Office of Thrift Supervision
Department of the Treasury
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MEMORANDUM FOR: **CHIEF EXECUTIVE OFFICERS**

FROM: Scott M. Albinson Scott M. A

SUBJECT: Update on Accounting for Loan and Lease Losses

On March 1, 2004, the Office of Thrift Supervision, along with the other federal financial institution regulatory agencies, issued guidance on accounting for credit losses, including the allowance for loan and lease losses (ALLL). The guidance includes an update on recent developments related to the AcSEC proposed *Statement of Position on Accounting for Credit Losses* (SOP), and highlights key provisions of current authoritative accounting and supervisory guidance for establishing and maintaining adequate ALLL.

A copy of the guidance is attached to this memorandum. Questions regarding this guidance should be directed to your regional OTS office or Patricia M. Hildebrand, Accountant, (202) 906-7048.

Enclosure: **Guidance**

UPDATE ON ACCOUNTING FOR LOAN AND LEASE LOSSES [1]

Purpose and Background

This guidance addresses recent developments in accounting for loan and lease losses and provides an update on the status of the proposed Statement of Position, "Accounting for Credit Losses" (SOP), issued by the Accounting Standards Executive Committee (AcSEC) of the American Institute of Certified Public Accountants (AICPA). Because an assessment of the appropriateness of the allowance for loan and lease losses (ALLL) is critical to the safety and soundness of a financial institution, this issuance also provides a listing of the existing allowance guidance that financial institutions should continue to apply.

Financial institutions are reminded of their responsibility for ensuring that controls are in place to consistently determine the ALLL in accordance with generally accepted accounting principles (GAAP), the institution's stated policies and procedures, and relevant supervisory guidance. To fulfill this responsibility, financial institutions should develop, maintain, and document a comprehensive, systematic, and consistently applied process to determine the amounts of the ALLL and provisions for loan and lease losses. Consistent with longstanding supervisory guidance, financial institutions must maintain an ALLL at a level that is appropriate to absorb estimated credit losses inherent in the loan and lease portfolio. Arriving at such an allowance involves a high degree of management judgment and results in a range of estimated losses. Accordingly, prudent, conservative, but not excessive, loan loss allowances that represent management's best estimate from within an acceptable range of estimated losses are appropriate.

Status of the Proposed SOP

In June 2003, AcSEC issued the proposed SOP for public comment. The issuance resulted from work over several years to clarify accounting guidance for loan and lease losses. The proposed SOP received a great deal of attention among bankers, auditors, regulators, and others who wrote nearly 300 comment letters to AcSEC. The Agencies expressed concerns over the proposed guidance, as did many other commenters. After carefully reviewing these comment letters, AcSEC decided, at its January 2004 meeting, to proceed only with guidance to improve disclosures. AcSEC's Allowance Task Force will evaluate existing ALLL disclosure requirements and disclosure recommendations received through the recent comment process and will present a list of recommended disclosure enhancements at AcSEC's April 2004 meeting.

[1] This guidance is being issued jointly by the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS), and the National Credit Union Administration (NCUA) (the "Agencies").

AcSEC also decided to submit to the Financial Accounting Standards Board (FASB) its recommendation that the accounting for loan losses (Statement of Financial Accounting Standards No. 5, "Accounting for Contingencies") be reconsidered.[2]

As a result of these decisions, it appears that AcSEC will not issue additional loss recognition and measurement guidance for the ALLL. Consequently, financial institutions should continue to determine the appropriateness of their ALLL on the basis of the existing guidance set forth in GAAP and in the Agencies' supervisory guidance. The Agencies also anticipate issuing supplemental guidance regarding the ALLL.

Current Guidance

The listing below presents the current sources of GAAP and supervisory guidance for accounting for the ALLL. Institutions and examiners should refer to the actual sources for complete guidance.

- Statement of Financial Accounting Standards No. 5, "Accounting for Contingencies" (March 1975)
- Securities and Exchange Commission (SEC) Accounting Series Release No. FR-28 (Article 9, Section 401.09), "Accounting for Loan Losses by Registrants Engaged in Lending Activities" (December 1986)
- Statement of Financial Accounting Standards No. 114, "Accounting by Creditors for Impairment of a Loan" (May 1993)
- Interagency Policy Statement on the ALLL[3] (December 1993)
- Emerging Issues Task Force (EITF) Topic D-80, "Application of FASB Statements No. 5 and 114 to a Loan Portfolio" (May 1999)
- Joint Interagency Letter to Financial Institutions[4] (July 1999)
- AICPA Audit and Accounting Guides[5]:
    - Banks and Savings Institutions, Chapter 7, "Credit Losses" (May 2000)
    - Credit Unions, Chapter 6, "Allowance for Loan Losses" (May 2000)
- FFIEC Policy Statement on ALLL Methodologies and Documentation for Banks and Savings Institutions (July 2001)
- SEC Staff Accounting Bulletin No. 102, "Selected Loan Loss Allowance Methodology and Documentation Issues" (July 2001)
- NCUA Interpretative Ruling and Policy Statement 02-3, "Allowance for Loan and Lease Losses Methodologies and Documentation for Federally Insured Credit Unions" (May 2002)

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[2] This recommendation, if adopted by the FASB, is likely to be a longer-term project.

[3] Jointly issued by the FDIC, FRB, OCC, and OTS.

[4] Jointly issued by the SEC, FDIC, FRB, OCC, and OTS.

[5] A new Audit and Accounting Guide for Depository and Lending Institutions that replaces the separate guides for banks and savings institutions, credit unions, and finance companies will be issued in 2004.