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I. INTRODUCTION

The banking industry is viewed from many differing perspectives.1 Customers view banks as a safe place for deposits and a source of loans.2 Shareholders consider banks a means of obtaining profit.3 Regulators view banking as “the backbone of our economy, the vehicle through which the Federal Reserve applies its monetary policy.”4 The credence given these varying perspectives changes with time; in the years after the Great Depression banking regulation focused “on the safety and soundness of the system.”5 Since the 1970s, however, regulatory emphasis reveals a change in focus from safety and soundness to investors’ interests.6 Recently, the Security and Exchange Commission (SEC) demonstrated this shift by accusing banks of using their loan-loss reserve accounts to “manage” earnings, making it difficult for investors to uncover accurate information from banks’ reported earnings data.7

2. Id.
3. Id.
4. Id.
5. Id.
6. Bennett, supra note 1, at 8.
7. Steve Burkholder, Accounting: Banks’ Loan Loss Reserves Focus For Rule-makers, SEC Staff At Conference, BNA BANKING DAILY, Nov. 3, 2000, at d4 [hereinafter Burkholder, Loan Loss Reserves]. In a pivotal 1998 speech that launched the SEC’s widespread effort to reduce earnings management, commission Chairman Arthur Levitt referred to loan-loss allowances as “cookie jar reserves” used by companies to smooth earnings. Id. Earnings management is “the strategic exercise of managerial discretion in influencing the earnings figure reported to external audiences.” Francois Degeorge, Jayendu Patel & Richard Zeckhauser, Earnings Management To Exceed Thresholds, J. OF BUS., Jan. 1999, at 2. Speaking at a November 2, 2000 conference for accountants and bankers in Washington, D.C., Mark Sever, the new chairman of the Accounting Standards Executive Committee (AcSec), commented that loan-losses appeared too “skinny” in years past. Burkholder, supra.
The SEC argues that banks should not use these accounts as "cookie jar reserves" to be raided in hard times to maintain the appearance of smooth earnings.\(^8\)

However, the banks and banking regulators, including the Federal Deposit Insurance Corporation, the Federal Reserve Board, the Office of the Comptroller of Currency, and the Office of Thrift Supervision, strongly support the notion that banks should freely put aside reserves to cushion against bad loans.\(^9\) In fact, banking regulators have been encouraging banks to increase reserves to protect themselves from a potential downturn in the U.S. economy.\(^10\) They maintain that there should be no requirement for these reserves to be tied to specific problem loans.\(^11\) Banks want to prepare for the unanticipated losses inherent in the loan making business.\(^12\) The banking agencies’ desire for safe and sound guarding against bad loans conflicts with the SEC’s push for adequate disclosure.\(^13\)

This Note will briefly recount the history of the loan-loss debate.\(^14\) A key focus of this Note is the current debate over a still evolving American Institute of Certified Public Accountants (AICPA) proposal on the recommended accounting for loan-loss reserves.\(^15\) This Note will next examine the arguments of the SEC.
and accounting regulators\textsuperscript{16} versus those of the banks and the banking regulators.\textsuperscript{17} The Note will then discuss the controversial element of subjectivity in setting loan-loss reserves.\textsuperscript{18} This discussion is followed by political and public policy reaction to the loan-loss reserve debate.\textsuperscript{19} The Note concludes with possible means of compromise and a discussion on the effect of fair value accounting on loan-loss reserve accounting.\textsuperscript{20}

II. HISTORICAL ACCOUNT OF LOAN-LOSS RESERVES

The debate over proper accounting for loan-loss reserves is not a recent phenomenon.\textsuperscript{21} In December 1993, hoping to end years of confusion, bank and thrift regulators agreed on a guideline formula for setting loan-loss reserves.\textsuperscript{22} The new policy was intended to end the battle between bankers and examiners over

\textsuperscript{16} See infra notes 65-77 and accompanying text.
\textsuperscript{17} See infra notes 78-90 and accompanying text. Keith Newton, a partner at the accounting firm Grant Thornton LLP, calls the debate over loan-loss reserve accounting "a lose-lose situation for the industry." Gillam, supra note 10, at 5. "On the one hand you have accounting rules that say you cannot recognize losses until they occur. But then you have regulators who are saying that times are not going to be as good so you need to start recognizing that in your loan losses. This is a catch twenty-two." Id.
\textsuperscript{18} See infra notes 91-108 and accompanying text.
\textsuperscript{19} See infra notes 109-120 and accompanying text.
\textsuperscript{21} See Barbara A. Rehm, Bank, Thrift Regulators Reach Accord on Formula For Loan-Loss Reserves, AM. BANKER, Dec. 22, 1993, at 3.
\textsuperscript{22} Id. The formula advised "examiners to calculate reserves against the sum of: 50\% of the portfolio classified as 'doubtful,' 15\% of the portfolio classified as 'sub-standard,' \[a\]nd estimated credit losses for the next year on unclassified portions of the portfolio." Id. The policy statement also contained factors to consider when setting loan-loss reserves beyond past loss experience. Id. These factors include "changes in lending policies and procedures, including underwriting standards and collection, chargeoff, and recovery practices;" "national and local economic and business conditions;" "[t]he nature and volume of the institution's portfolio;" "[t]he experience, ability and depth of lending management and staff;" "[t]he trend of the volume and severity of the nonperforming loans;" "[t]he quality of the institution's loan-review system;" "and the degree of oversight by the institution's directors." Id. Other variables to consider include "the existence and effect of any concentrations of credit and changes in those concentrations" as well as "external factors, such as competition and legal or regulatory requirements." Id.
proper accounting methods for loan-loss reserves. However, in 1994, after a congressional study found banks' methods for establishing reserves to be inadequate, the General Accounting Office (GAO) advised the Financial Accounting Standards Board (FASB) and banking regulators to develop a common approach for establishing loan-loss reserves. The GAO maintained that banks should analyze large loans individually, reserving just enough to cover likely losses. The GAO also stated that reserves should be established based on current loss exposure in banks' loan portfolios.

In 1998, the SEC began an investigation into the accounting practices at SunTrust Banks Inc. The SEC was concerned about excessively high loan-loss reserves which enabled SunTrust to create the impression of smooth earnings. The SEC prevented a merger between SunTrust and Crestar Financial Corporation by refusing to sign off on proxy materials required for shareholder vote on the merger. In order to win SEC approval of its acquisi-

23. Id. Though the policy statement was meant to be a guideline and not a requirement, it was sent to every bank and thrift. Id.
24. Olaf de Senerpont Domis, GAO Recommends that a Norm Be Set For Banks Establishing Loss Reserves, AM. BANKER, Nov. 7, 1994, at 3. After a study of twelve banks with assets over $1 billion, the GAO reported: "Investors, creditors, depositors, regulators, or other financial report users [are not] able to meaningfully compare the institutions' reserves in judging their adequacy and the quality of the institutions' loan portfolio." Id. The twelve banks' methods for establishing loss reserves were quite diverse. Id. To arrive at loss rates, some reached back only twelve months and others several years. Id. The GAO reported that for seven of the twelve banks, over 30% of total loan-loss reserves were "supplemental reserves not supported by evidence showing the losses to be likely and reasonably estimated." Id. The reserve account at one bank was $612 million in excess of what was deemed appropriate by its own portfolio analysis. Id.
25. Id.
26. Id.
27. David Weidner & Niamh Ring, Earnings Management Found In All Businesses, SEC Chief Says, AM. BANKER, Nov. 9, 1998, at 38. The SEC had focused on SunTrust's loan-loss reserve practices as part of a broader crackdown on earnings management in banking and other industries. Gillam, supra note 10, at 5.
28. Weidner & Ring, supra note 27, at 1. Speaking against earnings management, SEC Chairman, Arthur Levitt, described the process of manipulating earnings using loan-loss accounts by stating, "A third illusion played by some companies is using unrealistic assumptions to estimate liabilities for such items as sales returns, loan losses or warranty costs. In doing so, they stash accruals in cookie jars during the good times and reach into them when needed in the bad times." The Numbers Game, supra note 8, at 16.
tion of Crestar, SunTrust agreed to reduce its loan-loss reserves by $100 million.\textsuperscript{30} The SEC claimed its stance was aimed at ensuring consistent loan-loss accounting methodologies and denied harboring a desire to force all banks to lower their reserve levels.\textsuperscript{31}

Banking regulators and industry insiders quickly mobilized to criticize the SEC’s action against SunTrust and the inherent message the SEC sent to the industry.\textsuperscript{32} Financial analysts and bankers voiced concern that banks might feel pressure to decrease protection against loan-losses during a period of economic uncertainty.\textsuperscript{33} Banking regulators also faulted the SEC for making an example of SunTrust before providing clear methods for adding to loan-loss reserves without violating securities laws.\textsuperscript{34} While SunTrust officials apparently believed they were following the rules, the SEC disagreed.\textsuperscript{35} The SunTrust accusations set the stage for a monumental debate between banking and accounting regulators over the proper accounting for banks’ loan-loss reserves.\textsuperscript{36}

In November 1998, in the wake of the SunTrust merger, the SEC and the banking regulators agreed to work together on questions related to loan-loss reserves.\textsuperscript{37} The two sides reached an

\begin{enumerate}
\item Id. SunTrust’s reserves were restated by $25 million in 1994; $35 million in 1995; and $40 million in 1996. Id. at 5. The 13\% cut in reserves decreased total reserves from $766 million to $666 million leading to an increase in after-tax net income of $61 million over the three year period. Id.
\item Id. at 4. “We clearly don’t want to send the wrong message,” explained Lynn E. Turner, the SEC’s chief accountant. “We don’t want all the banks reducing their reserves. Our message is we want people to make sure they’ve gone through a methodology that is consistent with the guidance out there.” Id.
\item Id. “This hurts the industry and I don’t think it was necessary,” argued Sally Pope Davis of Goldman, Sachs & Co.” Id. “Banks need strong capital positions and strong reserve positions,” stated Richard Spillenkothen, the Federal Reserve Board’s director of banking supervision and regulation.” Id. Nancy A. Bush, an analyst with Ryan, Beck & Co. stated, “Everybody is concerned about the larger issue that the SEC is doing something that is completely counter to conservative practices in banks. It’s insanity. The SEC can stick to its guns, but it’s going to wreak havoc on what the regulators want to see in the banking industry.” Id. at 5.
\item Id.
\item Id. Donna J. Fisher, director of tax and accounting at the American Bankers Association, stated, “Banks believe they are following the accounting rules. If they are not, then we need some type of instruction of how to change our practices.” Id.
\item Gillam, supra note 10, at 4. SunTrust’s chief financial officer claimed, “We thought we had been following the rules all along and still believe we have been and are.” Id.
\item Id.
\item Id.
\item Rob Garver, Severe Curbs Urged On Loan-Loss Reserves, AM. BANKER, July
\end{enumerate}
agreement in March 1999, whereby the SEC agreed not to require banks to restate reserves the way it instructed SunTrust, and the bank regulators pledged to improve disclosure methods. However, in May 1999, this agreement fell through because of SEC endorsement of a FASB article calling for banks to reserve only for specific problem loans.

III. CURRENT DEBATE

Presently, the debate over how to account for banks’ loan-loss reserves is causing a rift between accounting rulemakers (SEC, FASB, and AICPA) and banking regulators. The controversy continues to revolve around an evolving draft proposal by the AICPA. In March 1999, the AICPA formed a ten-member task force charged with clarifying current generally accepted accounting principles (GAAP) applicable to banks’ loan-loss reserves. An early version of the proposal was leaked to American Banker in July 2000. This early version of the draft proposal pre-

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10, 2000, at 3 [hereinafter Garver, Severe Curbs Urged].
38. Id.
40. Garver, Severe Curbs Urged, supra note 37, at 3. Banks’ loan-loss reserves fall into two categories: specific reserves and general reserves. Id. Specific reserves are those that are meant to cover specific, anticipated losses. Id. General reserves are meant to cover potential but unidentified losses. Id. These general reserves are at the forefront of the dispute between accounting rulemakers and banking regulators. See id.
41. Steve Burkholder, Accounting: Rift Looming Between Bankers, Rulemakers On Loan Losses; Roukema Raises Questions, BNA BANKING DAILY, July 14, 2000, at d2 [hereinafter Burkholder, Rift Looming].
42. Id.
43. Garver, Severe Curbs Urged, supra note 37, at 3. The task force was specifically formed to apply FASB Statement No. 5, which addresses accounting for contingencies, to reserves for pools of loans, and FASB Statement No. 114, which covers accounting for the impairment of a loan. Id. Martin F. Baumann, a partner in Price-waterhouseCoopers' insurance practice, is leading the task force composed primarily of representatives of major accounting firms. Id. David Morris, financial director at Chase Manhattan Corp., and Randall Black, account administrator with MBNA Corp., are the only bankers in the group. Id. Also represented on the task force as a non-voting observer are the Comptroller's Office, the SEC, and the FASB. Id.
44. Id. The AICPA task force responsible for drafting the proposal continues to hold meetings marked by internal division. Burkholder, Rift Looming, supra note 41, at d2. The institution’s Accounting Standards Executive Committee is not expected
vented reserving against unspecified losses by only allowing banks to increase reserves after documenting the impairment of a specific loan. Banks would also be required to disclose the specific event or events causing the impairment of the loan. The draft also included a proposal requiring banks to state in their financial statements the methods used for identifying and reviewing problem loans. Banks would also have had to include in financial statements disclosures conveying information about banks’ loan-loss reserve accounts, including the balance at the beginning of the period; loan-losses charged against income; losses charged against reserves, by loan type; recoveries of chargeoffs, by loan type; and the balance at the end of the period.

On June 12, 2000, officials of the Federal Reserve Board, the Office of the Comptroller of Currency, the Office of the Thrift Supervision, and the Federal Deposit Insurance Corp. requested a meeting with the AICPA to discuss the proposal. The various of-

45. Garver, Severe Curbs Urged, supra note 37, at 3. The draft states that “[l]osses should not be recognized before it is probable that they have been incurred, even though it may be probable based on past experience that losses will be incurred in the future.” Id. at 1. Under GAAP, “additional or incremental components do not qualify for recognition under GAAP and should not be included in the allowance for loan losses.” Id. at 1. The July draft required that banks be allowed to reserve against loans only when they had been downgraded, in the case of a commercial loan, or had gone into default, in the case of a consumer loan. Rob Garver, Audit Group Seem More Flexible on Reserves, AM. BANKER, Dec. 8, 2000, at 1.

46. Garver, Severe Curbs Urged, supra note 37, at 3. Specific loss contingencies triggering loss recognition when found to be probable could include events related to

...collectibility of receivables; obligations related to product warranties and product defects; risk of loss or damage of enterprise property by fire, explosion, or other hazards; threat of expropriation of assets; pending or threatened litigation; actual or possible claims and assessments; risk of loss from catastrophes assumed by property and casualty insurance companies including reinsurers; guarantees of indebtedness to others; obligations of commercial banks under “standby letters of credit,” or agreements to repurchase receivables (or the repurchase the related property) that have been sold.


47. Id., at 1.

48. Id. at 1.

49. Rob Garver, Regulators Assail Plan To Limit Loss Reserves, AM. BANKER,
ficials claimed the proposal would mask institutions’ true financial condition. The bank regulators pointed out that the proposal would bar banks from holding any unallocated reserves and require every addition to reserve accounts to be accompanied by documentation of a specific loss. The banking regulators urged the task force to reconsider its position, warning, “loss recognition may be delayed if institutions believe the task force’s guidance requires greater certainty of a loss event than is prudent.” The officials went on to ask the task force to reconsider allowing banks only to reserve for loans that have been downgraded by the institution or have gone into default.

Criticism from the banking community led the AICPA to shift away from the use of these triggering events. On December 11, 2000 the AICPA’s Accounting Standards Executive Committee (AcSEC) was reportedly “overall supportive” of a plan by the group’s loan-loss task force that would depart from the more stringent requirements released last summer. The plan would do away with mechanical loss recognition triggers and let banks use a much more flexible standard for proving that a loss had been incurred. Instead of requiring the identification of specific events to trigger the impairment of a loan, the task force gives additional guidance on the proper accounting for contingencies. Leading

July 17, 2000, at 1 [hereinafter Garver, Regulators Assail Plan].

50. Id. While the task force’s aim is to reduce excessive reserves, the regulators wrote, “In practice, the guidance is likely to produce loan-loss allowances that are understated, particularly as the condition of borrowers weakens in periods preceding an economic turndown.” Id.

51. Id.

52. Id.

53. Id. They continued by writing that such indicators “should not be the sole determinants of loss recognition on loans.” Id. The regulators went on the claim that the banks should continue to be allowed to base loan-loss reserves on such things as historical evidence and economic factors. Id.


56. Id.

57. Id. The guidance related to the application of FASB Statement No. 5 includes:
banking agencies reiterate the continued significance of the loan-loss reserve accounting debate and are delighted with the latest developments of the proposal.\(^58\)

If the task force’s final proposal is approved by the AcSEC, which has meetings scheduled for February and March of 2001,\(^59\) it would be forwarded to the FASB, who must give the final approval for any such rule.\(^60\) The FASB’s responsibility is to ensure that any accounting guidance on loan-loss allowances is congruent with statements of GAAP.\(^61\) Primarily, in the case of loan-loss reserves, FASB Statement No. 5 (on accounting for loss contingencies) and FASB Statement No. 114 (on creditors’ accounting for impaired loans) set the GAAP.\(^62\) GAAP requires that impairment

\[\text{(A) requirement that credit losses be measured in relation to the observable data used to justify the loss recognition decision; the analysis and corresponding measures having to be “directionally consistent” with the underlying observable data over time; and the measurement’s reflecting “a consistent perspective” showing adherence to two fundamental principles—period-to-period uniformity of judgment and selection of a best estimate within a range of possible amounts of probable loss.} \]

\(\text{Id.}\)

58. Rob Garver, \textit{In Brief: Accounting Group to Ease Reserving Plan}, \textit{AM. BANKER}, Dec. 13, 2000, at 3. Donna J. Fisher, director of tax and accounting for the American Bankers Association stated, “This issue is critical for the banking industry. Banks must be permitted to use judgment to establish loan-loss reserves. Significant improvements have been made over the past few months by the AICPA, and we’re pleased with this progress.” \(\text{Id.}\)


61. Steve Burkholder, \textit{Accounting: Bankers Say AICPA Loan Loss Proposal Mechanical, Ignores Managers’ Judgment}, \textit{BNA BANKING DAILY}, Sept. 13, 2000, at d2 [hereinafter Burkholder, \textit{AICPA Proposal}]. GAAP are those principles that have a substantial authoritative support. Donald E. Kieso & Jerry J. Weygandt, \textit{INTERMEDIATE ACCOUNTING} 13 (9th ed. 1998). This support comes from a number of organizations that are instrumental in the development of financial accounting standards, or GAAP, in the United States, such as the SEC, AICPA, and the FASB. \(\text{Id.}\) The SEC is an agency of the federal government that has the broad powers to prescribe the accounting standards to be employed by companies that fall within its jurisdiction. \(\text{Id.}\) The AICPA issues accounting standards through its Committee on Accounting Procedure and Accounting Principles Board. \(\text{Id.}\) The FASB establishes and improves standards of financial accounting and reporting for the guidance and education of the public. \(\text{Id.}\) Possibly the most powerful force influencing the development of accounting standards are user groups such as within the banking industry. \(\text{Id.}\) Not surprisingly, accounting standards are as much a product of political action as they are of careful logic or empirical findings. \(\text{Id.}\)

62. Burkholder, \textit{AICPA Proposal}, supra note 61, at d2. FASB Statement No. 5 defines a contingency “as an existing condition, situation, or set of circumstances in-
of loan receivables be recognized only when it is probable that a loss has been incurred based on past events and conditions existing on the balance sheet date. Following FASB approval, the proposal would be released for a ninety-day public comment period, after which a final position would be adopted.

IV. SEC PERSPECTIVE

The SEC intensified the debate over loan-loss reserves by mounting its campaign to curb excesses in earnings management. In a 1998 speech, SEC Chairman Arthur Levitt warned that the reporting of corporate earnings has become “a game among market participants,” and he blamed management’s “zeal to satisfy consensus earnings estimates and project a smooth earnings path.” Levitt claimed the SEC is not attempting to single out the

66. The Numbers Game, supra note 8, at 14.
banking industry with its address of earnings management. In fact, earnings management has become standard procedure throughout corporate America. The accounting standards that govern public companies allow flexibility. Generally, regulators cannot stop companies from smoothing earnings as long as the financial maneuvering is appropriately disclosed. However, companies that use non-disclosed tactics to manage earnings force investors to make buy-and-sell decisions based upon misleading information.

The SEC's main concern is ensuring proper accounting for loan-loss reserves in order to protect investors. Investors should be able to differentiate institutions with high credit quality from those whose loan portfolios contain a high percentage of troubled loans. Mr. Levitt defends the SEC's need to protect investors and argues the agency's actions have been misconstrued. The

67. Weidner, supra note 27, at 38.
69. Id.
70. Id.
71. Id. SEC Chairman, Arthur Levitt claimed,

If a company fails to provide meaningful disclosure to investors about where it has been, where it is and where it is going, a damaging pattern ensues. The bond between shareholders and the company is shaken; investors grow anxious; prices fluctuate for no discernible reasons; and the trust that is the bedrock of our capital markets is severely tested.

The Numbers Game, supra note 8, at 14.

72. Burkholder, Accounting: Bankers Say AICPA Loan Loss Proposal Mechanical, Ignores Managers' Judgment, supra note 61, at d2. Under GAAP, receivables should only be recognized as impaired when the loss is probable based on past events and conditions. SEC Deputy Chief Accountant Looks At Loan Losses and Derivatives, supra note 63. The allowance for loan-loss should accurately portray the changes in an institution's credit quality. Id. As credit quality declines, a timely increase should be made to the allowance indicating the loss incurred. Id. An increase in credit quality would lead to a corresponding decrease to the allowance account. Id.

73. SEC Deputy Chief Accountant Looks At Loan Losses and Derivatives, supra note 63. The SEC emphasizes the role of disclosure in giving investors a clear understanding of the factors affecting an institution's credit quality and level of loan-loss allowance. Id. Disclosure should include trends and developments such as decline in profitability of an industry segment or an increase of loans in economically disadvantaged areas triggering additional allowances for loan-losses. Id.

SEC and FASB maintain that barring banks from reserving against a specific loan and then including it when setting general reserves represents an effort to clear up policies which already exist. The SEC argues for what analyst Ronald I. Mandle of Sanford C. Bernstein & Co. has called a “pay-as-you-go” approach to loan-loss reserves. The SEC is expected to embrace the AICPA’s draft proposals related to accounting for loan-loss reserves. The proposal would further the SEC’s goal of providing investors timely and accurate information concerning a bank’s fiscal health by preventing institutions from using large reserve accounts to maintain steady earnings in bad years.

V. BANKING REGULATORS’ STANCE

Perhaps the SEC has chosen a particularly dangerous time for its anti-reserve crusade. Over the last year, banks have been

75. Id. A 1994 GAO study stated:

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.


77. Garver, Severe Curbs Urged, supra note 37, at 3.

78. Tick, tick, tick: Worrying Signs at American Banks: A worrying hint about the quality of bank loans in America, ECONOMIST, Sept. 23, 2000, at 90. Allen Sanborn, president and chief executive officer of the Risk Management Association, remarked, “Given we have entered an environment where loan losses are beginning to increase . . . banks need to be really focused on their portfolios, to make sure that they are managing them well and that loan-loss reserves are adequate.” Garver, Audit Group Seen More Flexible on Reserves, supra note 45, at 1.
faced with increasing credit risk within loan portfolios. In the fourth quarter of 2000, Bank of America suffered a twenty-seven percent decrease in net income partly because of corporations that were unable to repay their debt. While bad loans seem to be increasing, banks' reserves are at their lowest in thirteen years. Despite the inherent reduction in profits and SEC disapproval, many banks have recently added significantly to loan-loss provisions. Normally, a percentage of "good" loans will go bad when the economy slumps. Banking regulators argue further that, in this era of massive consolidation, banks have no incentive to create excessive loan-loss reserves when price to earnings ratios and market capitalization are critical to a bank's survival. Unnecessarily
adding to loan-loss reserves reduces market capitalization, making it more likely that a bank will be acquired by a competitor. Also, increasing reserves reduces profits, which disheartens shareholders and causes a bank's stock price to drop.

In contrast to the SEC, banking regulators have traditionally felt banks should save for rainy days by adding to reserves during periods of increased earnings. The banks and bank regulators object to the evolving AICPA draft proposal to bring banks' loan-loss reserve accounting in line with GAAP. They have objected to the proposal, arguing that it would remove management's judgment from the assessment of the loan portfolio. Eliminating banks' ability to allow for a range of error in calculating sufficient reserves may result in inaccurate assessments of institutions' true conditions.

VI. ART VS. SCIENCE

Banking regulators feel that measuring credit risk necessarily involves subjective judgment and cannot be performed using the rigid, mechanical process favored by the SEC and AICPA task force. Whether loan-loss reserve decisions should be more of a subjective art or a mechanical science is a theme of the debate between banking and securities regulators. It has often been suggested that the loan-loss process is really an art. "Intuitive

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85. Id.
86. Tick, tick, tick: Worrying Signs at American Banks: A worrying hint about the quality of bank loans in America, supra note 78, at 90. In June 2000, the conservative North Carolina bank of Wachovia announced a $200 million charge against earnings to boost its loan-loss reserves which caused its stock price to sink. Sherer, supra note 20, at 11.
87. Cope, supra note 76, at 5.
89. Id.
90. Id.
91. Id.
92. Cope, supra note 76, at 5.
93. Garver, Accounting Board, supra note 88, at 4. Tim Journy, executive vice president and controller of Compass Bank in Birmingham, Alabama, claims, "The loan-loss process is really an art, and it has a lot of imperfections. Id. But the task force document has turned it into a mechanical process, eliminating management
knowledge" based on experience at the bank and familiarity with loan customers is arguably more useful in deciding appropriate loan-loss reserve levels than sophisticated number crunching. For instance, community bank officers often have customer information, such as a job loss or divorce, that is relevant to their banks' loan portfolio. FASB Statement No. 114 suggests that creditors should consider all available information when evaluating potential loan-losses. This includes "environmental" factors relevant to the collectibility of specific loans. Conversely, the SEC apparently believes reserves can be calculated with nearly mathematical certainty, and that there is little room for judgment by seasoned bankers and their regulators.

Federal Reserve Chairman Alan Greenspan insists bank management must account for its own risk assessments. A FASB project manager claims establishing loan-loss reserves is unavoidably subjective, and that it would be impractical to require a single, objective method to fit all institutions. Some suggest that be-

judgment." Id.
95. Id.
97. Id. Environmental factors would include existing industry, geographical, economic, and political factors that are relevant to collectibility of a loan such as decreasing profits in a specific industry or an increasing number of loans made in economically disadvantaged communities. Id.
98. Issac, supra note 84, at 6.

The criteria that are being set up for the purposes of making a judgment as to when a generic reserve can be put in place is far too high a barrier, and indeed it tends to mechanize what is a very sophisticated banking procedure. The one thing that banking is all about is judging future losses...You are going to make loans which fail, which are not repaid. You don't know which they are, or obviously you wouldn't make them. You have a general sense of what is out there. What differentiates good from bad bankers is those whose can do that. It strikes me that to inhibit that particular characteristic from being reflected on the books of the bank is a mistake.

Id.
100. Domis, supra note 4, at 3. Janet Danola stressed, "Implicit in determining
cause all banks differ with regard to their risk profile, there is no one-size-fits-all solution to setting loan-loss reserves.  

William J. McDonough, the president of the Federal Reserve Bank of New York, emphasized that bankers must be able to use their individual judgment when making reserve decisions. He insisted the burden must be on the banks to establish a paper trail showing a method for arriving at appropriate reserve levels.

Smaller banks serving small communities are especially concerned about restrictions on independent judgment in the loan-loss allowance process. Such restrictions could present an undue burden on smaller banks with fewer and less complex loans. Community bankers assert that federal banking regulators are "overstepping their bounds" by attempting to interpret GAAP related to loan-loss allowances. They criticize a September 7, 2000, announcement that changes in loan-loss reserves is a lot of judgment. If we took away that judgment, loan-loss reserves may not accurately reflect the loan losses of the individual institution."  

101. Cope, supra note 76, at 5.
102. Id.
103. Id.
104. Adam Wasch, Bank Supervision: Regulatory Proposal On Loan Reserves Threatens Independent Judgment, Banks Say, BNA BANKING DAILY, Nov. 8, 2000, at d3. Dale J. Torpey, Chairman of the Independent Community Bankers of America Lending Committee (ICBA), stated, community bankers "are not looking to manage earnings, only anticipate losses that they know from experience will be recognized. This is particularly important for agricultural banks due to the cyclical nature of the agriculture industry and to small banks serving small communities that have one dominant company or industry."  Id. Torpey went on to mention the difficulty that small banks have in diversifying their loan portfolios and mitigating exposure to cycles.  Id.
105. Id. In an effort to differentiate between large and small banks, Dale J. Torpey, Chairman of the Independent Community Bankers of America Lending Committee (ICBA), pointed out,

Smaller institutions with fewer and less complex loans may need less exhaustive supporting documentation for the ALLL [allowance for loan and lease losses] than will larger institutions. The ICBA strongly supports this guidance for smaller institutions and their examiners. Clearly, institutions with large and complex loan portfolios will need to undertake much greater analysis to determine the appropriate ALLL for their institution and provide more documentation of that analysis, than will small institutions with a small portfolio of loans that are not complex.

2000, interpretive policy statement by the Federal Financial Institutions Examination Council (FFIEC) proposing accounting and disclosure methods for loan-loss reserve accounts. The America's Community Bankers (ACB) claimed justifying their use of subjective judgment and experience would require "a disproportionately heavy burden of proof." 

VII. POLITICAL REACTION AND PUBLIC POLICY

The political arena has also commented on the loan-loss reserves. Rep. Marge Roukema (R-N.J.), head of the House Banking Financial Institutions Subcommittee, wrote to the chairman of the SEC and the FASB stating her disapproval of the alleged proposals. She voiced concerns related to safety and soundness. She also emphasized the importance of an individual bank's subjective judgment when it establishes reserves. In July 1999, Senators Chuck Hagel, (R-Neb.), and Charles E. Schumer, (D-N.Y.), urged Senate Banking Committee Chairman Phil

107. Id. The FFIEC is composed of the Federal Reserve, the Office of the Comptroller of Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration. Id.

108. Id. The letter states:

ACB strongly objects, however, to the costly administrative burden that implementation of the proposed methodology and validation requirements would impose on community banks. Although the proposed policy statement does provide that 'appropriate' adaptation of these requirements should be permitted based on the size and complexity of the institution, insufficient guidance is provided with respect to what adaptations can be made and what kinds of institutions are eligible to make them.

Id.


110. Burkholder, Rift Looming, supra note 41, at d2. Roukema stated, "I understand the critical importance of institutions' compliance with standard accounting rules, especially for publicly traded companies. However, I am concerned that certain aspects of the AICPA proposal could have important safety and soundness implications." Id.

111. Id.

112. Id. Roukema continued, "Any forthcoming accounting guidance should in no way harm the ability of bank management and the bank's primary regulator to use their best judgment when determining the appropriate level of loan-loss reserves, consistent with sensible accounting standards." Id.
Gramm (R-Tex.) to accept an amendment to the House financial reform bill that would make the SEC’s voluntary consultation with bank regulators mandatory.\textsuperscript{113} In addition, Republican senators criticized SEC Chairman Arthur Levitt’s crusade to lower banks’ loan-loss reserves.\textsuperscript{114} In response, Levitt defended the SEC’s duty to provide accurate financial earnings data to investors.\textsuperscript{115} Furthermore, Levitt reaffirmed SEC commitment to confer with banking agencies, but opposed legislation mandating cooperation.\textsuperscript{116} He spoke of an agreement indicating that the SEC would speak with a bank’s supervisor before insisting that the bank restate its reserves.\textsuperscript{117}

The banking agencies warned Congress that loan-loss reserves protect against unexpected losses from bad loans.\textsuperscript{118} They argued to congressional leaders that decreasing reserve accounts “could have a profound effect on the continued safety and soundness of America’s banking system and would not, in [their] judgment, be in the best interests of American taxpayers, the bank insurance funds, or shareholders.”\textsuperscript{119} Maintaining a strong level of reserves helps prevent banks from failing by allowing them to offset losses in troubled times.\textsuperscript{120}

\begin{itemize}
\item \textsuperscript{113} Rehm, \textit{Senators Want to Curb}, supra note 109, at 2.
\item \textsuperscript{114} Anason, supra note 74, at 2. “While the SEC has publicly stated that they are not trying to require reductions in loan-loss reserves, the implication still exists that they are,” said Senator Rod Grams, chairman of the Senate Banking’s securities subcommittee. \textit{Id.} “This mixed signal is confusing to regulators, auditors, and bankers and is simply unacceptable.” \textit{Id.}
\item \textsuperscript{115} \textit{Id.} “The banking agencies agree that there is no reason why a financial institution can’t have a prudent estimate of loan losses while, at the same time, reflecting management’s judgment on the quality of that portfolio to the marketplace.” \textit{Id.}
\item \textsuperscript{116} \textit{Id.} “It is very important that there be no doubt whatsoever as to our commitment to confer when appropriate with...the banking agencies,” said Mr. Levitt. \textit{Id.} “That commitment is and will be absolute.” \textit{Id}
\item \textsuperscript{117} \textit{Id.}
\item \textsuperscript{118} Garver, \textit{Severe Curbs Urged}, supra note 37, at 3.
\item \textsuperscript{119} \textit{Id.}
\item \textsuperscript{120} Eugene Ludwig, \textit{Viewpoints: Plan to Restrict Reserving Is a Nightmare, Ludwig Says}, AM. BANKER, Dec. 1, 2000, at 14. Ludwig points to bank failures of the early 1990s as evidence of the importance of holding adequate reserves. \textit{Id.} He criticizes early versions of the AICPA’s draft proposal for not allowing banks to add to reserves unless the entire amount can be matched to a specific event, which causes impairment. \textit{Id.} He argues that losses from individual loans cannot be predicted with such precision. \textit{Id.} Ludwig asserts that judgment and experience are crucial for
\end{itemize}
VIII. CONCLUSION

The creation of more accurate models for assessing the impairment of loan portfolios serves as a potential arena for compromise between banking and accounting groups. Better models would aid in banks’ efforts in setting accurate reserve levels while also satisfying the AICPA’s request for strict accounting. Such models could satisfy the SEC’s desire for a more disciplined methodology while allowing banks a certain level of subjective autonomy. Perhaps the most important tool for resolving the debate of loan-loss accounting is continued consultation between banking and accounting regulators. Current accounting guidelines for setting loan-loss reserves are subject to differing interpretation. Consequently, John W. Spiegel, SunTrust’s chief financial officer, pointed out that it is imperative for the industry, banking regulators, and the SEC to come to a common understanding of how to account for loan-losses. SEC Chairman Arthur Levitt mirrored this sentiment when he acknowledged a need for banking and securities regulators to define “a structure to protect investors and maintain the integrity of our markets.”

Any debate over banks’ accounting for loan-loss reserves must occur with one eye on the issue of fair value accounting.
As soon as 2002, banks and other financial institutions may be forced to value all financial assets at current market value.\textsuperscript{129} Eventually, entire loan portfolios at every financial institution would have to be marked to market.\textsuperscript{130} Banks that have failed to set aside sufficient reserves would write-off their capital as they begin this process.\textsuperscript{131} Fair value accounting would replace the current system of assigning reserves to cover potential loan losses.\textsuperscript{132} Instead, “changes in the value of loans would pass through quarterly income statements as profits and losses.”\textsuperscript{133} Accounting regulators are of the opinion that fair value accounting is a more accurate method of tracking value than cost accounting.\textsuperscript{134} However, bankers are leery of mandating fair value accounting methods before coming to terms with the many implementation issues involved.\textsuperscript{135} Bankers, loan traders, investors, banking regulators, and accounting-standard setters disagree on the final impact of fair value accounting.\textsuperscript{136} Perhaps its arrival would mark the only realistic end to the debate over setting appropriate reserve levels.

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\bibitem{129} Sherer, \textit{supra} note 20, at C1.
\bibitem{130} \textit{Id.}
\bibitem{131} \textit{Id.}
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\bibitem{133} \textit{Id.}
\bibitem{134} \textit{Id.}
\bibitem{135} Sherer, \textit{supra} note 20, at C1.
\bibitem{136} \textit{Id.}
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