.

Recommendations

GAO recommends that the Financial Accounting Standards Board (FASB), in close consultation with the federal depository institution regulators, develop a comprehensive standard for establishment of loan loss reserves. The standard should (1) require institutions to establish reserves for large impaired loans based on the results of individual loan assessments, (2) provide sufficiently detailed guidance for the use of loss history to estimate inherent losses existing in the portion of the portfolio which has not been specifically analyzed for impairment, and (3) require that all portions of the reserve, including any supplemental amounts, be directly linked to and justified by a comprehensive documented analysis of current loss exposure in the loan portfolio.

Agency and FASB Comments

Each of the four federal depository institution regulators and FASB provided written comments on a draft of this report. These comments are presented and evaluated in chapter 2. FDIC, FRB, and OTS indicated that recently issued accounting and regulatory guidance discussed in the report was generally sufficient to address GAO's concerns. However, their responses to GAO's draft report contained key differences in their characterization of interagency and other regulatory guidance. In addition, while FDIC, FRB, and OTS generally shared GAO's concerns about the need to adequately identify and measure loan losses, they expressed the belief that, from a regulatory perspective, it was beneficial for institutions to maintain supplemental reserves and, in some cases, add-on reserves for individually assessed impaired loans.

OCC generally supported GAO's recommendation that FASB address deficiencies in GAAP for determination of loan loss reserves, but stated that it believes that the existing body of regulatory guidance provides an appropriate framework for banks to determine an adequate level of reserves and for examiners to evaluate the sufficiency of those reserves. However, OCC generally referred to its own guidance, rather than the interagency guidance cited by the other regulators. OCC's views differed significantly from the other regulators in several areas, particularly with regard to supplemental reserves and the use of industry averages to establish reserves.

FASB stated that it believes existing authoritative accounting guidance establishes clear and common objectives which can be applied to recognizing loan losses. However, its response differed significantly from those of some of the regulators with regard to the objectives of establishing loan loss reserves.

The differences between FASB and the regulators, and among the regulators themselves, reflect the potential for inconsistent interpretations of current accounting and regulatory standards and underscore the need for more definitive, comprehensive authoritative accounting guidance for the establishment of loan loss reserves. In addition, the general support of FDIC, FRB, and OTS for reserving approaches that include supplemental and add-on reserves is further symptomatic of uncertainty over how to best identify and measure probable existing loan losses. GAO believes that reserve shortfalls as well as excesses are likely to result from this uncertainty, because fluctuations in loan quality may not be effectively captured by the reserving methodologies currently used by institutions and examiners. Further, GAO believes that if regulators want institutions to set aside cushions for future uncertainties, this could be accomplished through direct capital appropriations. Such cushions, however, should not be established as part of the loan loss reserve.

The findings in our report show that the objectives of loan loss reserves are not clear and are not uniformly applied in practice. Therefore, GAO believes it is incumbent on FASB to provide additional authoritative accounting guidance for loan loss reserves as recommended. The draft of this report sent out for comment also included a recommendation to the regulators to implement the principles of GAO's recommendations to FASB if FASB did not act to adopt those recommendations. After consideration of the differences in responses to the report among the regulators, including the differences in interpretations of existing joint regulatory guidance, GAO decided to delete the recommendation to the regulators in the final report. However, GAO encourages the regulators to support FASB in its efforts to develop a comprehensive accounting standard for establishment of loan loss reserves.

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Abbreviations

AcSEC	Accounting Standards Executive Committee
AICPA	American Institute of Certified Public Accountants
FDIC	Federal Deposit Insurance Corporation
FRB	Federal Reserve Board
FASB	Financial Accounting Standards Board
GAAP	generally accepted accounting principles
OCC	Office of the Comptroller of the Currency
OTS	Office of Thrift Supervision
SEC	Securities and Exchange Commission
SFAS	statement of financial accounting standards
SFAC	statement of financial accounting concepts

Introduction

In the late 1980s, loan loss reserves established by depository institutions were criticized by regulators as being inadequate to cover losses from bad loans. From 1980 to 1992, approximately 2,700 federally insured depository institutions failed, at a substantial cost to the insurance funds and taxpayers. Bad loans for agriculture, energy, less developed countries, and commercial real estate contributed to the large number of failures. In 1992, the condition and performance of the nation's depository institutions improved substantially. Commercial banks posted record earnings of $32 billion while savings institutions posted aggregate earnings of $6.7 billion, continuing a positive trend that began in 1991. For 1993, this improvement continued with commercial bank profits of $43.4 billion and savings institution profits of $7 billion. Recently, some depository institutions have been criticized by regulators for maintaining more reserves than they need.

Background

The management of a depository institution establishes loan loss reserves through periodic provisions or charges to operating expenses. When a provision for loan losses is recorded by management, loan loss reserves increase by a like amount.[1] Loan loss reserves adjust the institution's loans receivable to reflect amounts that management estimates will not be recovered. When losses associated with loans or portions of loans are confirmed or determined to be certain, the loans or portions of loans are removed from the books of the institution by writing off the loan against the loan loss reserve. This results in removing amounts from the reserve that are associated with the confirmed losses.

Loan loss provisions and reserves are key indicators of loan quality that are included in the financial reports of depository institutions. Depositors, investors, and other financial report users rely on these indicators to make decisions about the financial condition of the institution. Regulators evaluate the adequacy of loan loss reserves during on-site, full scope, safety and soundness examinations. These examinations are conducted periodically to identify problems early and control risk. Regulators also monitor reserves through financial reports received between examinations to track institutions' financial condition and performance. Because of their importance to various users of financial reports, loan loss provisions and

[1]Reserve balances are also affected by charge-offs and recoveries. Therefore, while the provision increases the reserve by a like amount, the net change in the reserve balance depends on the amount of charge-offs (net of recoveries). However, for purposes of this report, we focused our discussion and analysis on the relationship between the provision and reserve balances.

reserves need to accurately reflect specifically identified loss exposures as well as other inherent loss exposures[2] in the institution's loan portfolio.

Authoritative accounting rules for financial reporting are primarily established by the Financial Accounting Standards Board (FASB). These accounting rules are referred to as generally accepted accounting principles (GAAP) and are promulgated through the issuance of statements of financial accounting standards (SFAS) by FASB. The American Institute of Certified Public Accountants (AICPA), through its Accounting Standards Executive Committee (AcSEC), issues accounting guidance on issues not otherwise covered in authoritative literature. The Securities and Exchange Commission (SEC) has statutory authority to set accounting principles, but as a matter of policy it generally relies on FASB and the AICPA to provide leadership in establishing and improving accounting principles. However, SEC frequently issues accounting and disclosure regulations to supplement guidance provided by FASB and the AICPA.

We have previously reported the existence of significant problems in measuring and accounting for losses from problem loans and regulatory examinations of loan loss reserves. In our study of 39 banks which failed without warning in 1988 and 1989, we found that asset valuations the Federal Deposit Insurance Corporation prepared after the banks failed increased their loss reserves from $2.1 billion to $9.4 billion.[3] Although we acknowledged that several factors contributed to this difference, such as deterioration in loan values subsequent to failure, we concluded that a significant portion of it was caused by institutions making inadequate estimates of loan losses prior to failure.

In our assessment of regulatory examinations,[4] we found that the four federal financial institution regulators—the Office of the Comptroller of the Currency (OCC), the Federal Reserve Board (FRB), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS)—did not have a uniform risk-based methodology to judge an institution's loan loss reserves. Examiners lacked a consistent framework to quantify loan portfolio risks such as real estate exposure, unfavorable economic conditions, and deficient loan policies. Methods for assessing loan loss reserves varied among the regulators and the lack of a generally

[2]Inherent losses exist when events or conditions have occurred which will ultimately result in loan losses, but the losses are not yet apparent in individual loans.

[3]Failed Banks: Accounting and Auditing Reforms Urgently Needed (GAO/AFMD-91-43, April 22, 1991).

[4]Bank and Thrift Regulation: Improvements Needed in Examination Quality and Regulatory Structure (GAO/AFMD-93-15, February 16, 1993).

accepted method made it difficult for the regulators to successfully challenge management's estimates when the examiners believed reserves were inadequate.

Objectives, Scope, and Methodology

Our objectives were to determine whether

- loan loss reserve methodologies used by insured depository institutions resulted in reserve amounts that were justified by supporting analysis and comparable among institutions and
- accounting standards provided by FASB and regulatory guidance provided by OCC, FRB, FDIC, and OTS were sufficient to promote fair and consistent financial reporting of loan loss reserves among depository institutions.

To determine whether loan loss reserve methodologies used by insured depository institutions resulted in reserve amounts that were justified by supporting analysis and comparable among institutions, we conducted case studies of 12 depository institutions, each with total assets over $1 billion, which we judgmentally selected. They are referred to as Institutions A through L in this report. To include a cross section of depository institutions, we selected institutions supervised by OCC, FRB, FDIC, and OTS[5] that were currently being examined or had been examined during the last 12 months. For geographic diversity, we selected institutions located in California, Maryland, New York, North Carolina, Texas, and Virginia.

For each institution, we reviewed all major components of the loan loss reserve methodology, including individual loan assessments, analysis of historical experience, and other means used for reserve allocations. In addition, we reviewed the institution's overall loan loss assessment, including the criteria and methods used to estimate losses for both commercial[6] and consumer[7] loans. To accomplish our work, we reviewed examination working papers for loan loss reserves and the institution's loan loss reserve documents, when they were available. We also conducted detailed interviews with the regulatory examiner-in-charge

[5]The 12 institutions included 5 national banks regulated by OCC, 3 state chartered banks regulated by FDIC, 2 state chartered banks regulated by FRB, and 2 thrifts regulated by OTS.

[6]For purposes of this report, commercial loans are loans made for business, commercial real estate, and other trade-related activities. They do not include loans for 1-4 family residential property, consumer installment loans, and other consumer-related financing.

[7]For purposes of this report, consumer loans are defined as loans to individuals for residences, automobiles, household items, family needs, or other personal expenditures.

and/or management to discuss the institutions' loan loss reserving methodologies and the application of accounting rules and regulatory guidance.

To determine whether accounting standards and regulatory guidance were sufficient to promote fair and consistent financial reporting, we reviewed all relevant accounting and regulatory guidance for establishing loan loss reserves. This included SFAS No. 5, Accounting for Contingencies; SFAS No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings; SFAS No. 114, Accounting by Creditors for Impairment of a Loan; AICPA audit and accounting guides for banks and savings institutions; OCC Banking Circular 201, Allowance for Loan and Lease Losses; FDIC May 1991 Policy Memorandum for Allowance for Loan and Lease Losses; examination manuals for each of the four federal regulators; and the Securities and Exchange Commission's Financial Reporting Release No. 28, Accounting for Loan Losses by Registrants Engaged in Lending Activities.

Each of the four federal depository institution regulators and FASB provided written comments on a draft of this report. These comments are presented and evaluated in chapter 2 and are reprinted in appendixes I through V. Our work was performed between November 1992 and March 1994 in accordance with generally accepted government auditing standards.

Loan Loss Reserves Were Incomparable and Included Large Unjustified Amounts

The 12 depository institutions we reviewed used markedly different methods to establish their loan loss reserves, which resulted in incomparable reserves, and, in most cases, significant portions of their reserves were not justified by supporting analyses. Most of the institutions based large amounts of their reserves on loss history. Historical loss rates provide a valuable basis for estimating future losses and can be appropriately used to establish reserves for nonproblem loans and smaller-balance pools of loans. However, the methods used by the institutions to determine and apply historical loss experience did not consistently identify and measure loan loss exposure, which resulted in incomparable reserve amounts. In addition, historical loss rates were routinely applied to establish reserves for individual problem loans even though individual loan assessments provide the most accurate means to identify and measure loss exposure for such loans. Finally, most of the institutions maintained large supplemental reserves which were not linked to quantitative analyses of loss exposure or other evidence that demonstrated that the amounts were needed to cover likely loan losses.

Neither accounting standards nor regulatory guidance provided sufficiently detailed direction about how loan loss reserves should be established to ensure that reserves are clearly justified and comparable among institutions. Given such flexibility, the institutions used widely diverse loan loss estimating methods that resulted in incommensurable reserves and also reserves that may not have reflected the true risk of loss in their loan portfolios.

Loan loss reserves that cannot be compared or that misrepresent risks in loan portfolios impede investors, creditors, depositors, regulators, and other users of financial reports from understanding the true financial condition of depository institutions. Such reserving practices also impede early warning of changes in an institution's financial condition and timely regulatory actions to protect the banking and savings and loan insurance funds.

Reliability and Comparability Are Key Elements of Useful Financial Reporting

The primary purpose of financial reporting is to provide information to report users which they can utilize in making investment, credit, and similar decisions. Statement of Financial Accounting Concepts (SFAC) No. 2, Qualitative Characteristics of Accounting Information (FASB, May 1980), discusses criteria that are necessary for accounting information to be useful for making business and economic decisions. Reliability and comparability are two of the major criteria discussed in the statement.

SFAC No. 2 states that accounting information is reliable to the extent that users can depend on it to reflect the economic conditions or events that it purports to represent. Reliability of accounting information stems from representational faithfulness and verifiability. In other words, to be reliable, accounting information must be verifiable and directly related to the economic resources and obligations of the enterprise, as well as to transactions or events that change those resources or obligations. With regard to comparability, SFAC No. 2 states that information concerning an enterprise gains greatly in usefulness if it can be compared with similar information about other enterprises and with similar information for different periods of time or points in time for the same enterprise. The significance of information, especially quantitative information, depends to a great degree on the user's ability to relate it to some benchmark. One of the principal reasons for accounting standards is the desire for such benchmarks for purposes of making financial comparisons.

Loan Loss Reserves Are a Key Factor in Determining the Financial Condition of Depository Institutions

Loans are the largest single component of most depository institutions' assets; therefore, loan loss reserves and related provisions are critical to understanding the financial condition of a depository institution, including identification of changes in its credit risks and exposures. Provisions directly affect an institution's current earnings and represent the amount necessary to adjust the loan loss reserve to reflect estimated uncollectible loan balances outstanding. In theory, as the risks and exposures from uncollectible amounts in the loan portfolio increase or decrease, this should be reflected by a corresponding increase or decrease in the provision and reserve. Because of their importance as indicators of financial condition, loan loss provisions and reserves must reliably reflect estimated losses in the loan portfolios of institutions and be subject to meaningful comparison.

The loan loss reserve must be sufficient to cover both specifically identified loss exposures as well as other inherent loss exposures in the institution's portfolio. Therefore, an adequate reserve hinges on (1) timely identification and analysis of loss exposures on impaired[1] loans, and (2) analysis of loss exposures on unimpaired loans considering past trends and current conditions. Loss exposures on larger balance impaired loans are generally best evaluated using individual loan assessments, which include detailed review of the financial condition of the borrower, loan

[1]According to SFAS No. 114, Accounting by Creditors for Impairment of a Loan, a loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement.

payment history, fair value[2] of collateral, loan guarantees, and other relevant information. In contrast, loss exposures on unimpaired loans and smaller-balance loans are generally best evaluated on a group basis by assessing historical loss experience for pools of loans with similar characteristics, adjusted for changes in economic and business conditions which affect the institution's lending operations.

Results of Individual Assessments Often Not Used

All 12 institutions regularly reviewed their commercial loans individually as part of assigning risk ratings or grades[3] for credit quality to these loans. However, to establish reserves for commercial loans that were identified as problem loans through this process, most of them routinely reverted to loss history in lieu of using individual loan assessment results or to supplement the results. We were not able to determine the percentage of the institutions' total reserves that were established using these approaches because the amounts could not be sufficiently segregated from other reserves based on historical losses, including reserves for pools of nonproblem loans. However, based on our review of the institutions' policies, discussions with management or examiners, and review of samples of problem commercial loans, we found that historical losses were reverted to in lieu of or in addition to individual problem loan assessments in the following cases.

- Institutions D and E used average historical loss rates that closely resembled loss rates for the overall banking industry in place of individual loan assessments.[4] Institution D always used these rates to set reserves for

[2]Fair value is the amount one can reasonably expect to receive in a current sale, not a forced or liquidation sale, from a willing buyer.

[3]Financial institution personnel assign risk ratings or grades to loans to monitor exposure to risk. Institutions use various rating ranges but all ranges typically include categories which coincide with the regulators' loan classifications of pass or unclassified, special mention, substandard, doubtful, and loss. A pass or unclassified loan is considered of sufficient quality to preclude a special mention or an adverse rating. Special mention loans have potential weaknesses, which may if not corrected, lead to inadequate protection of the institution at some future date. Substandard loans are inadequately protected by the current sound worth and repayment ability of the obligor or by the pledged collateral, if any. Doubtful loans have all the weaknesses inherent in an asset classified substandard and whose collection or liquidation is highly questionable. Loss loans are considered uncollectible and of such little value that their continuance as active assets is not warranted.

[4]Management officials of Institutions D and E stated that the percentages were developed through management consensus or other analyses; however, there was no support for the loss percentages in either of the institutions' most recent analysis of reserves. The regulatory examiners stated that the loss percentages were based on the regulator's examination "bench mark" or "rule of thumb" percentages. These percentages were developed by the regulator from industry historical averages, with no adjustment for differences in loan policies, loan administration practices, portfolio composition, or economic conditions affecting individual institutions.

problem commercial loans. Institution E used the loss rates only when they resulted in more reserves than the individual assessments.

- Institutions A, B, and H used their own historical loss rates to establish reserves for individually assessed loans when the rates resulted in more reserves than the individual assessments.
- Institution G used its own historical losses to establish reserves for individually assessed loans when no loss exposure was identified by the individual assessments.
- Institutions C, F, I, and K used detailed assessments to establish specific reserves for individual loans. These institutions used their own loss history to establish additional reserves over and above reserves determined from the detailed assessments.[5] In at least one case, these additional amounts were intended to cover possible deterioration in the current fair value of the loan's collateral.

Because individual loan assessments provide the most accurate means to identify and measure loss exposure for larger-balance impaired loans, the use of historical losses by the institutions in place of or in addition to individual assessments may have overstated or understated reserves for these loans and thus misrepresented the risk in their loan portfolios.

For example, the collateral gap[6] for one problem commercial real estate loan we reviewed at Institution D was $21.2 million. Because there was no evidence in the loan examination file we reviewed that other payment sources, such as loan guarantors, could be relied upon to cover this gap, we determined that the loss exposure for the loan was the full $21.2 million. However, as shown in table 2.1, the reserve that was established by Institution D with loss rates that closely resembled industry averages was only $8.1 million. We believe that this $13.1 million difference represented a material understatement of Institution D's loss exposure.

Also, as shown in table 2.1, had this same loan been in the portfolio of Institution E, reserves would have likely covered most if not all of the $21.2 million deficiency. This is because Institution E's policy was to reserve for the greater of estimated losses based on loss rates which closely resembled industry averages or individual loan assessments.

[5]Institution I also compared its historical loss rates to minimum benchmark rates that were judgmentally selected by management and used the higher of the two rates to establish reserves.

[6]The collateral gap is the difference between the outstanding loan balance and the current fair value of the loan's collateral. It is the major indicator of loss exposure for problem commercial real estate loans.

Institution F, under its policy, would have likely established reserves for the entire $21.2 million deficiency noted above plus an additional $2.4 million,[7] based on its own loss history, to cover possible deterioration in collateral value.

Table 2.1: Reserving Methods Produce Different Results for the Same Loss Exposure

Dollars in millions

Institution	Collateral gap	Loan loss reserve allocation	Reserve excess/ (deficiency)	Collateral gap covered (percent)
D	$21.2	$8.1	($13.1)	38
E	$21.2	$21.2	$0	100
F	$21.2	$23.6	$2.4	111

The use of historical industry loss rates, or even historical loss rates for the institution, in place of individual loan assessments can just as easily materially overstate loss exposure on an individual problem loan where the collateral value or other payment source sufficiently covers the outstanding loan balance. For example, another commercial real estate loan we reviewed at Institution D had an outstanding balance of $21.5 million, and the appraised fair market value of the loan's collateral was $25 million. Notwithstanding the fact that the collateral adequately covered the loan balance, the institution reserved $4.3 million for this loan as a result of using loss rates which closely resembled industry loss rates.

Historical losses based on industry averages or an institution's own past experience do not accurately reflect the specific borrower's current financial condition, ability to make timely loan payments in the future, the current fair value of loan collateral, or other payment sources. As a result, the historical loss factor cannot identify potential loss in a specifically identified impaired loan as reliably as a detailed assessment. The use of historical loss rates in place of individual loan assessment results or to supplement such results can produce unreliable reserves and misrepresent the level of losses present in individually assessed loans.

Inconsistent Methods Used to Calculate Historical Loss Rates

Historical loss analysis can provide useful indications about how large groups of homogenous loans have performed in the past. This type of analysis can be used as a basis to estimate inherent losses on nonproblem commercial loans, as long as the estimate is appropriately adjusted in a verifiable manner to reflect current characteristics of the loan portfolio.

[7] The institution's historical loss factor of 12.5 percent would have likely been applied to the loan's collateral value of $19.2 million to arrive at the $2.4 million additional reserve.

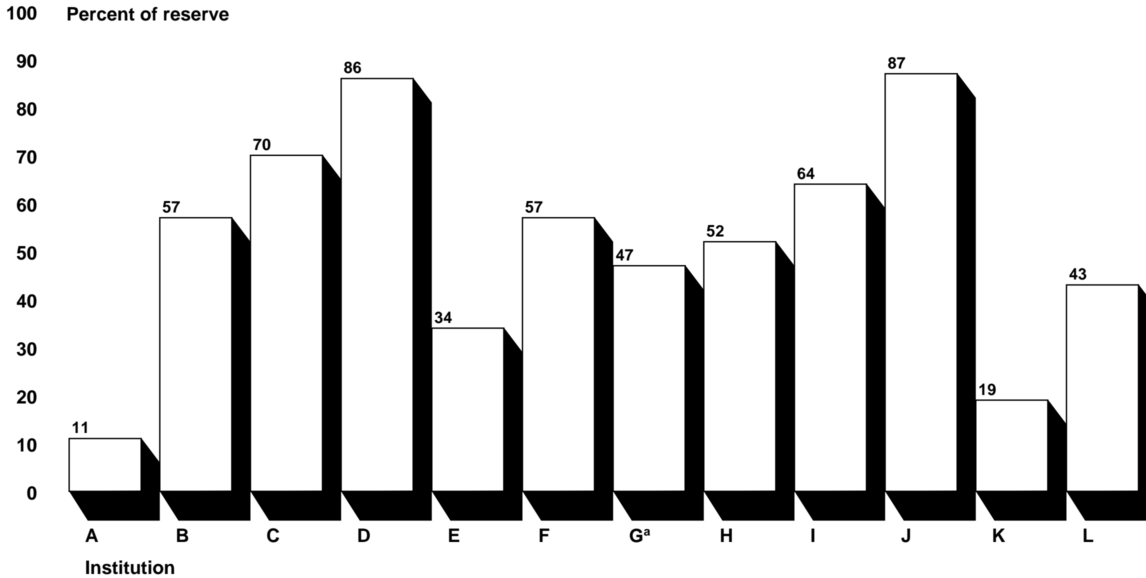
Such analysis is also effective for estimating inherent losses in smaller, low-risk loans such as consumer loans.

All of the institutions used historical losses to establish reserves for loans that were not individually assessed. As previously discussed, most of the 12 institutions also used historical losses in some form to establish reserves for specifically identified problem loans even when individual loan assessments were performed. Thus, significant amounts of the reserves of most of the institutions were based on historical losses. However, because the methods used to determine and apply these historical losses varied widely the resultant reserve amounts were not comparable among the institutions.

As shown in figure 2.1, the 12 institutions used loss history to establish from about 11 percent to 87 percent of their total loan loss reserves.[8] Nine of the institutions relied on loss history to determine 40 percent or more of their total reserves.

[8]We estimated the amount of each institution's loan loss reserve that was determined from loan loss history and other factors—such as current economic conditions—based on our review of institution documents, examination working papers, discussions with management, and/or interviews with examiners. Our estimates for historically determined reserves reflect amounts that we could clearly link to historical loss rates. In certain cases, historical loss rates were used to establish reserves for loans that were individually assessed. For individually assessed loans, we could not always segregate amounts based on loss history from amounts that were based on detailed individual loan assessments. The reserve amounts shown in figure 2.1 could be even greater had we been able to segregate all amounts included in individual reserves which were based on historical factors.

Figure 2.1: Percent of Reserves Based on Historical Losses



[a]Institution G's reserves based on historical losses included management adjustments for economic conditions, regulatory examination results, and other supplemental factors, which we were unable to segregate.

As shown in table 2.2, the major methods that were used by the institutions to determine historical loss rates ranged from a relatively simple approach which used actual losses for 1 year to a relatively complex method known as migration analysis. Migration analysis is a process by which loans are tracked and recorded by the institution as they move through various risk grades until they are charged-off as losses. Using migration analysis, an institution can estimate losses for the current year and subsequent years for loans in each loan grade.

Table 2.2: Major Methods Used by Institutions to Determine Historical Loss Rates

	Commercial loans		Consumer loans	
Institution	Method of historical analysis	Length of time data analyzed	Method of historical analysis	Length of time data analyzed
A	Actual losses	1 year	Loss trends	3 years
B	Migration analysis	7 years	Delinquency flow-through analysis[a]	2 or 3 years depending on loan type
C	Migration analysis	10 years	Delinquency flow-through analysis	2 to 4 years based on management judgment
D	Average loss rate for industry	Not applicable	Actual losses	3 months
E	Average loss rate for industry	Not applicable	Loss trends	25 months to 4 years depending on loan type
F	Average losses	3 years	Average losses	1 year
G	Actual losses	20 months	Average losses	5 years
H	Average losses	Midpoint of 1 year and 4 years[b]	Delinquency flow-through analysis	8 or 12 months depending on loan type
I	Migration analysis	1 year	Average losses	3 years
J	Migration analysis	4 years	Migration analysis	4 or 6 years depending on loan type
K	Average losses	5 years	Average losses	5 years
L	Unable to obtain[c]	Unable to obtain	Unable to obtain	Unable to obtain

[a]Delinquency flow-through analysis is a process by which loans are tracked and recorded by the institution as they move through various delinquency categories (based on number of days past due) until they are charged-off as losses.

[b]Institution H calculated two loss estimates by using the average losses from the previous year and 4 years. The institution used the midpoint of these two loss estimates to determine historical losses for reserve purposes.

[c]Institution L's federal regulatory examiner did not know how the institution determined its loss history. We requested this information from the institution's management but it declined our request.

As noted in table 2.2, Institutions B, C, I, and J used migration analysis to derive historical loss factors for their commercial loan portfolios.[9] Most of the other institutions used either actual charge-offs over a relatively short time period or average annual charge-offs to compute historical loss rates. Generally, institutions that use annual charge-offs to develop historical loss rates attempt to identify losses that are likely to be confirmed and charged-off over the coming year. In contrast, institutions can use methods such as migration analysis to attempt to capture losses that will likely be confirmed and charged-off during the life of the loan portfolio. Because commercial loans can have maturities beyond 1 year, the loss rates developed using methods such as migration analysis will generally cover a longer period and, therefore, will be greater than rates based solely on annual charge-offs.

The institutions also used markedly different time periods of past experience to determine historical loss rates. As shown in table 2.2, the institutions' historical bases ranged from 1 year to 10 years for commercial loans and from 3 months to 6 years for consumer loans. The objective of using longer time periods to determine historical loss rates is to preclude a particularly good or bad year from having an inordinate effect on the institution's current reserves. Ideally, a sufficient number of years should be used so that historical loan performance can be gauged over the course of the institution's economic cycle.[10] However, the objective of using shorter time periods such as 1 year is typically to reflect only an institution's most recent loss experience. Reserves based on several years' losses can be significantly different than reserves based on the most recent 12 months, which could be a particularly good or bad year.

For example, for one institution we reviewed, the average charge-off rate was 1 percent of total loans from 1989 through 1992. Had the reserves been based on this average, they would have amounted to about 13 percent of the institution's capital at the end of 1992. However, had the reserves been based on charge-offs for the most recent 12 months, which amounted to 2.6 percent of total loans during 1992, the institution would have established reserves of about 33 percent of 1992 capital. Clearly, in

[9]Institutions B and C used migration analysis to track criticized loans, which include loans graded special mention, substandard, doubtful, and loss. Institutions I and J used migration analysis to track all commercial loans. According to officials at Institution B, plans are being made to expand the use of migration analysis to track all commercial loans. Management officials at Institution I stated that they had just begun to use migration analysis and only had historical data for about 1 year. They stated that plans are being made to expand the period of time used to conduct their migration analysis.

[10]An institution's economic cycle is the time period that typically encompasses expansions and contractions in business activity for its major commercial customers.

this case, the use of the average charge-off rate would have resulted in significantly different loss estimates than use of the most recent charge-off rate.

Finally, most of the institutions used their own loss history to develop historical loss rates. However, as mentioned previously, Institutions D and E used rates that closely resembled industry averages to establish reserves. The industry averages were developed by the institutions' federal regulator, with no adjustment for differences in loan policies, loan administration practices, portfolio composition, or economic conditions affecting individual institutions.

Loss reserve methods that rely predominantly on standard industry loss percentages are likely to create misleading loan loss provisions and reserves because they do not consider the particular characteristics of the institution's loan portfolio. In addition, the use of such percentages creates reserves that are not comparable to reserves of institutions which use their own loss experience to estimate losses.

For example, Institution H's loan loss reserve for commercial loans, which was based largely on its own loss history, totaled approximately $708 million. However, application of the loss rates used by Institution D to Institution H's commercial loan portfolio balances, would have increased its reserve for commercial loans to about $1,139 million, or by 61 percent.

These inconsistencies in the application of historical loss experience to determine current reserve estimates resulted in wide disparities in reserves among institutions. These disparities were exacerbated by the fact, as stated previously, that most of the institutions used historical loss experience as their primary means to estimate loan loss reserves. The resultant incomparability in reserves can be a major impediment to financial report users, as it hampers their ability to assess the true financial condition and relative health of depository institutions.

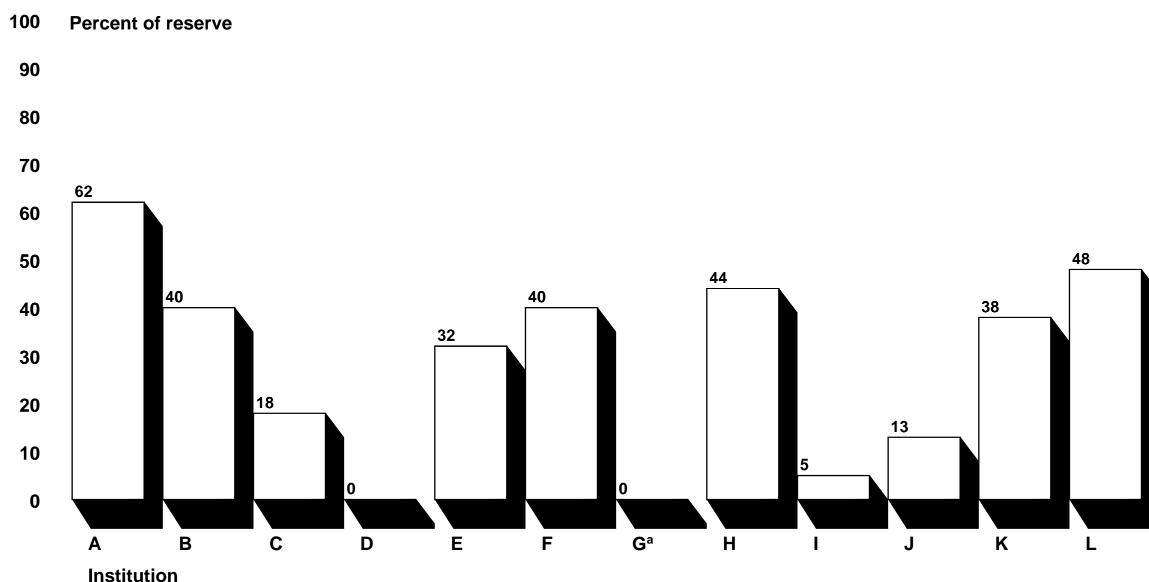
Large Supplemental Reserves Not Adequately Justified

Supplemental reserves are reserves established by management over and above amounts determined by analyses of individual loans and loss history. Although supplemental reserves may be needed to cover specific loss exposure not identified by individual loan assessments and loss history, they can conceal the true condition of an institution's loan portfolio and distort its earnings and capital position if used

inappropriately. Further, unjustified supplemental reserves are not comparable to reserves that reflect only estimates of likely losses.

As shown in figure 2.2, supplemental reserves comprised over 30 percent of the total loan loss reserves for 7 of the 12 institutions we reviewed.

Figure 2.2: Percent of Reserves Comprised of Supplemental Reserves



[a]Institution G's reserves included management adjustments for economic conditions, examination results, and other supplemental factors, which we were unable to segregate from reserves based on historical losses presented in figure 2.1.

In most cases, the supplemental reserves were not quantitatively linked to an analysis of loan loss exposure nor was there adequate support to demonstrate that they were based on reasonable estimates of likely losses. The rationale for supplemental reserves varied among institutions. We were told by management or examiners that the supplemental reserves were intended to adjust loss history for current conditions, provide a cushion for future uncertainties, or appease regulators. Regulatory examiners for two institutions told us that the supplemental reserves resulted, in part, from management not reducing reserve amounts recorded in the institutions' records to reflect the most recent estimates of

loss exposure. By categorizing the differences between current loss exposure estimates and their recorded reserves as supplemental reserves, these institutions avoided taking a negative loan loss provision.

Although two institutions linked a portion of their supplemental reserves to specific portfolio risk analyses, the majority of supplemental reserves were not adequately linked to specific loss exposure. Explanations provided by management or examiners for supplemental reserves generally did not demonstrate that the reserves were justifiable loan loss estimates. Several examples of substantial supplemental reserves that were not adequately linked to loan portfolio risk and likely losses follow.

- Institution B built its supplemental reserve to about 40 percent of its total loan loss reserve after federal regulators directed it to increase its reserve after an examination in 1992. In the third quarter of 1992, the institution's detailed analysis of loan losses indicated that it needed an additional $301 million in loss reserves. However, the regulator required the institution to take a loss provision of $400 million and increase its loan loss reserve by a like amount. According to a senior management official, although not justified by the institution's loan portfolio analysis, management agreed to take the additional $99 million provision to comply with the regulator's decision. Even though the institution's detailed analysis of its loan portfolio in the 3 subsequent quarters indicated that it had sufficient loan loss reserves, it continued to charge earnings by taking additional provisions each period with the encouragement of the federal regulator. At the end of the second quarter of 1993, the institution's reserve was about $612 million over what was justified by its own loan portfolio analysis. This amounted to about 15 percent of capital and exceeded the previous year's earnings by over 80 percent.
- Institution L's supplemental reserve comprised about 48 percent of its total loan loss reserve. Documents prepared by the institution indicated that most of this reserve was considered to be excess. The federal regulatory examiner for the institution told us that he believed the institution used the excess reserve as a plug or cushion for the difference between the reserve that was needed to cover estimated losses and the reserve recorded in its books. Although the federal regulator did not criticize the level of the institution's reserve, the state regulator believed that it was too high. According to the federal regulatory examiner, the institution was not directed to adjust its reserve but requested to adequately support all supplemental reserve components in the future.
- Institution H's supplemental reserve comprised about 44 percent of its total loan loss reserve. This amounted to about 8 percent of its capital and

56 percent of its earnings. Neither the institution nor the federal regulator demonstrated that the supplemental reserve was based on reasonable estimates of likely losses. According to management officials, most of the supplemental reserve was established through management judgment and consensus and was intended to cover possible losses associated with anticipated bulk sales of some of the institution's bad loans, potential errors in loan grading, inexperience with acquired banks, and local and national economic conditions. However, there was no linkage of these factors to reserve amounts in the analyses we reviewed. Further, factors used to set supplemental reserves for specific types of loans were not supported. One official stated that the institution maintains a large supplemental reserve, in part, to "keep the regulators happy." He stated that regulatory examiners have relied on "rule of thumb" percentages to determine reserve adequacy and have been more comfortable when the institution maintains a large reserve.

- Institution E had a supplemental reserve that comprised about 32 percent of its total loan loss reserve. Management officials chose to keep the supplemental reserve at current high levels to protect the institution against credit concentrations and possible economic swings even though they had noted that each of the institution's loan quality indicators had improved. Management officials stated that the large supplemental reserve was added to the current loan loss estimate, in part, to make the estimate equal to the reserve recorded in the institution's records. This enabled the institution to avoid adjusting the recorded reserve downward to reflect the current estimate of loss exposure. The supplemental reserve amounted to about 73 percent of earnings and 6 percent of capital.

Supplemental Reserves May Conceal Changes in Portfolio Condition

Large supplemental reserves can mask changes in an institution's loan portfolio that are critical to understanding its financial condition. Previously established supplemental reserves can be used to absorb current increases in estimated losses. In such instances, an institution can avoid increasing its current loan loss provision and reserve to reflect the deterioration in the portfolio. In these cases, neither the institution's current loss provision nor changes in existing reserves would be reliable indicators of the increased risk in its loan portfolio. Large supplemental reserves can also overstate risk by inappropriately hiding improvements in an institution's loan portfolio.

Table 2.3 illustrates hypothetically how supplemental reserves can conceal current loan portfolio deterioration as well as improvement.

Table 2.3: Examples of How Supplemental Reserves Can Conceal Changes in Loan Portfolio Condition

	Year				
	1	2	3	4	5
Loan loss estimate	$1,800	$1,600	$1,500	$2,200	$2,400
Recorded reserves	2,000	2,100	2,200	2,300	2,400
Provision needed	(200)	(500)	(700)	(100)	0
Actual provision	100	100	100	100	100
Supplement	300	600	800	200	100

As shown in table 2.3, by taking loan loss provisions during years when the recorded reserve is greater than estimated loss exposure, the institution can build a substantial unjustified supplemental reserve. The build-up of the supplemental reserve not only masks the improvement in the condition of the loan portfolio during years 1 through 3, but also enables the institution to conceal the significant increase in loss exposure which occurs during years 4 and 5. Loss exposure increases by 60 percent between years 3 and 5; however, the loan loss reserve increases by only about 9 percent. As a result of the unjustified supplemental reserve, neither the institution's annual provisions nor changes in its recorded loan loss reserve balances reflect the significant changes which occur in the quality of its loan portfolio.

In order for institutions' loan loss reserves and related provisions to provide reliable information about the quality of their loan portfolios, these loan quality indicators must coincide with the institutions' verifiable estimates of loss exposure. The use of large unjustified reserves undermines the credibility of these important financial condition barometers. As previously noted, 7 of the 12 institutions we reviewed had supplemental reserves which totaled at least 30 percent of their total reserves. Conceivably, these institutions could use these reserves to absorb increases in estimated loan losses and not record loss provisions or adjust reserve levels to reflect changes in the condition of their portfolios for several periods. Conversely, if their loan portfolios were improving and they continued to build supplemental reserves by maintaining the same levels of provisions and reserves as in prior periods, these loan quality indicators would not reflect this improvement.

Some amount of supplemental reserve may be needed to cover specific loss exposure over and above that identified by analysis of individual loans and loss history. However, an unjustified supplemental reserve can be used to manipulate earnings and capital position and, therefore, distort financial reports such that investors, creditors, depositors, regulators, and

other report users do not have a clear basis for making decisions about the financial condition of an institution. This lack of transparency is compounded when financial statement users attempt to compare institutions whose reserves are not comparable because they use significantly different approaches to establish reserves. As a result, institutions that use unjustified supplemental reserves can seriously compromise both the reliability and comparability of financial information: two key elements of useful financial reporting.

Authoritative Guidance Does Not Provide Adequate Standards for Establishment of Reserves

Accounting and regulatory guidance for the establishment of loan loss reserves is too flexible to ensure reserves are determined in a consistent and reliable manner. Only broad authoritative accounting standards exist for establishment of overall loss reserves, and they have been applied liberally in practice. Regulatory guidance discusses the types of risks that need to be considered in setting reserves; however, the guidance does not provide sufficient information about how risks should be quantified and linked to reserve allocations. Further, guidance provided by the four federal regulators is not always consistent. The lack of adequate standards has resulted in reserve amounts which cannot be meaningfully compared among institutions and which may not represent the true level of risk in institutions' loan portfolios.

The primary authoritative accounting literature governing establishment of overall loss reserves is SFAS No. 5, Accounting for Contingencies. Although SFAS No. 5 states that provisions for losses should be made only when losses are probable and can be reasonably estimated, neither it nor any other authoritative accounting literature provides guidance or establishes parameters to ensure that loan loss history and other factors that are used to identify losses meet these two conditions.

Recently, FASB issued SFAS No. 114, Accounting by Creditors for Impairment of a Loan.[11] SFAS No. 114 provides loss recognition and measurement criteria for individual loans that are identified for evaluation of collectibility. The statement specifies that, for loans which are individually assessed, impairment should be measured on the basis of the present value of the loan's expected cash flows, the loan's observable market price, or the fair value of the collateral if the loan is collateral dependent. SFAS No. 114, however, does not specify how a creditor should identify loans that are to be individually assessed for collectibility, address how an institution should determine loss reserves for loans that are not

[11]SFAS No. 114 applies to financial statements for fiscal years beginning after December 15, 1994.

individually assessed, or provide additional guidance for the establishment of overall reserves. Therefore, while SFAS No. 114 provides specific guidance for determining when a loan has been impaired and how to quantify the impairment, it does not resolve the problems we identified in our review.

Further, while the guidance in SFAS No. 114, if properly implemented, may be an improvement over current practice for assessing individual impaired loans, it will still lead to inconsistencies in establishing reserves, particularly for collateral dependent loans. The three alternative approaches under the statement could result in very different loss estimates for the same loan because the fair value of the loan collateral could be quite different from the current market price of the loan. The current market price, in turn, is also likely to be different from estimated discounted cash flows to be received from the borrower. In addition, the timing of cash receipts may be difficult to predict. In commenting on the Exposure Draft for SFAS No. 114, we advised FASB of our view that fair value accounting should be required for all collateralized problem loans, which would eliminate this inconsistency. We believe that the fair value of collateral is the most objective and accurate measure to use to determine the loss exposure on a collateral dependent impaired loan.

Regulatory guidelines developed by the four federal regulators are not consistent and generally lack specific direction for the establishment of overall loan loss reserves. The guidelines for three of the regulators state that loan loss reserves must be adequate to absorb all estimated losses that meet SFAS No. 5's two conditions for loss recognition; however, one regulator's guidelines do not mention these criteria. Regarding the use of loss history, none of the regulatory guidelines explain the merits and limitations of using migration analysis over other approaches to identify and measure losses that are probable and estimable. Further, while the guidelines for two of the regulators do not address the number of years that should be included in determining historical losses, one regulator recommends 5 years and another requires 3 years.

Regarding the way loss history should be applied to set reserves for loans, one regulator's guidelines clearly state that loans individually assessed should not receive reserve allocations based on loss history. However, the guidelines for another regulator require institutions to add reserves to those determined from individual loan assessments. A policy official for the regulator told us that institutions are required to add reserves for the fully collateralized portion of individually assessed problem loans. Two

regulators do not specifically address the application of historical information to individually assessed loans in their guidelines.

Some of the requirements and suggested procedures in the regulators' guidelines promote the establishment of reserves over and above losses that are clearly probable and based on reasonable loss estimates. Although each of the regulator's guidelines list a number of valid factors that an institution should consider in setting reserves, no discussion is included in any of the guidelines about how such factors should be assessed to ensure that all amounts allocated to the loan loss reserve are for likely losses and supported by verifiable analysis. Further, one regulator's guidelines encourage institutions to use supplemental reserves to cover errors in the loss estimating process but do not provide parameters for establishment of such reserves.

Management officials of three institutions told us that better guidance is needed for loan loss reserves. Officials of the first institution stated that accounting and regulatory guidance is not helpful to institutions in setting reserves because they do not address how various subjective factors should be measured. They also stated that there is too much variation in how reserves are established by institutions and that such variation needs to be addressed by accounting and regulatory guidance so that loss reserves are comparable among institutions. Officials of the second institution stated that regulators and management are frustrated because there is no consistent approach to establishing loan loss reserves. They stated that one regulator goes beyond GAAP by requiring the institution to set reserves for fully secured portions of loans. A management official of the third institution stated that the guidance needs to include standards for the use of loss history so that institutions use a common basis for establishing loan loss reserves.

The lack of accounting and regulatory standards for establishment of overall loan loss reserves has led to the evolution of a hodgepodge of accounting practices with no clear and common objectives. Without adequate accounting and regulatory standards, management of depository institutions are afforded excessive flexibility in establishing loan loss reserves, and regulators may be prone toward arbitrary determinations of required reserve levels.

Federal Regulators Issue Interagency Policy Statement for Loan Loss Reserves

On December 21, 1993, OCC, FRB, FDIC, and OTS issued an interagency policy statement for loan loss reserves. The statement supplements existing regulatory guidance and is intended to provide consistent approaches among the regulators to assess reserve adequacy. The statement clearly states that an institution's reserves must be maintained at a level to absorb estimated losses that meet the loss criteria of GAAP. Therefore, each of the regulators acknowledge that provisions and reserves must be adequate to cover losses that can be reasonably estimated and that will likely occur as stated in SFAS No. 5. The interagency statement, however, does not adequately address the problems we identified in our review—reserves not being comparable and possibly misrepresenting portfolio risk because of the use of loss history to supplement individual loan assessment results, inconsistent use of loan loss history, and unjustified supplemental reserves.

According to the statement, the institution should rely primarily on an analysis of the various components of its portfolio to determine reserves, including analysis of all significant credits on an individual basis. For individual loans, however, it does not prohibit or discourage institutions from using loss history to supplement reserves determined from specific detailed assessments. Further, it does not state whether institutions should reserve for portions of individual loans that are adequately covered by collateral. As previously discussed, institutions' use of loss history in place of individual loan assessment results can significantly overstate or understate loss exposure for problem loans and produce reserves that are not comparable.

Although the interagency statement states that losses should be estimated over the remaining effective lives of loans classified substandard and doubtful, it does not provide specific guidance or minimum requirements for the use of migration analysis or other techniques to ensure that losses are estimated in this manner. Rather, the statement states that methods for determining historical losses can range from a simple average over a relevant number of years to more complex techniques, such as migration analysis. No discussion is included regarding what constitutes a relevant period of years for computing loss averages for loans or what must be done to ensure that all institutions consistently measure losses for the lives of their current loan portfolios. As previously discussed, numerous inconsistencies in the determination of historical loss experience created disparities in reserves among institutions.

Finally, according to the interagency statement, management's analysis of loan loss reserves should be conservative and include an "additional margin" so that overall reserves reflect the imprecision inherent in most estimates. In addition, the statement lists numerous factors that management should consider that are likely to cause current estimated losses to differ from historical loss experience. As previously discussed, most of the institutions' reserves were comprised of significantly large supplemental reserves which were not adequately justified. This resulted in reserves which were not subject to meaningful comparison and which may have distorted the true condition of the institutions' loan portfolios.

We believe the statement will encourage institutions to continue to use large unjustified supplemental reserves because it does not emphasize that inherent imprecision in loss estimates can result in overstatements as well as understatements of actual losses. As a result, institutions will be encouraged to add to their estimates to cover potential error even if the estimates are too high. Further, no discussion is included in the guidance to ensure that allocations to reserves are linked to the specified factors in a reasonable and verifiable manner and that the factors are used only to identify and measure likely losses.

Conclusions

Current loan loss reserve practices used by the 12 depository institutions we reviewed often did not result in meaningful assessments of the risk of loss due to uncollectible loan balances. In addition, the flexibility in accounting for loan loss reserves resulted in incomparability of reserves among the depository institutions and gave them the opportunity to use reserves to manipulate their operating results and capital. While establishment of reserves will always require some degree of management judgment, it should not be an exercise in total management discretion, nor should it be subject to arbitrary regulatory adjustments. However, until more specific standards are established by authoritative accounting bodies, incomparable and potentially unreliable reserves will continue to hamper the usefulness of financial reports of depository institutions.

Recommendations

We recommend that FASB, in close consultation with OCC, FRB, FDIC, and OTS, develop a comprehensive standard for establishment of loan loss reserves, which includes

- a requirement that reserves for all large impaired loans be based on detailed individual assessments, and no specific reserve amounts in excess

of those determined from such assessments should be allowed for those loans. For collateral dependent commercial loans, a reserve should be established to cover the difference between the outstanding loan balance and the estimated recoverable amount from the collateral based on an assessment of the collateral's fair value;

- guidance regarding the use of historical analyses to estimate inherent losses existing in the portion of the portfolio which has not been specifically analyzed for impairment. Such guidance should address methods of analyses as well as the appropriate time periods of historical data to be included; and
- a requirement that all portions of the reserve, including any supplemental amounts, should be directly linked to and justified by a comprehensive documented analysis of current loss exposure in the loan portfolio and that the periodic provision for loan losses adjust the reserve balance to the level determined necessary by such an analysis.

Comments and Our Evaluation

Each of the four federal depository institution regulators and FASB commented on the report. The regulators generally shared our concerns about the need to adequately identify and measure loan losses. However, FDIC, FRB, and OTS indicated that, from a regulatory perspective, it was beneficial for institutions to maintain supplemental reserves and, in some cases, add-on reserves for individually assessed impaired loans. In addition, they expressed their view that recently issued regulatory and accounting guidance discussed in the report are generally sufficient to address our concerns. OCC generally supported our recommendation that FASB address deficiencies in GAAP for the determination of loan loss reserves, but stated it believes that the existing body of regulatory guidance provides an appropriate framework for banks to determine an adequate level of reserves and examiners to evaluate the sufficiency of those reserves.

FASB disagreed with our conclusion that the lack of accounting and regulatory standards for establishment of loan loss reserves has led to the evolution of a hodgepodge of accounting practices with no clear and common objectives. It stated that it believes that SFAS No. 5 establishes a broad set of clear and common objectives which can be applied to recognizing loan losses. It also stated that if creditors ignore those objectives, "hodgepodge" accounting certainly could be the result. However, FASB's response differed significantly from the responses of some of the regulators with regard to the objectives of establishing loan loss reserves. Further, although the regulators' responses were often

similar, we noted key differences in how they characterized various aspects of their interagency and other regulatory guidance.

We believe that these differences between FASB and the regulators, and among the regulators themselves, reflect the potential for inconsistent interpretations of current accounting and regulatory standards and underscore the need for more definitive, comprehensive authoritative accounting guidance for the establishment of loan loss reserves. In addition, we believe the general support of FDIC, FRB, and OTS for reserving approaches that include supplemental and add-on reserves is further symptomatic of uncertainty over how to best identify and measure probable existing loan losses. We further believe that reserve shortfalls as well as excesses are likely to result from this uncertainty, since fluctuations in loan quality are not being effectively reflected by the reserving methodologies currently used by institutions and examiners.

The draft of this report sent out for comment also included a recommendation to the regulators to implement the principles of our recommendations to FASB if FASB did not act to adopt those recommendations. After consideration of the differences in responses to the report among the regulators, including the differences in interpretations of existing joint regulatory guidance, we decided to delete the recommendation to the regulators in the final report. However, we encourage the regulators to support FASB in its efforts to develop a comprehensive accounting standard for establishment of loan loss reserves.

The following sections include summaries of the comments we received from FASB and the regulatory agencies on our conclusions and recommendations and our evaluation of those comments. The written comments we received from FASB, FDIC, FRB, OCC, and OTS are reprinted in appendixes I through V, respectively. Our comments on additional issues raised by the four regulators and FASB are also included in these appendixes. It should be noted that, in the case of FASB, although our draft report was circulated to all Board members, its written comments do not represent FASB's official position. The Board takes formal positions on accounting matters only after appropriate due process. In that regard, FASB stated its Financial Accounting Standards Advisory Council would include the issues discussed in the report as a potential project in its 1994 survey questionnaire.

Comments on Individual Loan Assessments

FASB and OCC generally agreed with our first recommendation that reserves for all large impaired loans should be based specifically on detailed individual loan assessments. However, they also stated that review of loans with similar risk characteristics on an aggregated basis is acceptable. FDIC and OTS agreed that significant impaired loans should be individually assessed and stated that such assessments are recommended by existing regulatory guidance. However, OTS also believed additional reserves over and above those based on individual assessments should be provided in some cases. FRB stated that basing reserves on individual loan assessments of large impaired loans was required under existing regulatory guidance and is standard banking practice, but also advocated consideration of standard industry loss percentages in establishing reserves for individual problem loans.

In responding to our first recommendation, FASB indicated that SFAS No. 114, which applies to all large loans that are impaired, requires that impairment of those loans be measured on a loan-by-loan basis, unless the loans have common risk characteristics. In that case, FASB stated SFAS No. 114 allows the use of aggregation techniques to measure impairment of loans with common risk characteristics. FASB also indicated that if a creditor measures and recognizes impairment for a particular loan in accordance with SFAS No. 114 and SFAS No. 5, any additional loss recognition for that loan would not be appropriate. Therefore, FASB stated it expects that many of the issues raised about individual measurement in the report will be resolved, or at least mitigated, when financial institutions adopt SFAS No. 114.

OCC made similar comments with regard to aggregation techniques in responding to the first recommendation. OCC generally agreed that banks should analyze all significant doubtful credits individually and attempt to estimate probable loss associated with each loan. However, it stated that as a practical matter, loan-by-loan estimates are not always possible, even for loans that are classified doubtful and especially for loans that are classified substandard. Therefore, OCC believes that an estimate based on the bank's own historical loss experience on a pool of similar loans (adjusted for changes in conditions and trends) is an acceptable, and often more realistic, alternative.

We agree that the type of aggregation techniques described by FASB and OCC can provide meaningful estimates of losses on impaired loans with similar risk characteristics. However, the individual impaired loans we reviewed which were held by the institutions in our sample were large

commercial real estate loans. These loans generally have different types of collateral, borrower characteristics, loan terms, and geographic locations. The loans we reviewed had all been assessed individually by the institutions and by the examiners for purposes of loan classifications, and in most cases sufficient information was available to estimate probable losses. Nonetheless, many institutions reverted to establishing reserves based on loss history in lieu of or in addition to using the results of these individual assessments for large impaired loans. The report includes examples of how these practices can distort the loss exposure in individual loans and resulted in reserves that could not be meaningfully compared among institutions.

SFAS No. 114 does not specifically preclude institutions from using loss history factors to add on to reserves established based on individual loan assessments. In addition, SFAS No. 114 does not specify how a creditor should identify loans to be evaluated for collectibility. We believe this provides institutions with the flexibility to structure identification criteria such that certain impaired loans would be excluded, thereby allowing continued use of historical factors and other methods to set reserves for large impaired loans. Therefore, we do not agree with FASB that SFAS No. 114 resolves or mitigates the issues relative to individual loan assessments raised in the report.

In its comments on our first recommendation, FDIC stated that the 1993 Interagency Policy Statement, its own guidance, and SFAS No. 114 already require institutions to assess all significant credits on an individual basis. FDIC also stated that the Federal Financial Institutions Examination Council's (FFIEC) Request for Comment on Implementation Issues Arising From New Loan Impairment Accounting Rule, which was issued on May 13, 1994, states that the federal regulators do not plan to automatically require reserves over and above those established using SFAS No. 114 criteria.

OTS made similar comments in response to our first recommendation, but also specifically stated it disagreed with the portion of the recommendation that indicates that no specific reserve amounts over and above those based on detailed individual assessments of large impaired loans should be allowed. OTS stated that there may be losses inherent in any pool of assets, including pools of loans that have been individually assessed. It went on to say that certain individually assessed loans still pose sufficient risk to an institution to warrant an additional reserve. As a result, OTS believes it is appropriate to use both individual loan

assessments and broader assessment techniques which incorporate risk factors that are not loan specific to establish reserves for large impaired loans.

As discussed in the report, the 1993 Interagency Policy Statement referred to by FDIC and OTS does state that an institution should rely primarily on an analysis of the various components of its portfolio to establish reserves, including an analysis of all significant credits on an individual basis. The statement also clearly states that an institution's reserves must be maintained at a level to absorb estimated losses that meet the loss criteria of GAAP. However, as discussed in the report, the statement does not prohibit or discourage institutions from using loss history to supplement reserves determined from specific detailed assessments.

Additionally, while FFIEC's May 13, 1994, Request for Comment does state that the federal regulators do not plan to automatically require reserves over and above those established using SFAS No. 114 criteria, it also states that an additional allowance on impaired loans may be necessary based on consideration of institution-specific factors, such as historical loss experience. The implication of this statement appears to be that under certain circumstances it is appropriate for institutions to establish reserves for large impaired loans over and above what is determined necessary from detailed individual loan assessments. OTS's comments indicate that it takes this viewpoint. We believe this flexibility and inconsistency in regulatory policy will continue to promote inconsistent and, at times, inappropriate, reserving practices for large impaired loans.

FRB stated that the approach we advocate with regard to large impaired loans has been general banking practice for many years and is consistent with SFAS No. 114. FRB further stated that estimating the collectibility of large impaired loans on an individual basis is inherently judgmental and any single institution has limited historical experience with which to assess fully the many factors that affect the collectibility of an individual credit. Thus, institutions and examiners should also consider the loss experiences of other lenders on similar problem loans.

Our findings do not support FRB's contention that the use of individual loan assessments to set reserves for large impaired loans has been general banking practice for many years. As stated in the report, most of the institutions in our sample reverted to loss history in lieu of using individual loan assessment results to establish reserves for problem commercial loans. In addition, the two banks in our sample that were

regulated by FRB used average historical loss factors which appeared to be based on industry averages as the basis to establish their reserves, including those for large impaired loans. Individual loan assessments were performed on these loans, but were often used only to determine the loan classifications. Standard percentages were then applied based on these classifications to establish the reserves. As stated in the report, standard industry loss percentages do not consider the particular characteristics of the institution's loan portfolio. We demonstrated in the report how the use of such industry averages can both understate and overstate reserves on large impaired loans. In its comments, OCC agreed with our position on this issue.

Comments on Use of Historical Analyses

Regarding our second recommendation that guidance is needed for the use of historical analyses to estimate inherent losses existing in the portfolio, FDIC, FRB, and OTS all believed that the interagency policy statement provided adequate guidance on the use of historical loss experience. However, their specific interpretation of that guidance varied, especially with regard to how industry averages for loss experience should be used. OCC did not refer to the interagency policy statement, but indicated it believes that a bank's use of historical analyses should be based on its own experience, and not on industry averages. FASB stated it believes that providing specific guidance in this area would impede the banks' ability to use the historical data that are most relevant to their particular situation.

FDIC and FRB indicated that regulatory guidance provided in the interagency policy statement is generally sufficient with regard to the use of historical analyses to estimate loan losses. They stated that the policy statement purposely does not provide specific, detailed guidance on the length of past experience that should be used by an institution or the methods that institutions should use to factor historical losses into their reserve estimates. They believe differences among institutions in estimation methods are warranted based on differences in institution-specific factors and due to consideration of the benefits versus the costs of utilizing more complex, data-intensive approaches such as migration analysis.

We recognize that institutions vary greatly in size and complexity and have different financial and technical resources. Therefore, we believe it is important for standards and guidance to focus on alternative historical loss methods, including the time periods used to develop ratios or other

historical data, so that probable losses that exist in similar loan portfolios of different institutions are identified and measured in a manner that produces comparable results. While the approaches used to accomplish this may be somewhat different, the basic parameters used should be the same, and therefore the results should be comparable.

FRB also stated that while specific guidance to institutions on past loss experience is not provided in the policy statement, the statement does provide quantitative guidance based on industry loss experience that examiners should use to review the overall reasonableness of an institution's reserve estimates. OTS made reference to this same guidance in the policy statement; however, it characterized it as specific guidance for the use of historical loss experience, including appropriate time periods. It stated that the guidance provides that experience based on the institution's average annual rate of net charge-offs over the last 2 or 3 years for similar loans, adjusted for current conditions and trends, should be used. It also stated that industry-average net charge-off experience is appropriate only when the institution does not have a sufficient basis for determining this amount.

The specific guidance in the interagency policy statement that OTS and FRB referred to is listed under the "Examiner Responsibilities" section of the statement as follows.

"After analyzing an institution's policies, practices, and historical credit loss experience, the examiner should further check the reasonableness of management's (reserve) methodology by comparing the reported (reserve) against the following amounts:

(a)50 percent of the portfolio that is classified doubtful;

(b)15 percent of the portfolio that is classified substandard; and

(c)for the portions of the portfolio that have not been classified, estimated credit losses over the upcoming 12 months given the facts and circumstances as of the valuation date."

According to the policy statement, the first two factors in the above reasonableness formula are based entirely on industry averages. The last factor is to be based on the institution's average annual rate of net charge-offs over the previous 2 or 3 years. If this information is not available, then the examiner may use industry average net charge-off rates for nonclassified loans.

Consistent with FRB's characterization, the policy statement says that the above formula is meant only as a reasonableness test to be applied by examiners. We do not agree with OTS's statement that this formula provides specific guidance for the use of historical analyses. In addition, we believe the use of this formula by examiners or institutions could be misleading because it is based largely on industry averages. As previously mentioned, standard industry loss percentages do not consider the particular characteristics of the institution's loan portfolio and, as demonstrated in the report, can result in overstated or understated reserves.

OCC did not cite the interagency policy statement in its comments regarding this or any other recommendation. OCC stated that it believes banks' analyses should have an internal focus on the unique composition and historical loss experience of their own portfolios rather than on external comparisons with average experience of the industry. OCC also stated that because no single approach has been determined to be the best, it does not require banks to use a specific method or time period to determine their own historical loss experience. In addition, it stated that the method used will depend to a large degree on the capabilities of the individual bank's information systems. OCC indicated that its examiners have been instructed, given the individual bank's systems capabilities, to determine whether a bank's methodology for evaluating the allowance produces reasonable estimates of probable losses which are inherent in its portfolio.

Similar to OCC, FASB interpreted this recommendation to be a request that it develop a specific method for using loss experience—for example, that the last 3 years of experience should be used to estimate current year losses. It believes banks should have the flexibility to use the historical data that are judged to be most reflective of its current loan losses. By developing a specific method for using historical experience, FASB believes that banks' ability to use the most relevant data would be eliminated.

While we agree conceptually with FASB and OCC that banks should be given the latitude to use what they determine to be the most meaningful approach to establishing reserves based on historical losses, we believe that in practice such flexibility would likely result in significant under-reserving in times of economic decline and over-reserving in times of economic prosperity. In addition, as demonstrated in the report, major inconsistencies and therefore incomparability can result when institutions

use methods which produce significantly varying amounts of reserves for the same loss exposure.

We believe such inconsistency and incomparability result, in part, from the lack of clarifying guidance by FASB related to the types of “existing conditions” referred to in SFAS No. 5 that are indicative of probable loan losses, as well as the lack of guidance on specific actions to be taken if “future events” confirming the losses fail to occur. We believe it is incumbent on FASB to provide clarification on these and other issues relating to the use of historical analyses to estimate probable loan losses.

Comments on Required Analyses and Supplemental Reserves

Regarding our recommendation that all portions of the reserve, including any supplemental amounts, should be directly linked to and justified by documented analyses, all regulators agreed that documentation was important, but there were significantly differing views on whether large supplemental reserves should be allowed. FASB did not believe it was responsible for providing the type of guidance we recommended, but agreed that the type of justification we described should support an appropriate estimate of reserves.

FDIC, FRB, and OTS all agreed that documentation of the reserve analyses was important, but they believed that the interagency policy statement provided sufficient guidance on the required level of documentation of reserves.

The interagency policy statement does state that the board of directors and management are expected to adequately document the institution’s process for determining adequate loan loss reserves. However, this language is not significantly different from that contained in prior regulatory guidance. We believe this level of guidance is too general, as demonstrated by the significant amounts of unjustified reserves discussed in the report.

With regard to our findings and conclusions on unjustified supplemental reserves, FDIC and FRB indicated that from a regulatory perspective, reserves should be more conservatively estimated in order to protect the deposit insurance funds. Therefore, they stated they would hesitate to suggest that an institution reduce its reserves, even if a reduction was indicated by the institution’s analyses of probable existing losses. We find this position to be contrary to their comments regarding the need for

documented analyses to support the level of reserves, but consistent with the findings in the report.

As indicated in the report, over 30 percent of the total reserves of 7 of the 12 institutions we reviewed were supplemental reserves which were generally not justified by supporting analyses. As demonstrated in the report, unjustified supplemental reserves can not only mask the improvement of a loan portfolio in good times, but can also enable an institution to conceal increases in loss exposure during bad times. In addition, we believe these large unjustified supplemental reserves reflect institutions' and regulators' uncertainty as to how to best identify and measure probable losses in the loan portfolio—such uncertainty is likely to result in misstated reserves, especially when institutions rely heavily on supplemental reserves as "cushions" rather than doing the specific, comprehensive analyses necessary to identify existing probable losses. We do not believe that reserves should be used by regulators as cushions for future uncertainties or that such cushions should be commingled with reserves whose purpose is to reflect losses already existing in the portfolio. Further, we believe that if regulators are concerned about future losses, then direct capital appropriations could be made rather than using the loan loss reserve to address this concern.

In its comments on this recommendation, OCC stated it believes some margin for error is desirable, but that it shares GAO's concerns about large supplemental reserves. It believes that reducing the relative size and importance of this unallocated component of the allowance will produce a more refined and reliable estimate of an appropriate reserve level in most banks. OCC also stated that it revised Banking Circular 201 in February 1992 and expects the long-term effects of this revised guidance, as well as the implementation of SFAS No. 114, to result in a reduction in supplemental reserves.

We analyzed the revised Banking Circular 201 in connection with our 1993 report on OCC bank examinations[12] and also in connection with our work for this report. While the revised banking circular does provide sound general guidance, it does not provide for a methodology to quantify the various risk factors that are to be considered by banks and examiners in assessing the reserve. Therefore, we believe Banking Circular 201 still provides too much latitude in banks' reserving practices.

[12]Bank Examination Quality: OCC Examinations Do Not Fully Assess Bank Safety and Soundness (GAO/AFMD-93-14, February 16, 1993).

As discussed in the report, SFAS No. 114 only addresses reserving for individual loans identified by the institution for evaluation of collectibility. It does not address overall reserving practices which encompass estimates of inherent, as well as specific, losses. Therefore, as stated in the report, we do not believe the application of SFAS No. 114 will resolve the problems we identified in the report with regard to supplemental reserves.

FASB's comments on this recommendation indicated that while the type of analysis and documentation advocated by GAO should support an appropriate financial statement estimate, the form and detail is generally left to the institution and its auditor. It stated that FASB does not prescribe how an entity should demonstrate its compliance with GAAP.

While we agree that FASB should not be required to prescribe demonstration of GAAP compliance, we do believe it should develop or clarify GAAP standards when it becomes clear that existing guidance does not provide the desired result of consistent and reliable financial information. We believe the report clearly demonstrates that the desired result is not being achieved with regard to supplemental reserves and therefore that FASB needs to take action.

Comments From the Financial Accounting Standards Board

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

Financial Accounting Standards Board
401 Merritt 7, P.O. Box 5116, Norwalk, Connecticut 06856-5116 | 203-847-0700
Fax: 203-849-9714

DENNIS R BERESFORD
Chairman

July 27, 1994

Mr. Robert W. Gramling
Director, Corporate Financial Audits
U.S. General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Bob:

This letter is in response to your letter of June 13, 1994, requesting the FASB's comments on the GAO's June 1994 Draft Report, *Depository Institutions: Divergent Loan Loss Methods Undermine Usefulness of Financial Reports.* The Draft Report recommends that the FASB, in conjunction with federal depository institution regulators, develop a comprehensive standard for establishment of loan loss allowances that would (a) require use of individual loan assessments for large loans, (b) provide specific guidance for the use of loss history, and (c) require all portions of the allowance for loan losses, including any supplemental amounts, to be directly linked to and justified by a comprehensive analysis of current loss exposure in the loan portfolio. While the Draft Report and this response have been circulated to all Board members for comment, this response does not represent the official position of the FASB. The Board takes formal positions on accounting matters only after appropriate due process.

LOSS CONTINGENCIES--FASB STATEMENT NO. 5, *ACCOUNTING FOR CONTINGENCIES*

See comment 1.

The Draft Report states, "The lack of accounting and regulatory standards for establishment of overall loan loss reserves has led to the evolution of a hodgepodge of accounting practices with no clear and common objectives." We disagree. We believe that FASB Statement No. 5, *Accounting for Contingencies*, establishes a broad set of clear and common objectives for recognizing loss contingencies, including loan losses.

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However, if creditors and others ignore those objectives, "hodgepodge" accounting certainly could be the result.

The Draft Report indicates that financial institutions have recorded large "supplemental reserves" that are not linked to quantitative analysis of loss exposure or other evidence that demonstrates that the amounts are needed. We are unable to tell whether the use of the term "supplemental reserves" refers to amounts recognized that relate to future losses or to amounts recognized for impaired loans that have not yet been specifically identified as impaired. Statement 5 defines a contingency as "an existing condition . . . that will ultimately be resolved when one or more future events occur or fail to occur." Under this definition, the risk of loss in the future does not create a recognizable loss. Unless a loss already has occurred, there is no impairment of assets to be recognized. Therefore, the "contingency" in a loss contingency is the future event that is needed to confirm the existence, or the extent of, a loss that has *already occurred*. Said another way, Statement 5 precludes a creditor from recognizing amounts for future loan losses but requires a creditor to recognize losses for impaired loans that may not yet be specifically identified as impaired.

See comment 2.

A creditor that recognizes amounts for future losses has departed from generally accepted accounting principles. As the Draft Report accurately depicts, recognizing those amounts is a misleading accounting practice that has the potential to reduce reported income in good years and improve reported income in bad years (by reversing previously recorded amounts). That practice obscures a financial statement user's ability to assess the financial condition of the creditor. Some have argued that by recognizing amounts for future losses, a financial statement preparer can avoid "bad surprises" in financial reporting. They maintain that a financial statement preparer should strive to report stable earnings because financial statement users are ill served by volatility. We disagree. There is no such thing as a "good" misrepresentation.

The Draft Report criticizes FASB Statement No. 5, *Accounting for Contingencies*, for allowing creditors too much flexibility in determining their overall allowance for loan losses. The Draft Report states, "Although SFAS No. 5 states that provisions for losses should be made only when losses are probable and can be reasonably estimated, neither it

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nor any other authoritative accounting literature provides guidance or establishes parameters to ensure that loan loss history and other factors that are used to identify losses meet these two conditions." We agree that Statement 5 is a general standard that provides guidelines without many detailed rules. However, loan loss accounting is unavoidably subjective, and creditors must make difficult judgments about collectibility and estimates of losses that are needed to determine the appropriate level of the allowance for loan losses. Creditors may prepare estimates with great care, but those estimates will differ from estimates that other creditors would have made and each estimate will very likely turn out to be wrong to some extent.

MEASURING IMPAIRMENT OF LOANS--FASB STATEMENT NO. 114, *ACCOUNTING BY CREDITORS FOR IMPAIRMENT OF A LOAN*

The Draft Report recommends that loan loss allowances for all large impaired loans should be based on detailed individual assessments and that no additional allowances for those loans should be recognized. It also recommends that the allowances for collateral-dependent commercial loans be based on the fair value of the collateral.

Measurement of Large Loans

FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan,* applies to all impaired loans except for large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment. That is, the Statement applies to all large loans that are impaired. It requires that impairment of those loans be measured on a loan-by-loan basis, unless they have risk characteristics in common. Paragraph 12 of Statement 114 states:

> Some impaired loans have risk characteristics that are unique to an individual borrower, and the creditor will apply the measurement methods described [in this Statement] on a loan-by-loan basis. However, some impaired loans may have risk characteristics in common with other impaired loans. A creditor may aggregate those loans and may use historical statistics, such as average recovery period and average amount

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> recovered, along with a composite effective interest rate as a means of measuring [impairment of those loans].

See comment 3.

Because some impaired loans have risk characteristics in common with other impaired loans, the Board accepted use of aggregation techniques to measure impairment of those loans at the present value of expected future cash flows. Past experience with loans having similar risk characteristics may provide an indication of the average time it takes to work out impaired loans and the average amount a creditor will recover. We believe that making estimates of the expected future cash flows and calculating the present value of those cash flows based on the creditor's experience with loans with similar risk characteristics are consistent with the requirement for a creditor to make its best estimate of expected future cash flows and with loan-by-loan measurement. We expect that many of those issues raised about individual measurement in the Draft Report will be resolved, or at least mitigated, when financial institutions adopt Statement 114.

Additional Allowances for Loans Losses

If a creditor measures and recognizes impairment for a particular loan in accordance with Statement 114 and Statement 5, any additional loss recognition for that loan would be inappropriate.

Measurement of Collateral-Dependent Commercial Loans

Paragraph 13 of Statement 114 requires that a creditor measure impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate, except that as a *practical expedient,* a creditor may measure impairment based on a loan's observable market price or the fair value of the collateral if the loan is collateral dependent. During its deliberations, the Board concluded that impairment of a loan is not an event that should result in a new direct measurement of the loan at fair value at the date impairment is recognized. Noting that unimpaired loans are not carried at fair value after origination, the Board concluded that loan impairment should be recognized based solely on deterioration of credit quality as evidenced by a decrease in expected future cash flows rather than on changes in both expected future cash flows and other current economic events, such as changes in interest rates.

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See comment 4.

The Draft Report asserts that "the fair value of collateral is the most objective and accurate measure to use to determine the loss exposure on a collateral dependent impaired loan." Appraisers generally assess sales of comparable assets or discount projected future cash flows at a current interest rate to estimate the fair value of collateral. Those techniques for estimating fair value are subject to judgment and error and may be no more objective or accurate than the discounted cash flow approach described in Statement 114.

USING HISTORICAL LOSS EXPERIENCE TO MEASURE LOAN IMPAIRMENT

The Draft Report recommends that the FASB develop guidance about the use of historical analysis to estimate inherent losses existing in the portion of the portfolio that has not been specifically analyzed for impairment and that that guidance should address the methods of analyses as well as the appropriate time periods of historical data to be included. We interpret that to be a request that the FASB develop a specific method for using historical loss experience (for example, "use the last 3 years of loss experience to estimate loan losses for the current year") in determining the appropriate level of loss recognition for certain loans.

See comment 3.

The use of historical loan loss experience is a valuable tool used by creditors to estimate current loan losses. A creditor uses the historical data that is judged to be most reflective of its current loan losses. Sometimes historical data provides little relevant information about current losses. If the Board were to develop a specific method for using historical loss experience, the creditor's ability to use the most relevant data would be eliminated. While a specific method might result in consistent calculations among creditors, the results of those calculations probably would not provide meaningful information about the actual losses incurred.

JUSTIFYING THE ALLOWANCE FOR LOAN LOSSES

The Draft Report recommends that the FASB develop a requirement that all portions of the allowance for loan losses be directly linked to and justified by a comprehensive documented analysis of current loss exposure in the loan portfolio and that the periodic

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July 27, 1994
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provision for loan losses adjust that allowance to the level determined necessary by such an analysis. While that type of analysis and documentation should support an appropriate financial statement estimate, the form of the analysis and level of detail is generally a matter agreed to by a creditor and its auditor. The FASB does not prescribe how an entity should demonstrate its compliance with generally accepted accounting principles.

See comment 3.

FASB'S DUE PROCESS AND SUGGESTED NEXT STEPS

During August, the Board will begin to redeliberate the issues raised in the March 31, 1994 FASB Exposure Draft, *Accounting by Creditors for Impairment of a Loan--Income Recognition.* In that Exposure Draft, the Board asked constituents whether it should consider adding to its technical agenda a project to address how and when a creditor should measure and report interest income on impaired loans, including how a creditor should record cash receipts on those loans and when a creditor should charge off an impaired loan. During its redeliberations, the Board will consider the responses to that question as well as the recommendations in the Draft Report and will decide if an additional project on loan impairment should be added to the its agenda. Among other things, the Board will consider the pervasiveness of the problem, alternative solutions, technical feasibility, and practical consequences.

See comment 3.

In setting its agenda, the Board follows certain due process procedures. The Financial Accounting Standards Advisory Council (FASAC), which advises the Board on agenda decisions, conducts an annual survey of the projects and priorities of the FASB. The Board refers to the results of that survey throughout the year as it allocates time and resources to current projects and as it makes decisions about adding projects to its agenda. The 1994 survey questionnaire will include as a potential project the project that is recommended in the Draft Report.

It is interesting to note that the 1993 survey questionnaire included as a potential project a broad project dealing with credit losses of financial institutions. The project ranked tenth out of the 23 potential projects described in the survey. It was the first time in five years that the project did not rank in the top 5. Respondents to the survey indicated that

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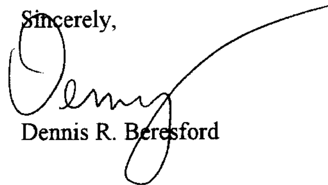
Statement 114 had addressed most of the important issues about credit losses of financial institutions.

In closing, we would like to suggest that a meeting of the GAO, the FASB, and other interested parties may be a productive way to address the issues raised in the Draft Report. As always, we would be pleased to discuss our comments with you at your convenience.

Sincerely,



Dennis R. Beresford

The following are GAO's comments on the Financial Accounting Standards Board's letter dated July 27, 1994.

GAO Comments

1. We do not believe the issues we identified in the report resulted from creditors ignoring the objectives of SFAS No. 5, but rather from the need for those objectives to be more definitively stated in terms of loan loss reserving practices. For example, SFAS No. 5 does not include specific parameters for determining what types of "existing conditions" are indicative of probable loan losses, nor what types of "future events" would confirm the existence and extent of the loss. In addition, there is no specific guidance on what should be done if the future event does not occur. FASB's belief that SFAS No. 5 provides sufficient guidance for establishment of loan loss reserves is contrary to the findings in our report.

2. We agree that recognizing future losses is a departure from GAAP. However, as indicated above, we do not believe the concept of what constitutes "future losses" versus "existing conditions that will ultimately be resolved when one or more future events occur or fail to occur" is at all clear with regard to estimation of loan loss reserves. This lack of clarity was manifested in the inconsistent and, in some cases, potentially misleading reserving practices of the institutions in our sample.

While we agree that loan loss accounting will always involve estimates and judgments, we believe that the current level of subjectivity in making these estimates and judgments is too high. At a minimum, the basic concepts discussed above must be addressed by FASB in order to avoid the potential for "misrepresentation" in financial statements that currently exists in accounting for loan loss reserves.

3. See the "Comments and Our Evaluation" section in chapter 2.

4. We believe fair value is the most objective and accurate measure to determine the loss exposure on collateral dependent loans precisely because it is reflective of current economic events such as changes in interest rates and real estate values. Once a loan has been identified as impaired, the current value of the collateral is the recoverable amount in the event of default and therefore should be the basis for the loss estimate. While techniques for estimating fair value involve judgments, we believe such judgments are likely to be better estimates of loss exposure than the

alternative approaches described in SFAS No. 114, because the basic premise behind the judgments is more sound.

Comments From the Federal Deposit Insurance Corporation

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

FDIC
Federal Deposit Insurance Corporation
Washington, DC 20429 Division of Supervision

July 14, 1994

Mr. Robert W. Gramling
Director
Corporate Financial Audits
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Gramling:

The staff of the FDIC's Division of Supervision has reviewed the General Accounting Office's (GAO) draft report, Depository Institutions: Divergent Loan Loss Methods Undermine Usefulness of Financial Reports, submitted June 13 for our review and comments. We understand that your staff surveyed twelve depository institutions, each with total assets over $1 billion, and that three of the institutions were state nonmember banks regulated by the FDIC. The report indicates that, between November 1992 and November 1993, your staff reviewed information concerning these institutions' loan losses reserves (also called the allowance for loan and lease losses or "ALLL") in examination working papers and in the institutions' documents, when available. You also conducted detailed interviews with the examiner-in-charge and/or management to discuss each institution's loan loss reserving methodology and its application of accounting rules and regulatory guidance. Your staff also reviewed all relevant accounting and regulatory guidance.

See comment 1.

Although three FDIC-supervised institutions were included in this survey, we understand from GAO staff that FDIC examination workpapers were reviewed and interviews with FDIC examiners were conducted for only two of the institutions. The examiners of these two institutions recall GAO personnel reviewing the FDIC's ALLL worksheet for each institution, but in their opinion, their contact with GAO staff was very limited. Furthermore, no findings were shared with our examiners, despite their request for GAO staff to do so. We assume that any information on the third FDIC supervised institution was obtained from management. Therefore, given the few institutions reviewed and the nominal contact with the FDIC staff, we must question the adequacy of the support for your conclusions.

See comment 2.

However, the general thrust of the three recommendations offered by GAO as a result of its survey of the 12 institutions have merit and conceptually we would agree with GAO's ideas. In fact, we believe that the Financial Accounting Standards Board (FASB) and the agencies have already implemented the spirit of many of these suggestions. Our concern is that a too literal reading of the recommendations could yield unworkable, excessive micro-management of what is, after all, a matter of assumptions and judgments. In our view, fixed formulas will not work in this area.

2

Unfortunately, from the timing of your survey, it appears that your staff did not fully consider the effect of the guidance contained in the Statement of Financial Accounting Standards No. 114, "Accounting by Creditors for Impairment of a Loan" (FAS 114), which was issued in May 1993, or the Interagency Statement of Policy on the Allowance for Loan and Lease Losses, dated December 21, 1993 (1993 Interagency Policy Statement). Another recent development is the FFIEC's publication of a Request for Comment on Implementation Issues Arising From New Loan Impairment Accounting Rule, on May 17, 1994 (1994 Request for Comment). This latter document not only solicits public comment on certain issues, but also advises institutions that they will be required to adopt FAS 114 for regulatory reporting purposes and describes several policies of the agencies with regard to implementing FAS 114.

See comment 2.

However, the draft report seems to suggest a degree of precision in determining an adequate ALLL for each institution that, in our opinion, does not exist. Rather, the ALLL is an "estimate" of the probable losses inherent in the loan portfolio. As such, it is not a single and specifically determinable amount for each institution, but falls within a range of acceptable amounts covering the spectrum from an optimistic to a pessimistic assessment of the collectibility of the loan portfolio. The amount chosen as an adequate allowance should be the best estimate within that range in the judgment of the management and is reviewed as such by the institution's auditor and examiner. Management is expected to provide sufficient documentation to support its determination of the best estimate within the range, but GAO's suggestion that better documentation be made of the best estimate may be appropriate.

See comment 3.

In addition, the draft report suggests that many of the institutions surveyed have unjustified supplemental reserves because their estimates of probable loan losses have decreased. In that situation, the report indicates that an institution should adjust its reserve levels by taking a negative loan loss provision. We believe that government supervisors must take a more conservative position. Since an adequate ALLL is considered a range of amounts, the FDIC is most hesitant to suggest that an institution record a negative provision to reduce the ALLL so long as the amount of the ALLL is within what management and the examiner judge to be the acceptable range. Furthermore, if management believes that its ALLL is above the acceptable range, the FDIC does not object if an institution, in consultation with its outside accountant, decides to reduce the ALLL by taking smaller or nominal provisions in future periods until the ALLL again falls within the acceptable range. In this regard, we take exception to the implication in the draft report that the size of an institution's loan loss provision and its ALLL is the sole determinant of an institution's loan quality. Equally important for determining loan quality, in our opinion, are the volume and trend of past due and nonaccrual loans, and the volume, trend and severity of adverse examination classifications.

See comment 2.

See comment 4.

In view of this range concept for the ALLL, we believe that the draft report's emphasis in the discussion section on the number of institutions with what GAO characterizes as excess "supplemental" reserves and these institutions' unwillingness to take negative provisions is unwarranted. If this GAO study was really precipitated by earlier findings that the substantial costs to the deposit insurance funds during the late 1980s and early 1990s resulted from failed institutions which generally "made inadequate estimates of loan losses prior to failure," this emphasis and conclusion seem contrary to the protection of the insurance funds. In this

regard, the draft fails to consider that the purposes of the ALLL from the standpoint of investors and creditors likely differs from the purpose of the ALLL from a safety and soundness perspective.

Recommendations

We note that GAO's recommendations are directed primarily to the FASB. We agree that it is appropriate for the spirit of these recommendations to be incorporated into generally accepted accounting principles to ensure that they are applicable to all lenders, not just FDIC-insured institutions.

The first GAO recommendation is that all reserves for significant credits should be assessed on an individual basis and no specific reserve amounts in excess of those determined from individual loan assessments should be permitted. The 1993 Interagency Policy Statement and prior FDIC guidance already recommend that institutions assess all significant credits on an individual basis. FAS 114 also requires assessment of impaired loans on an individual basis (with aggregation permitted, but not required, for impaired loans with common risk characteristics). In addition, the 1994 Request for Comment states that "the agencies do not plan to automatically require additional allowances for credit losses for impaired loans over and above what is required on these loans under FAS 114."

The first recommendation also states that reserves for collateral dependent commercial loans should be measured using the estimated recoverable amount from the collateral based on the fair value of the collateral. We agree with this suggestion and it is a long established practice for banks. Institutions were advised in the 1994 Request for Comment that they will be expected to measure impaired, collateral-dependent loans for purposes of regulatory reports at the fair value of the collateral. FAS 114 also provides that estimated costs to sell must be considered when measuring impairment if such costs will reduce the cash flow available to satisfy the loan.

See comment 2.

The second recommendation concerns the use of historical analyses to estimate inherent losses on loans not individually assessed. GAO recommends that specific accounting or regulatory standards should be developed to address acceptable methods of analyses and the appropriate time periods of historical data to be included.

The 1993 Interagency Policy Statement discusses the use of historical analysis for pools of homogeneous loans. Historical loss experience, used by many institutions to begin estimating losses inherent in pools of loans, is a common practice, but institutions are advised that any historical data must be adjusted to reflect numerous factors listed in the policy statement, including current economic conditions and concentrations of credit. The institution's documentation should explain the basis for these adjustments.

While there may be room for improvement in the guidance on the use of historical analysis, it is not clear to us what level of additional detail GAO would view as appropriate. The wide range of asset size and loan portfolio mix of the approximately 13,000 FDIC-insured institutions in this country preclude the agencies from prescribing specific and detailed

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methodologies as the only acceptable ways to determine an adequate ALLL. Migration analysis is one method encouraged for use by many larger institutions, but requiring the many small banks and thrifts (under $100 million in total assets) to perform such complex analyses would be unduly burdensome and cost prohibitive. Similarly, requiring a fixed time period for use in historical analyses would not permit the differences in the length of the business cycle to be reflected by each institution.

See comment 2.

The third recommendation states that the entire ALLL, including any supplemental amounts, should be linked to the documented analyses performed. Throughout the 1993 Interagency Policy Statement, emphasis is placed on the necessity of maintaining comprehensive documentation concerning an institution's analyses and conclusions regarding the adequacy of the ALLL and the factors affecting loan collectibility. The importance of consistently applying these analytical procedures and reserving methodologies is also reinforced. Although the report stresses the need for sufficient documentation, it does not explain the type of documentation that GAO would consider sufficient to support an institution's reserve balance, including the portion GAO characterizes as "supplemental" reserves.

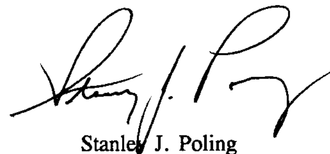
See comment 2.

Lastly, the GAO recommends requiring that an institution's reserve balance be adjusted to the ALLL level determined to be adequate by management's comprehensive documented analysis. Conceptually the FDIC concurs with this recommendation, but as discussed above, we do not believe that an adequate ALLL is a single and specifically determinable amount for each institution, but a range of amounts. Thus, we would generally expect adjustment to the reserve balance only when an institution's management or an examiner judges it to be outside the acceptable range.

See comment 3.

We appreciate this opportunity to comment on the draft GAO report.

Sincerely,



Stanley J. Poling
Director

The following are GAO's comments on the Federal Deposit Insurance Corporation's letter dated July 14, 1994.

GAO Comments

1. As stated in the report, we conducted case studies of 12 depository institutions, each with total assets over $1 billion, which we judgmentally selected. To include a cross section of depository institutions we selected institutions supervised by OCC, FRB, FDIC, and OTS. Further, for geographic diversity, we selected institutions located in California, Maryland, New York, North Carolina, Texas, and Virginia. It was not our objective to evaluate loan loss reserve methodologies of banks regulated specifically by FDIC or any other agency, but rather to evaluate this cross section of institutions to assess the overall reliability and comparability of their reserving practices.

We interviewed examiners for two of the three FDIC-supervised institutions in our sample, and reviewed examination working papers for all three institutions. We were not able to interview the examiner for the third institution, despite several efforts to do so. However, we were able to meet with officials of the institution to obtain the remaining information necessary to complete our work.

As our work did not center on the quality of examinations or the adequacy of specific conclusions made by examiners, we did not find it practicable or necessary to inform FDIC examiners of the status of our work as it progressed. Our findings were brought to the attention of FDIC headquarters officials in a draft of this report.

2. See the "Comments and Our Evaluation" section in chapter 2.

3. We recognize that the reserve is an estimate of probable losses inherent in the loan portfolio. We also recognize that management's analyses of the reserve adequacy may include consideration of several scenarios. However, the reserve recorded on the financial statements and call reports and used in determining capital adequacy is a single amount. This amount, regardless of whether it is the best estimate within a range or the final result of a complex reserving model, must justifiably reflect existing losses in the loan portfolio which are probable and estimable.

4. While we agree that examiners have the ability to evaluate loan quality based on other factors, many other financial statement users do not. The provision for loan losses is a key component in quarterly earnings

calculations and is looked to by many financial statement users as the primary gauge of changes in loan quality. The provision for loan losses and the related reserve are the only direct indicators of loan quality reported in the income statement and the balance sheet, respectively, of an institution. These two financial statements are the primary vehicles through which results of operations and financial condition are reported to the public. In addition, the provision and reserve are reported on regulatory call reports and are factored into calculations of regulatory capital.

As stated in the report, the primary purpose of financial reporting is to provide information to report users which they can rely on for making business and economic decisions. Financial information is most useful in making these decisions if it can be compared with similar information about other enterprises and with similar information for different periods of time or points in time for the same enterprise. We do not believe that existing authoritative accounting or regulatory guidance provides for reliable and consistent reporting of loan loss provisions and related reserves, thus undermining the usefulness of financial reports of banks and thrifts.

5. The purpose of the reserve for loan losses is to reflect management's best estimate of probable losses currently existing in the loan portfolio. We do not believe that reserves meeting this purpose should differ based on whether they are determined for creditor, investor, or regulator needs. As stated in the report, we believe that current authoritative accounting and regulatory guidance for establishment of loan loss reserves are not sufficient to consistently meet these needs. Reserves that are excessive in times of economic prosperity are symptomatic of the inadequacies in guidance, as are reserves that are deficient in times of economic decline. The basic problem is the lack of a comprehensive, consistent approach which produces reserves that track with changes in the quality of the loan portfolio.

Comments From the Federal Reserve Board

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

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

DIVISION OF BANKING
SUPERVISION AND REGULATION

July 13, 1994

Mr. Robert W. Gramling
Director, Corporate Financial Audits
General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Gramling:

I am writing to provide Board staff comments on your draft report on divergent loan loss methods. As you are aware, the Federal Reserve Board has worked closely with the other federal banking agencies in recent years to improve the guidance to bankers and examiners on the ALLL. While we share your objective of improving the quality of loan loss reserve estimates, we have concerns about some aspects of the report, which are summarized below.

The draft report concludes that loan loss reserve practices used by the institutions reviewed did not provide meaningful assessments of the risk of loss inherent in the loan portfolios. Furthermore, the report states that the methodologies used in determining loan loss reserves were not comparable among institutions. The report also states that these methodologies varied greatly regarding the use of individual loan assessment results, the determination and application of historical loss experience, and the inclusion of unjustified supplemental reserves that were not clearly linked to likely loan losses. Thus, the report recommends that the Financial Accounting Standards Board (FASB), in close consultation with depository institution regulators, should develop a comprehensive standard for establishment of loan loss reserves which includes:

- A requirement that reserves for all large impaired loans be based on detailed individual assessments, and no specific reserve amounts in excess of those determined from such assessments should be allowed for those loans. For collateral dependent commercial loans, a reserve should be established to cover the difference between the outstanding loan balance and the estimated recoverable amount for the collateral based on an assessment of the collateral's fair value;

- Guidance regarding the use of historical analyses to estimate inherent losses existing in the portion of the portfolio which has not been specifically analyzed

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for impairment. Such guidance should address methods of analyses as well as the appropriate time periods of historical data to be included; and

- A requirement that all portions of the reserve, including any supplemental amounts, should be directly linked to and justified by a comprehensive documented analysis of current loss exposure in the loan portfolio and that the periodic provision for loan losses adjust the reserve balance to the level determined necessary by such an analysis.

The report further recommends that if FASB does not add the development of such a comprehensive standard to its current agenda, then depository institution regulators should proceed to implement the principles of the above recommendations until FASB fully addresses this issue.

See comment 1.

As discussed in more detail below, we have concerns with a number of aspects of the report and its specific recommendations. Beginning with our general concerns, as noted in the report, loan losses were the major cause of many of the depository institution failures that occurred from 1980 through 1992, and some of these institutions may not have had adequate loan loss reserves. Thus, we believe it is appropriate to focus our attention on ensuring that loan loss reserves are adequate and conservatively measured.

In addition, the report does not appear to fully take into account the December 1993 Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL Policy), the November 1991 Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans, and the positions taken by the Federal Financial Institutions Examination Council (FFIEC) in the May 1994 Federal Register Notice on 'Implementation Issues Arising from FASB Statement No. 114, "Accounting by Creditors for Impairment of a Loan"' (FAS 114). We believe the guidance set forth in these issuances address some of the concerns set forth in the report. The report also appears to underestimate the extent to which our policies and practices depend on individual loan review in estimating and assessing the adequacy of loan loss reserves. Such an approach has been general banking practice for many years, and the ALLL policy specifically indicates that an institution should analyze all significant credits on an individual basis in determining the appropriate level of loan loss reserves.

See comment 1.

Furthermore, the report appears to take the view that a loan loss reserve for each large impaired loan should be a single amount that can be determined by specific analysis of each loan, and that no supplemental reserve should be permitted. However, we believe that the reserving process -- while seeking to establish an adequate loan loss reserve -- is a complex and inexact science, and there is sometimes a large degree of imprecision in loan loss reserve estimates. Economic trends, market conditions, and other circumstances affecting the reserving process can change unexpectedly, which makes it very difficult for institutions to accurately estimate the amount of loan loss reserves. Thus, there is significant judgment required in determining the appropriate amount of loan loss reserves, and such

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reserves should be viewed as being an estimate within a range of possible outcomes. Given this degree of imprecision, we do not believe that any one method of estimating reserves clearly outperforms other methods, nor is it appropriate to mandate any one reserving methodology. It should be recognized that no matter what method of reserving is followed, looking back with "20-20 hindsight" it may be found that the amount of reserves of a particular institution overstated or understated the amount of losses that actually occurred.

See comment 1.

We also believe the report greatly exaggerates the potential problem that the maintenance of unallocated or supplemental components of loan loss reserves could mask changes in the quality of the loan portfolio and financial condition of an institution. Neither supervisors or financial markets evaluate these items based solely -- or even primarily -- on the amount of loan loss reserves, but rather based on other information collected in Reports of Condition and Income (Call Reports) and other financial reports. Such information includes the amounts of various types of loans that are past due, nonaccrual, and restructured, charge-offs and recoveries of these loans, and a reconciliation of the change in the allowance for loan and lease losses during the period. This information, in addition to balance sheets, other items collected in financial reports, and consideration of economic conditions and trends, provide substantial material to the banking agencies to monitor, off-site, the quality of an institution's loan portfolio and identify whether an institution's financial condition has declined. Furthermore, the agencies primarily rely on periodic full-scope on-site examinations in order to assess the asset quality and the safety and soundness of an institution, including extensive classification of bank problem loans, and expect prompt charge-offs of all identified losses. All of this information provides much greater insight to regulators than the amount of the allowance or loan loss provisions each period.

See comment 2.

While we have concerns with the report's recommendations, there may be ways to improve loan loss reserving practices beyond the steps we have already taken in the last several years. Over this time frame we have developed a consistent examination framework that includes review of individual loans representing a substantial portion of the total dollar volume of a bank's portfolio (e.g., approximately 50 percent), review of controls and loan administration functions, uniform classifications (i.e., substandard, doubtful, and loss) of problem credits, and other measures. We believe the ALLL policy may be further improving loan loss reserving practices. Furthermore, Federal Reserve Board staff is actively reviewing what additional information we may provide to examiners and institutions to assist in analyzing the adequacy of loan loss reserves. This guidance would be intended to further improve loan loss reserving practices, while preserving sufficient flexibility to institutions to develop reserve estimates that are appropriate in their circumstances. In addition, we are reviewing on an interagency basis various implementation issues arising in connection with FAS 114. The agencies plan to issue further guidance on FAS 114 later this year. With all these recent changes relating to loan loss reserves occurring, we question whether it would be appropriate for FASB to undertake a project that could significantly affect loan loss reserving practices.

See comment 1.

Response to Specific Recommendations

With respect to the first recommendation, the Federal Reserve agrees that institutions should be required to establish reserves for large impaired loans based on the results of individual loan assessments. Such an approach has been general banking practice for many years, and the ALLL policy specifically indicates that an institution should analyze all significant credits on an individual basis in determining the appropriate level of loan loss reserves. Moreover, such an approach is consistent with FAS 114, which the banking agencies are requiring institutions to adopt in 1995 regulatory reports. Furthermore, for collateral dependent loans, we agree that the loans should generally be measured based on the fair value of the collateral. The agencies specified such a requirement in the policy statement on the Review and Classification of Commercial Real Estate Loans and have indicated that they intend to keep this requirement when FAS 114 become effective.[1] Accordingly, we question whether there is any need for FASB or the agencies to undertake a project to address this recommendation.

See comment 1.

While we agree that individual loan assessments are a key factor in developing loan loss reserve estimates for large impaired loans, it is very important that institutions also consider other factors, such as peer group loss experience on loans with similar risk profiles. Estimating the collectibility of large impaired loans on an individual basis is inherently judgmental, and any single institution has limited historical experience with which to assess fully the many factors that potentially affect the collectibility of an individual credit. Thus, institutions and examiners should also consider the loss experiences of other lenders on similar problem loans when considering the reasonableness of loan loss reserve estimates. Peer group loss statistics reflect much of the collection experience that is available on loans with similar risk profiles and is less likely to be subject to wide disparities in loan loss estimates that could arise when such estimates are based on the limited experience of a single institution.

With regard to the second recommendation, the ALLL policy now provides guidance to institutions and examiners on the net charge-off horizon that should be covered by the ALLL. In general, this guidance indicates that the ALLL should cover estimated credit losses over the remaining effective lives for classified loans and over the next twelve months for unclassified credits.[2] Furthermore, the policy statement indicates that these estimates must be based on current economic conditions and trends. Thus, the ALLL policy should lead to greater consistency in this area among institutions.

[1] See the FFIEC's May 17, 1994, Federal Register Notice on Implementation Issues Arising from FAS 114.

[2] However, as discussed in the ALLL policy, the net charge-off horizon for unclassified credits could be more or less than 12 months depending on such institution-specific factors as the composition of the loan portfolio, charge-off policies, and loan review function.

However, the ALLL policy does not provide specific, detailed guidance on the length of past experience that should be used by an institution in determining historic credit losses or the methods (e.g., a migration analysis) that institutions should use to factor historical losses into their reserve estimates. While providing such guidance in a regulatory policy may lead to greater consistency in methodologies of using historical charge-offs and their effect on loan loss reserves, such consistency may not lead to better estimates of credit losses (i.e., charge-offs to occur in the future). Indeed, differences among institutions in determining the length of past experience to be considered may be warranted, based on institution-specific factors. Such factors include changes in lending policies and procedures, underwriting standards, collection practices, and charge-off and recovery practices. Furthermore, differences among institutions in estimation methods may be warranted based on consideration of the benefits versus the costs of utilizing more complex, data-intensive approaches such as a migration analysis. For these reasons, the guidance provided in the policy statement focuses on the objectives to be addressed by the loan loss reserve and not the specific means of accomplishing these objectives.

See comment 1.

While specific guidance to institutions on past loss experience is not provided in the ALLL policy statement, the policy statement does provide quantitative guidance to examiners -- to be used like a "surveillance screen" -- when assessing the adequacy of an institution's reserve estimates. For classified loans, quantitative guidance has been provided based on estimates of industry average loss experience over time on similarly classified credits (e.g., 50 percent for doubtful and 15 percent for substandard). For unclassified loans, this guidance instructs examiners to consider charge-offs incurred by the institution over the previous two to three years on similar loans. Examiners are to review the reasonableness of the institution's loan loss reserve estimates by comparing them to this quantitative guidance. This guidance is intended to provide additional discipline over the reserving process while at the same time preserving adequate flexibility to account for institution-specific circumstances.

With respect to the third recommendation, while we agree that the reserve should be supported by a comprehensive analysis of current credit loss exposure in the loan portfolio, we question whether it is prudent from a safety and soundness perspective to specifically limit any supplemental components. While a theoretical argument can be made that the amount of the reserve should be strictly limited to what is directly determined and justified from such an analysis, from a practical perspective we believe that better reserving practices arise when a margin for the imprecision inherent in most estimates of expected credit losses is included in the reserve. Such a margin, which is discussed in the ALLL policy, is consistent with current GAAP, safety and soundness considerations, and our responsibility to protect the deposit insurance fund, and helps ensure that loan loss reserves are conservatively and reasonably estimated.

This principle of conservatism is consistent with the requirements set forth in the FDIC Improvement Act of 1991 (FDICIA). Section 121 of FDICIA requires that accounting principles applicable to regulatory reports should (a) result in financial statements and reports of condition that accurately reflect the capital of such institutions, (b) facilitate

See comment 1.

effective supervision of the institutions, and (c) facilitate prompt corrective action to resolve the institutions at the least cost to the insurance funds. The prompt corrective action provisions of FDICIA place great emphasis on the adequacy of capital, and therefore the adequacy of loan loss reserves, in the supervision of depository institutions. We believe that conservative estimation processes for loan loss reserves, based on timely credit grading frameworks and loan review systems, help achieve these objectives by reducing the likelihood that regulatory capital ratios are overstated, thus ensuring the timeliness of corrective actions taken under the authority of FDICIA.

In addition, our conservative philosophy to loan loss reserving is balanced by disincentives for institutions to overstate loan loss reserves. For example, an institution would seek to avoid an overstatement because it would generally cause lower capital ratios and, thus, could possibly subject the institution to prompt corrective action.

We appreciate the opportunity to comment on your draft report and the recommendations it contains.

Sincerely,

Richard Spillenkothen
Director

The following are GAO's comments on the Federal Reserve Board's letter dated July 13, 1994.

GAO Comments

1. See the "Comments and Our Evaluation" section in chapter 2.

2. While we agree that examiners have the ability to evaluate loan quality based on other factors, many other financial statement users do not. The provision for loan losses is a key component in quarterly earnings calculations and is looked to by many financial statement users as the primary gauge of changes in loan quality. The provision for loan losses and the related reserve are the only direct indicators of loan quality reported in the income statement and the balance sheet, respectively, of an institution. These two financial statements are the primary vehicles through which results of operations and financial condition are reported to the public. In addition, the provision and reserve are reported on regulatory call reports and are factored into calculations of regulatory capital.

As stated in the report, the primary purpose of financial reporting is to provide information to report users which they can rely on for making business and economic decisions. Financial information is the most useful in making these decisions if it can be compared with similar information about other enterprises and with similar information for different periods of time or points in time for the same enterprise. We do not believe existing authoritative accounting or regulatory guidance provide for reliable and consistent reporting of loan loss provisions and related reserves, thus undermining the usefulness of financial reports of banks and thrifts.

Comments From the Comptroller of the Currency

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

Comptroller of the Currency
Administrator of National Banks
Washington, D.C. 20219

August 2, 1994

Mr. Robert W. Gramling
Director, Corporate Financial Audits
Accounting and Information Management Division
United States General Accounting Office
Washington, DC 20548

Dear Mr. Gramling:

We have reviewed your draft audit report titled **DEPOSITORY INSTITUTIONS: Divergent Loan Loss Methods Undermine Usefulness of Financial Reports.** You conducted the review to learn what methods federally insured depository institutions use to establish loss reserves for potentially uncollectible loans, because you were concerned that accounting standards and regulatory guidance do not provide sufficient direction. Your review included interviews with financial institutions and OCC examiners and a review of reports of examination and supporting workpapers. You found that results of individual assessments are often not used by financial institutions in determining reserves, that there is no consistent method used to calculate historical loss rates and that large supplemental reserves are not adequately justified. Therefore, you are making recommendations to the Financial Accounting Standards Board (FASB) at this time. You are recommending that FASB work in close consultation with OCC and the other financial regulators to develop a comprehensive standard for establishment of loan loss reserves which would include requirements for individual assessment of certain types of loans and documentation of the analysis of current loss exposure. In addition, you recommend that FASB provide guidance regarding the use of historical analyses.

See comment 1.

In general, we support the GAO's recommendation that the FASB address deficiencies in the determination of the allowance for loan and lease losses (allowance). In our view, however, the determination of an adequate level for a bank's allowance is a highly judgmental process that does not lend itself to "one-size-fits-all" rules of thumb. We believe that the existing body of regulatory guidance provides an appropriately flexible analytical framework for banks, which must make the initial determination of an adequate level for the allowance, and for examiners, who must evaluate the bank's allowance evaluation process and the validity of its conclusions.

Use of Individual Loan Assessments to Establish Reserves

The draft report seems to suggest that the probable loss in larger-balance, impaired loans can be estimated with a fairly high level of precision if the loans are analyzed individually. In our view,

the amount of probable loss on any given loan and, by extension, the amount of an adequate allowance as a whole, will fall within a range of values and cannot be precisely determined until the losses have been confirmed and charged off.

In general, the OCC agrees that banks should analyze all significant doubtful credits individually and attempt to estimate the probable loss associated with each loan, based on existing facts, conditions, and values. As a practical matter, however, such loan-by-loan estimates are not always possible, even for loans that are classified doubtful. On an unsecured commercial credit, for example, it is not always possible to estimate the amount of probable loss with any great degree of certainty. In such situations, the OCC believes that an estimate based on the bank's own historical loss experience on a pool of similar loans (adjusted for any changes in conditions and trends) is an acceptable, and often more realistic, alternative.

See comment 1.

Similarly, for loans that are classified substandard, there generally will not be sufficient information available to reach loan-by-loan conclusions about the exposure to loss. For such loans, an analysis of the bank's historical loss experience on pools of similar substandard loans is the more usual and preferred approach to estimating an appropriate reserve. Indeed, if there is enough information to estimate the probable loss on an individual substandard credit, a question arises as to whether the loan should be classified as doubtful.

Regardless of the severity of classification or the method of estimating probable loss, the allowance provision for all loans must be reasonable and well documented. OCC examiners are, for example, under instructions to look closely at individually analyzed credits that are provided for at a rate that is below the bank's historical loss rate for pools of similar loans. Decisions to diverge from the bank's own historical experience on similar loans must be clearly supported by the nature of the collateral or other circumstances that distinguish the loan from similarly classified credits.

Historical Loss Rates

The OCC agrees very strongly with the GAO's observation, "Loss reserve methods that rely predominantly on standard industry loss percentages are likely to create misleading loan loss provision and reserves because they do not consider the particular characteristics of the institution's portfolio." We believe banks' analyses should have an internal focus on the unique composition and historical loss experience of their own portfolios rather than on external comparisons with the average experience of the industry. However, because no single approach has been determined to be the best, or most appropriate for all banks, the OCC does not require banks to use a specific method or time period to determine their own historical loss experience. In our view, the method a bank uses will depend to a large degree on the capabilities of its information systems.

See comment 1.

In principle, the goal of any allowance methodology that applies historical loss experience to a current pool of loans should be to provide for unconfirmed losses that probably exist as of the evaluation date. How that goal is accomplished, including the analysis timeframes that are used, will depend on the characteristics of the pool and the particular methodology. OCC examiners have been instructed to determine whether, given the capabilities of its systems, a bank's methodology for evaluating the allowance is producing reasonable estimates of the inherent losses in its portfolio.

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Deficiencies in the bank's methodology that appear to materially affect its estimates of inherent losses are to be brought to the attention of management.

Justification of Large Supplemental Reserves

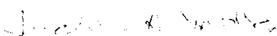
Because of the subjectivity and the risk of error and imprecision in the entire allowance allocation process, the OCC believes that some margin for error is desirable. However, the OCC shares the GAO's concerns about large, unallocated or supplemental reserves. We believe that reducing the relative size and importance of this unallocated component of the allowance will produce a more refined and reliable estimate of an appropriate level for the allowance in most banks.

See comment 1.

In the past, many banks have incorporated the margin for error into a single, relatively large, unallocated component of the allowance. One of the OCC's objectives when it revised Banking Circular 201 in February 1992, was to encourage banks to provide these margins on a loan-by-loan and pool-by-pool basis rather than in the aggregate, thus reducing the size of the unallocated component of the allowance. We believe that another study conducted a year or two hence will show that the November 1992 to November 1993 timeframe of the GAO's current study did not capture the longer term effects of our revised guidance. We also expect that the implementation of FAS 114 will be an inducement for banks to allocate their supplemental reserves to specific loans and pools of loans, thereby further reducing the unallocated component of the allowance in many banks.

Thank you for the opportunity to review and comment on the draft report.

Sincerely,



Judith A. Walter
Senior Deputy Comptroller for Administration

- 3 -

The following are GAO's comments on the Comptroller of the Currency's letter dated August 2, 1994.

GAO Comments

1. See the "Comments and Our Evaluation" section in chapter 2.

Comments From the Office of Thrift Supervision

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

Office of Thrift Supervision
Department of the Treasury
Director
1700 G Street, N.W., Washington, D.C. 20552 • (202) 906-6590

July 13, 1994

Mr. Robert W. Gramling
Director, Corporate Financial Audits
General Accounting Office
Washington, D.C. 20548

Dear Mr. Gramling:

Thank you for the opportunity to review the draft General Accounting Office (GAO) Report entitled "Depository Institutions: Divergent Loan Loss Methods Undermine Usefulness of Financial Reports."

In general, the Office of Thrift Supervision (OTS) believes that many of the issues that you raise about institutions' methodologies for determining appropriate loan loss allowances do not undermine the usefulness of financial reports. As you are aware, the determination of appropriate allowance levels is not an exact science. Further, the reliance, in part, on historical experience to determine allowance levels may result in an under-estimate of inherent losses during an economic downturn and an over-estimate of inherent losses in an economic recovery. While we agree that greater consistency between institutions on their methodologies for determining allowances is appropriate, we believe that the December 21, 1993, "Interagency Policy Statement on the Allowance for Loan and Lease Losses," and the interagency guidance to be issued related to Statement of Financial Accounting Standards (SFAS) No. 114, "Accounting by Creditors for Impairment of a Loan," will sufficiently address the issues you raise in your draft Report.

See comment 1.

OTS Response to GAO Recommendations

In your draft Report, you make several specific recommendations. Below are the OTS's responses to these recommendations.

OTS Response to GAO Report
Page 2

GAO Recommendations:

We recommend that [the] Financial Accounting Standards Board (FASB), in close consultation with the Office of the Comptroller of the Currency (OCC), Federal Reserve Board (FRB), Federal Deposit Insurance Corporation (FDIC) and OTS, develop a comprehensive standard for establishment of loan loss reserves, which includes:

-- a requirement that reserves for all large impaired loans be based on detailed individual assessments, and no specific reserve amounts in excess of those determined from such assessments should be allowed for those loans. For collateral dependent commercial loans, a reserve should be established to cover the difference between the outstanding loan balance and the estimated recoverable amount from the collateral based on an assessment of the collateral's fair value;

OTS Response: We agree that all large impaired loans should generally be assessed on an individual basis. On page five of the December 21, 1993 Interagency Policy Statement, we clearly encourage institutions to assess their allowance levels for all significant credits on an individual basis. We also believe that institutions, for purposes of measuring impairment under SFAS 114, will often undertake a loan-by-loan analysis.

Also, in terms of the recommendation to assess collateral-dependent loans based on the fair value of the collateral, in the May 17, 1994, "Request for Comment" on SFAS 114 that the agencies published in the Federal Register, we specifically stated that the agencies expect institutions to measure impaired, collateral-dependent loans for purposes of regulatory reports at the fair value of the collateral.

For safety and soundness reasons, OTS disagrees with your recommendation that "no specific reserve amounts in excess of those determined from such assessments should be allowed for those loans." We believe that there may be losses inherent in any pool of assets, including pools of loans that have been individually assessed. Such inherent losses may arise from non-loan-specific factors such as an institution's historical loss experience compared with estimates of such losses, concerns about the reliability of cash flow estimates, or concerns about the quality of an institution's loan review function and controls over its process for estimating allowances.

OTS Response to GAO Report
Page 3

In addition, certain individually assessed loans still pose sufficient risk to an institution to warrant an additional allowance. For example, for an impaired, collateral-dependent loan, an allowance that addresses the portion of the loan in excess of the fair value of the underlying collateral still leaves the net carrying amount of the loan with an effective loan-to-value (LTV) ratio of 100%. The combination of the 100% LTV ratio and the troubled nature of the loan leads us to believe that some level of additional allowances is often prudent. A determination as to whether an additional allowance is appropriate would be based on institution-specific factors (such as those mentioned above).

See comment 1.

Thus, for larger-balance loans, we believe that it is appropriate to utilize both individual loan assessments and broader assessment techniques to determine appropriate allowance levels. To do otherwise would, in our view, not incorporate risk factors that are not loan-specific.

-- guidance regarding the use of historical analyses to estimate inherent losses existing in the portion of the portfolio which has not been specifically analyzed for impairment. Such guidance should address method of analyses as well as the appropriate time periods of historical data to be included; and

OTS Response: We agree with the usefulness of having guidance on the use of historical analyses, including the method of analyses and the appropriate time period. In terms of the method of analyses to be used, as you point out in your draft Report, the December 21, 1993 Interagency Policy Statement states that there are a range of methodologies that can be used. While we agree with the GAO that the use of a migration analysis is often the most appropriate methodology to use[1], we do not believe it is appropriate to mandate any specific methodology, as institutions vary considerably in their ability to undertake such analyses.

1. In the recently-issued Thrift Activities Regulatory Handbook Section 261, "Adequacy of Valuation Allowances" (attached), we specifically encourage savings associations to use migration analysis and we provide (in Appendix B) an example of how it works.

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See comment 1.

In terms of what historical experience to use and the appropriate time period to use for historical analysis, the December 21, 1993 Interagency Policy Statement included specific guidance, on page nine, that experience based on the institution's average annual rate of net charge-offs experienced over the last two or three years for similar loans, adjusted for current conditions and trends, should be used. Footnote 9, on the same page of the interagency document, indicates that use of industry-average net charge-off experience is appropriate only when the institution does not have a sufficient basis for determining this amount[2].

See comment 2.

In terms of the issue of whether allowance levels should reflect losses expected over the lives of the current portfolio or losses expected over the coming year, page three of the Interagency Policy Statement states that, for loans and leases that are adversely classified, credit losses over the remaining effective lives should be addressed; for the components of the loan and lease portfolio that are not classified, estimated credit losses over the upcoming 12 months should be addressed.

-- a requirement that all portions of the reserve, including any supplemental amounts, should be directly linked to and justified by a comprehensive documented analysis of current loss exposure in the loan portfolio and that the periodic provision for loan losses adjust the reserve balance to the level determined necessary by such an analysis.

OTS Response: We agree with this GAO recommendation and believe that the December 21, 1993 Interagency Policy Statement makes this point very clearly, throughout the document. For example, on pages four and five, we state that a key responsibility of boards of directors and management is to "ensure that the institution's process for determining an adequate level of the [allowance for loan and lease losses] is based on a comprehensive, adequately documented and consistently applied analysis of the

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2. Handbook Section 261, "Adequacy of Valuation Allowances," also contains additional guidance on when to use industry net charge-off data in lieu of institution-specific data. The guidance states that the use of industry data could be appropriate if there is no institution-specific data available, such as where the institution offered a new product and had no historical data, or if the institution had substantially changed its underwriting such that old historical data would not accurately reflect expected losses.

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institution's loan and lease portfolio that considers all significant factors that affect the collectibility of the portfolio." We also direct our examiners to "review the adequacy of the documentation that has been maintained by management to support the adequacy of the [allowance for loan and lease losses]" (page 8).

See comment 1.

Your draft Report also contains the following recommendation:

If FASB does not add a project to address these recommendations to its current agenda, we recommend that the four federal regulators revise or enhance their policies for loan loss reserves to implement the principles of our recommendations to FASB until FASB completes its rule-making process and issues a new comprehensive standard for the establishment of loan loss reserves. Once established, the regulators should determine the adequacy of the FASB standard and adopt it as is or develop additional guidance to address the principles of our recommendations to FASB.

See comment 1.

OTS Response: While we do not know what action the FASB will take in response to your recommendations, we believe that the guidance provided in the December 21, 1993 Interagency Policy Statement, and any additional guidance the agencies issue related to the implementation of SFAS 114, will provide sufficiently detailed direction to depository institutions on the establishment of loan loss allowances. We will, of course, carefully track FASB actions on this issue and, if appropriate, develop any additional guidance that is necessary.

Other OTS Comments on Draft Report

Now on page 2.

See comment 3.

On page 4 of your draft Report, you state that "loss potential is reflected in institutions' financial reports in the form of loan loss reserves." This is not technically accurate, as it implies a focus on potential (e.g., future) losses, rather than losses that already exist in the portfolio. Regulatory guidance states that the allowance for loan and lease losses is established to absorb estimated credit losses associated with the loan and lease portfolio, meaning an estimate of the current amount of the loan and lease portfolio that is not likely to be collected.

Now on page 16.
See comment 3.

On page 23 of your draft Report, footnote 3, which lists the loan classifications used by the regulatory agencies, does not include the "Pass" classification. We recommend that it be included, as most loans should be classified as "Pass."

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Now on page 22.

On page 33 of your draft Report, you indicate that, for purposes of a historical time period to use for loss estimates, "a sufficient number of years should be used so that historical loan performance can be gauged over the course of the institution's economic cycle." In footnote 12 on the same page, you define an institution's economic cycle as "the time period that typically encompasses expansions and contractions in business activity for its major commercial customers."

See comment 4.

We do not believe that it would be appropriate to use an institution's "economic cycle" as the appropriate time period for measuring historical losses. For many institutions, an "economic cycle," under your definition, could be five to ten years or more. Such action would, in our view, consistently result in significant over-statement or under-statement of appropriate allowance levels, as the current condition of the portfolio would not be the focus of the allowance determination process.

Now on page 28.

See comment 5.

On page 44 of your draft Report, you do not reference the AICPA Audit and Accounting Guides, "Audits of Savings Associations" and "Audits of Banks" or the Auditing Procedure Study of AICPA, "Auditing the Allowance for Credit Losses of Banks." These publications offer extensive guidance on the establishment of allowances.

Now on page 31.

In your discussion on page 49 of the December 21, 1993 Interagency Policy Statement, you criticize the document because:

> "it does not prohibit or discourage institutions from using loss history to supplement reserves determined from specific detailed assessments. Further, it does not state whether institutions should reserve for portions of individual loans that are adequately covered by collateral."

See comment 1.

We believe that this criticism is misplaced. The use of loss history to supplement allowances determined to be appropriate from specific assessments may be appropriate in certain instances. For example, as indicated above, for an impaired, collateral-dependent loan, an individual assessment may only result in sufficient allowances to bring the loan to a 100% LTV ratio. Given the troubled nature of the loan and the 100% LTV ratio, an additional allowance may be both reasonable and prudent. Such a determination would depend, in part, on the institution's historical loss experience compared with estimates of such losses, concerns about the reliability of cash flow estimates, or concerns about the quality of an institution's loan review function and controls over its process for estimating allowances. We also note that if no additional

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allowance were required on such an asset, the loan would be treated less stringently -- from an accounting standpoint -- than non-troubled loans with low LTV ratios (where an allowance based on historical loss experience is expected).

See comment 1.

In terms of whether institutions should reserve for portions of loans that are "adequately covered" by collateral, we believe that such a requirement will vary depending on the institution. For example, for a collateral-dependent loan that has had its net carrying value adjusted to the fair value of the collateral, an institution that has rarely experienced any additional losses may not need to establish additional allowances on the loan (as it is "adequately covered" by the collateral value), while another institution that has historically experienced additional losses (due to inaccurate estimates of collateral value or other reasons) should establish an appropriate allowance to address this risk.

Now on page 32.

See comment 6.

In your draft Report, on pages 50 - 51, you also criticize the Interagency Policy Statement's discussion of the need for management's analysis to be conservative so that the overall allowance level appropriately reflects a margin for the imprecision inherent in most estimates of expected losses. We do not believe that this guidance will "encourage institutions to use large unjustified supplemental reserves." It is OTS's position that if an association's loss allowance has historically been sufficient to cover actual losses, then the margin for imprecision can be minimal. The updated Handbook Section 261 includes explicit guidance on this issue.

See comment 1.

In closing, we believe that the December 21, 1993 Interagency Policy Statement, OTS Handbook Section 261, and the interagency guidance to be issued related to SFAS 114 address the issues you raise in your draft Report and that they will provide sufficiently detailed direction to institutions and examiners on the establishment of allowances. Your draft Report indicates that your field work occurred from November 1992 through November 1993. As such, you did not have the benefit of seeing how institutions and examiners implement the new Interagency Policy Statement or SFAS 114 and whether such implementation addresses your concerns. We believe that our guidance will not only help to improve the "comparability" of institutions' allowance levels, but that they will also help to further ensure that institutions are reflecting loss exposure as accurately as possible, given the inherent imprecision in the allowance determination process.

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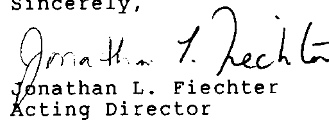
We will, however, continue to review institutions' determinations of appropriate allowance levels as part of our examination process. If we find that there are areas that require additional guidance or clarification, we will develop and issue such information, as appropriate.

Please contact David Martens, Chief Accountant, at (202) 906-5646 or Robert Fishman, Acting Deputy Assistant Director for Supervision Policy, at (202) 906-5672, if we can be of further assistance to you on this draft Report.

Sincerely,



Jonathan L. Fiechter
Acting Director

Attachment

The following are GAO's comments on the Office of Thrift Supervision's letter dated July 13, 1994.

GAO Comments

1. See the "Comments and Our Evaluation" section in chapter 2.

2. The interagency policy statement does state that reserves should reflect losses expected over the remaining effective lives of classified loans, but does not provide specific guidance or minimum requirements for the use of migration analysis or other techniques to estimate losses in this manner. The policy statement also states that reserves should reflect all estimated credit losses over the upcoming 12 months for loans that are not classified. No rationale for the use of a 12-month time frame for these loans is provided in the policy statement.

We believe that parameters are needed to ensure that all loss estimates represent existing conditions that are likely to result in losses during the period of time the institution holds the loans. These same criteria exist for all loans—classified or unclassified. Therefore, we do not believe the use of different loss time frames based on loan classifications is appropriate. We believe the focus of authoritative accounting and regulatory guidance should be on identification of the types of existing conditions that are indicative of probable loan losses. Once such a condition has been identified, then the estimated probable loss should be reserved for, regardless of whether the event which confirms that loss is expected to occur over the next 12 months or at some later point in the life of the loan.

3. We agree with OTS's comment and have changed the report accordingly.

4. The discussion in the report OTS refers to is an explanation of the objectives of using longer versus shorter time periods to determine historical loss rates. The purpose of this discussion was to compare and contrast the different approaches—we did not express our view on the appropriateness of either approach.

5. As stated in the report, we reviewed AICPA audit and accounting guides for banks and savings institutions. These guides present broad discussions relative to accounting for loan loss reserves, but they do not provide specific guidance that management can use to effectively address the concerns that we identified in the report.

The AICPA auditing procedure study was designed to assist auditors of bank financial statements in developing an effective audit approach, rather than to provide detailed guidance on how management should establish loan loss reserves. Further, neither FASB nor the AICPA considers such procedure studies to be authoritative accounting standards.

6. As stated in the report, we believe the interagency statement will encourage institutions to continue to use large unjustified supplemental reserves because it does not emphasize that inherent imprecision in loss estimates can result in overstatements as well as understatements of actual losses. As a result, institutions may continue to add to their estimates to cover potential error even if the estimates are too high. OTS's handbook, section 261, includes language similar to the interagency policy statement and states its position that if an association's reserve historically has been sufficient then the "margin for imprecision can be minimal." However, it does not define how institutions should calculate the margin for imprecision or what OTS means by minimal.

Major Contributors to This Report

Accounting and Information Management Division, Washington, D.C.

Linda M. Calbom, Senior Assistant Director
Daniel R. Blair, Auditor-in-Charge

Dallas Regional Office

Kenneth R. Rupar, Project Manager
Amy E. Lyon, Site Senior
Matthew F. Valenta, Evaluator

New York Regional Office

David J. Deivert, Site Senior

San Francisco Regional Office

John M. Lord, Site Senior
Yola Lewis, Evaluator

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