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TESTIMONY OF EMORY W. RUSHTON

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Before the

FINANCIAL INSTITUTIONS AND CONSUMER CREDIT SUBCOMMITTEE

of the

COMMITTEE ON BANKING AND FINANCIAL SERVICES

of the

U.S. HOUSE OF REPRESENTATIVES

June 16, 1999

Statement required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Introduction

Chairwoman Roukema and members of the Subcommittee, I am Wayne Rushton, the Senior Deputy Comptroller for Bank Supervision Policy. I have been a national bank examiner for 34 years, and I appreciate this opportunity to present the testimony of the Office of the Comptroller of the Currency (OCC) on the important issues associated with the allowance for loan and lease losses (loan loss reserves).

History has shown repeatedly that loan losses are difficult to accurately measure before they become obvious. Nonetheless, the procedures banks employ to estimate loan losses are critical to their health. Loan losses that exhausted a bank's reserve, and ultimately wiped out equity capital, have been the primary cause of almost all bank failures. For that reason, it is critical that any external actions that could have the effect of causing banks to lower their reserves receive close scrutiny.

The OCC does not believe there is a widespread problem with inflated loan loss reserves. Bank examiners and public accountants who regularly review financial institutions' reserves have not reported such problems. Moreover, we are especially concerned that the current debate on the treatment of reserves occurs at a time when the risk of loss in many bank loan portfolios is increasing.

The SEC's primary mandate of investor protection and the banking agencies' primary mandate of safety and soundness are not in conflict. Indeed, conservative reserve practices that protect a bank's capital also protect investors. The best antidote for concerns about the possible misuse of loan loss reserves is clear and consistent guidance by all the agencies on process, documentation, and disclosure.

My testimony today begins with an overview of the practical application of loan loss reserves, followed by a brief discussion of how OCC examiners assess the reserving policies and practices of national banks. I will then respond to the questions posed in your letter of invitation.

The Role of Loan Loss Reserves

Loan loss reserves play a critical role in the health of the banking system. Simply stated, a bank's reserve should represent the best estimate its management can make of how much money the bank will lose on the loans it has made. A bank creates and replenishes its reserve by charging a loan loss provision expense against income and setting that amount aside in a separate account on the bank's books. The reserve does not count as part of the bank's equity capital, and the bank may use it only for the purpose of absorbing loan losses[1].

When a bank charges off a bad loan, it makes the charge against the reserve. Periodically, but not less frequently than quarterly, each bank must reassess

[1] See 12 CFR Part 3, Appendix A, section 2(b)(1).

whether the amount remaining in its reserve is appropriate, given the amount of estimated losses inherent in its remaining loans. A wide range of factors comes into play in that analysis, including economic trends and other environmental influences. If the reserve is found to be too small, then the bank must increase its provision--the amount it takes out of earnings--to restore the reserve to an appropriate amount. If, on the other hand, the reserve exceeds the amount of estimated losses, the bank must decrease its provision.

It is fair to say that the bank and thrift failures of the 1980's and early 1990's are still fresh in the minds of most bankers. As a result, most of them have tilted toward maintaining healthy reserves to provide a margin for error in their estimates of loan losses. Indeed, the bank regulators have consistently encouraged them to do so. For example, when I began my present assignment two years ago, one of my first actions was to send a letter to each national bank's chief executive officer to remind them of the need for capital and reserves commensurate with their risks.

This does not mean, however, that banks should build their reserves to levels that are beyond the amount they can reasonably justify or that they should engage in pure speculation about losses that could possibly materialize in the future. Nor should they in any way manipulate their reserves to achieve some predetermined path for earnings or otherwise deceive investors or regulators. The OCC, through its examination processes and its written guidance, has emphasized the need for national banks to maintain *appropriate* levels of loan loss reserves.

The OCC's Assessment of National Banks' Loan Loss Reserves

Lending remains one of the riskiest businesses that banks conduct. Therefore, the evaluation of credit risk receives a very high priority in our examinations. Our general examiner staff is bolstered by a cadre of credit specialists who maintain state-of-the-art knowledge and skills in analyzing particular forms of lending. Our staff of Ph.D. economists provides macro-analyses of major borrowing industries and collaborates with our examiners in the use of a variety of computer-assisted models designed to predict the risk of default and loss in loans.

At the largest national banks, we have on-site teams of full-time credit experts who track loan quality and trends on a real-time basis so that our assessments of credit quality are predictive as well as historical. At smaller national banks, examiners typically assess the reserve on-site at least once every 12 to 18 months, depending on the bank's size and risk profile. We supplement this with interim off-site analyses of reported data and through telephone contact with bank management.

Our examinations include a review of a bank's internal loan reports and the work of outside auditors. Importantly, however, we also perform independent testing procedures to determine the adequacy of reserves. We dig into the loan files, analyze financial statements, check loan covenants, and evaluate collateral. We also evaluate the bank's loan loss reserve methodologies and the quality of the documentation of its reserves. This comprehensive approach enables us to make an independent judgment about a bank's exposure to losses and the adequacy of its reserves. If we find that a bank is significantly over- or under-reserved or that it lacks adequate documentation, we require the bank to take corrective action.

Based on those direct assessments**,** our opinion is that national banks, as a group, are not materially over- or under-reserved. That is why we are so concerned about any government action that might have the effect, albeit unintended, of applying general downward pressure on bank reserves.

Madam Chairwoman, I will now turn to the questions posed in your letter of June 8, 1999.

Responses to Questions

1. Federal law requires that financial statements to be filed by banks with the Federal bank agencies must be in compliance with GAAP. Some have suggested that in the area of loan loss reserves the Federal banking agencies apply regulatory accounting principles ("RAP") to banks and thrifts, which are less stringent than GAAP. Please discuss what accounting standards the Federal banking agencies apply to financial institutions, and if it is GAAP, the process by which the Federal banking agencies interpret and apply GAAP.

The Federal banking agencies require all institutions to follow GAAP, including the provisions of GAAP applicable to loan loss reserves. Interpretations of GAAP are provided by the OCC's Chief Accountant's office. All of the accountants on its staff are Certified Public Accountants (CPAs) and intimately knowledgeable with all aspects of GAAP affecting banks. For interpretations of GAAP on areas in which GAAP is not definitive, the Chief Accountant's staff frequently consults with the staffs of the other banking agencies, the SEC, the Financial Accounting Standards Board (FASB), and the American Institute of Certified Public Accountants (AICPA). This consultation helps to ensure consistent GAAP application among all federal government agencies that have a regulatory role over the banking industry.

GAAP is applied through both the reporting and examination processes. Banks are required to file quarterly and annual financial reports (call reports) prepared in accordance with GAAP. The call report instructions provide a summary of the more significant GAAP standards affecting banks.

During bank examinations, examiners seek to ensure the accuracy of those financial reports. Our examining staff includes a number of CPAs, and we provide accounting guidance for all examiners. For example, the Allowance for Loan and Lease Losses booklet of the *Comptroller's Handbook for National Bank Examiners* specifically emphasizes the importance of understanding the guidance in Financial Accounting Standard No. 114 (SFAS No.114) as a prerequisite to any discussion about the allowance determination process. Furthermore, the Federal Financial Institutions Examination Council (FFIEC) call report instructions and the Interagency Policy Statement on the Allowance for Loan and Lease Losses also provide guidance that is consistent with GAAP.

2. Please discuss how frequently examiners review a financial institution's loan loss reserves. In reviewing loan loss reserves do the Federal banking agencies compare loan loss reserves to financial institutions in the same peer group as well as local and regional economic trends?

OCC examiners review and determine the adequacy of the reserve in conjunction with every full-scope on-site examination. This occurs at least once every 18 months for the smallest, lowest risk national banks, and annually for all others. Examiners conduct more frequent reviews of the reserve, if deemed necessary, based on the level and direction of a bank's credit risk, and the quality and effectiveness of its credit risk management.

During their on-site reviews, examiners consider the following factors:

- The quality of bank underwriting standards and risk selection criteria;
- Product risk (high loan-to-value lending, leveraged finance, etc.);
- Portfolio composition, including concentrations and correlations among portfolio exposures;
- Loan growth rates;
- The quality and effectiveness of risk management and control processes, such as policy making, loan administration, loan review;
- Management integrity, expertise, and risk tolerance (overall lending culture);
- Historical default and loss rates, including those experienced through a business cycle; and,
- The bank's capacity and experience in collecting loans, such as through workout and/or collateral liquidation.

In addition to on-site reviews, examiners perform quarterly off-site monitoring of the condition of all national banks using call reports and other submitted financial information. Depending on the bank's risk profile, an examiner may require the bank to submit specific information about its loan portfolio and credit quality. In most cases, these reviews will include analyses of credit risk and reserve levels, and the effect of local and regional trends on the bank's credit risk. Any significant change in risk levels requires further investigation by the examiner, which may range from a telephone call to bank management up to an on-site visit. The quarterly financial information examiners use includes bank-specific and peer-bank data on both the reserve and the loan portfolio. Examiners look for deviations from the selected peer group(s) that signal the need for further inquiry or analysis.

In addition to bank financial information and peer data, examiners also use several analytical tools designed to identify risk outliers. They apply these analytical tools systematically to each national bank every quarter and use comparative financial information and analytical models to identify banks, and specific risk areas within and among banks, including the reserve, that may warrant further investigation.

It is important to point out that this quarterly monitoring only serves as an interim and analytical tool. It is not a substitute for on-site examination. The determination of the adequacy of the reserve requires on-site analysis and verification of the risks in individual credits as well as portfolios of credits.

Does the guidance require examiners to review allowances to determine if they are in accordance with GAAP?

Yes, as noted in my response to Question One, we train our examiners to review loan loss reserves consistent with GAAP requirements. As also noted in that answer, the *Comptroller's Handbook for National Bank Examiners* emphasizes the importance of understanding the guidance in SFAS No. 114. In addition, call report instructions and the Interagency Policy Statement on the Allowance for Loan and Lease Losses provide guidance that is consistent with GAAP.

3. Some have suggested that the Federal banking agencies always encourage institutions to increase their reserves, whether warranted or not, due to safety and soundness concerns. Please indicate whether this is consistent with existing examiner guidance.

The OCC does not encourage banks to increase their loan loss reserves unnecessarily; our guidance to examiners on this subject is clear. Within the context of the OCC's responsibility to ensure the safety and soundness of the national banking system and consistent with GAAP, the OCC requires that a bank's financial statements accurately reflect its risks. Given the difficulties of measuring credit risk precisely, the OCC encourages prudence and conservatism in measuring and reporting such risks.

One of the major examination objectives in the Allowance for Loan and Lease Losses booklet of the *Comptroller's Handbook for National Bank Examiners* is: "To determine if the process for determining the *appropriate* (emphasis added) level for the allowance is sound, based on reliable information, and well documented." The booklet, published in June 1996, makes it clear that "appropriate" includes: "determining whether there has been a significant misstatement of the operating results and financial condition of the bank." It also points out that the allowance should be neither "inadequate" nor "excessive." The section addressing adjustment to the allowance concludes: "If, after considering all available information, the examiner concludes that the allowance has been significantly misstated, bank management should be requested to make the necessary adjustments to bring the allowance to an appropriate level." We chose the word "appropriate," instead of the word "adequate," so that examiners and bankers would understand that both "inadequate" and "excessive" levels of the loan loss reserve are unacceptable. Examiners are also directed to ensure that banks have consistent and well-documented processes for establishing their reserves. Such processes and documentation help to prevent decisions to arbitrarily increase or decrease reserve levels.

More recently, the OCC released Advisory Letter 97-8 (AL 97-8) dated August 6, 1997. The advisory cautioned national banks about observed diverging trends in credit risk and reserve levels and advised them to carefully review their reserve methodologies in light of these trends. The advisory states, in part, that the OCC considers unallocated reserves to be a prudent way for banks to recognize the imperfect nature of most estimates of inherent loss. But it also cautions that unallocated reserves "must not be used to obfuscate the determination of overall allowance adequacy, mask significant deteriorating trends, or 'manage' earnings." The advisory further states that "bank management is expected to have a clear and consistent methodology and supporting documentation for determining an adequate allowance, including the size of both the allocated and unallocated components. Examiners will work with banks to ensure that flawed methodologies are corrected promptly."

4. Please discuss whether the SEC has consulted with and coordinated its comments on loan loss reserves with the Federal Reserve and other federal banking regulators. Please discuss whether you believe consultation between the SEC and the regulators prior to the SEC issuing loan loss reserve comments would be workable and whether prior consultation would promote a more consistent approach to GAAP.

Although SEC staff occasionally consult with the OCC's Chief Accountant's staff on accounting issues, the SEC has not generally done so on issues involving comments for a specific registrant, particularly regarding the registrant's loan loss reserve.

The OCC believes that such consultation would promote a more consistent approach to GAAP. However, because of examination timing and other logistical issues, such consultation, if practiced for all filings, might detract from the SEC's ability to ensure that registrants receive timely reviews of their statements. A more efficient approach would be for the SEC to consult with bank regulators on filings where it has significant questions pertaining to a registrant's loan loss reserve.

5. Please discuss whether you believe there is a widespread problem with financial institutions inflating their loan loss reserves outside of what is permitted under GAAP.

The OCC does not believe there is a widespread problem with inflated loan loss reserves. Bank examiners and public accountants who regularly review financial institutions' reserves have not reported such problems. To the contrary, the OCC has for the past several years been concerned about increasing credit risk trends within bank portfolios. This prompted the OCC to issue Advisory Letter 97-8 in August 1997, which discussed our concerns with concurrent declining trends in allowance coverage and increasing portfolio credit risk indicators.

That concern has not abated. Indicators of increasing credit risk continue to surface. They include relaxed underwriting standards and risk selection standards by banks (e.g., increasing willingness by banks to lend to leveraged or subprime borrowers and to extend high loan-to-value real estate loans to consumers), significant loan growth, high and increasing consumer debt levels, and high consumer loan past due, charge-off and bankruptcy rates. We believe that this increase in credit risk may require some banks to increase reserves to account for expected inherent loss.

6. In the early 1990's several bank holding companies were sued for securities fraud with respect to arguably inadequate loan loss reserves. Did you take action against any of the banks or bank holding companies involved?

During the late 1980's and early 1990's, there were numerous actions brought by both the government and shareholders against bank holding companies concerning public statements by such companies about the adequacy of their loan loss reserves. With respect to companies with significant national bank subsidiaries, the OCC had a key role in those actions, involving both formal and informal actions.

Many of those actions had certain procedural similarities. The precipitating event in those cases was an OCC on-site examination that identified deficiencies in the bank's allowance levels and methodologies. At the conclusion of the examination, the OCC required the bank to provide a significant additional allowance provision, make fundamental changes to the reserve process, and institute independent loan review programs and/or other similar enhancements. In many cases, the OCC also brought formal enforcement action against the institution, including requiring a restatement of relevant call reports.

In many of the cases referenced above, the SEC followed up the OCC's actions with enforcement actions of its own. Leveraging off of the OCC's supervisory and enforcement actions, and relying on OCC documents and OCC examiners as experts, the SEC commenced enforcement proceedings against the bank's parent holding company under section 15 of the Securities Exchange Act of 1934. The fundamental allegation in those proceedings was that the understatement of the loan loss reserve resulted in an overstatement of the company's net income. For an example of a typical enforcement proceeding, see *In the Matter of Texas Commerce Bancshares, Inc.,* Securities Exchange Act of 1934, Release No. 34-24803 (August 17, 1987). In the late 1980's and early 1990's, the OCC referred or otherwise provided information to the SEC on over forty similar cases involving inadequate allowances.

7. In response to the problems of the early 1990's, did the SEC meet and work with the Federal banking agencies on loan loss reserves?

In developing new accounting guidance, the OCC routinely consults not only with the other Federal banking agencies, but others as well with expert accounting knowledge such as the SEC, FASB and AICPA.

a. Did the SEC review or have input into the 1993 Interagency Statement on loan loss reserves? Please comment generally on how bank loan loss reserve practices have changed since 1993.

Yes, the consultation process on the 1993 interagency statement on loan loss reserves included seeking the SEC's review and comments. The SEC's Chief Accountant's office reviewed the draft interagency statement and provided a number of comments and suggestions. These comments were an important contribution to the final interagency statement.

Reserve techniques have continually improved and become more sophisticated since the late 1980's, partially as a consequence of the lessons learned from bank failures caused by under-estimated loan losses. For example, during the period since 1993, the number of institutions using analytical tools such as stress testing, concentration and correlation analysis, and other similar devices in the management of credit risk has grown. Banks often use these tools to assist in the development of a bank's loan loss reserve. While use of these tools does not eliminate the inherent imprecision in the allowance process, the tools provide valuable prospective information upon which to apply sound judgment consistent with both safety and soundness and GAAP.

b. Please describe how the SEC and Federal banking agencies communicated and coordinated on the loan loss reserve accounting between 1993 and November of 1998.

As stated above, the banking agencies endeavored to ensure that the 1993 interagency statement on loan loss reserves was consistent with GAAP by seeking the SEC's views, as well as others'. During the intervening time period from 1993 until early 1998, the OCC and SEC staffs had only a few discussions on loan loss reserve issues. This was due in part to a lack of problem loan situations and few questions involving the loan loss reserve.

The OCC issued AL 97-8 in August 1997 on the allowance for loan and lease losses to address questions resulting from examination observations. Because AL 97-8 focused on supervisory issues, we did not consult with the SEC.

Within the last year, the OCC and SEC have also discussed loan loss reserves relating to the Year 2000 issue.

c. In November of 1998 and March of 1999 the agencies issued interagency statements on the loan loss reserve issue. Please discuss these statements and how the coordination provided for in these statements is working.

Both the November 1998 and March 1999 issuances emphasized ongoing cooperative relationships among the Federal banking agencies and the SEC (collectively, the Agencies) and a commitment to work with the accounting profession and standard setters, and with the banking industry. The March 1999 issuance also went somewhat further by establishing two joint SEC/banking agency working groups to provide additional guidance on the allowance with respect to financial statement disclosure and best practices for loan loss reserve documentation.

Both the November and March issuances were intended to provide a consistent message on the level, documentation, and disclosure of the allowance for loan losses. Recently, however, the SEC determined that institutions could use a “change in accounting principle” mechanism ("transition adjustment") to adjust their loan loss reserve in light of an April 12, 1999 FASB *Viewpoints* article. Although many bankers and accountants viewed this as reflecting an expectation that banks should make significant reductions in reserves, SEC Chairman Levitt on May 19 strongly stated that it was not the SEC's intention to promote widespread reductions in levels of reserves.

The November and March statements have established clear points of agreement among the Agencies on important aspects of reserve practices. For example, all have agreed that:

- Arriving at an appropriate allowance involves a high degree of management judgment and results in a range of estimated losses;

- Prudent, conservative, but not excessive loan loss allowances that fall within an acceptable range of estimated losses are appropriate. In accordance with GAAP, an institution should record its best estimate within the range of credit losses, including when management’s best estimate is at the high end of the range;

- The process for determining the allowance for loan losses is inevitably imprecise, and an appropriate allowance falls within a range of estimated losses;

- An “unallocated” loan loss allowance is appropriate if it reflects an estimate of probable losses, determined in accordance with GAAP, and is properly supported;

- Allowance estimates should be based on a comprehensive, well-documented, and consistently applied analysis of the loan portfolio; and

- The loan loss allowance should take into consideration all available information existing as of the financial statement date, including environmental factors such as industry, geographical, economic, and political factors.

Further, interagency efforts are ongoing to provide the banking industry and accounting profession with enhanced guidance on appropriate methodologies, disclosures, and supporting documentation for loan loss allowances. The Agencies, in cooperation with the AICPA Allowance for Loan Loss Task Force, will continue efforts to clarify several aspects of GAAP related to the allowance. In addition, the Agencies will continue to seek input and guidance from the banking industry and accounting profession in all of these efforts.

8. The FASB issued Statement No. 114 in 1993. This statement was supposed to supplement FASB Statement No. 5. Did the SEC, Federal banking agencies and FASB work on Statement No. 114 together?

Yes. The OCC has an excellent working relationship with the FASB. OCC staff, along with representatives from the other Federal banking agencies, meet quarterly with the staff of the FASB. Also, the OCC's accounting staff frequently consults with the FASB staff on banking matters, and the OCC's Chief Accountant has served on the FASB's Financial Instruments Task Force.

During the development of SFAS No. 114, the OCC provided its comments and concerns to the FASB separately and in joint efforts with the other Federal banking agencies. Further, OCC accounting representatives informally discussed these issues with members of the SEC's Chief Accountant staff.

As a result of this process and the comments of other parties, the FASB delayed the effective date of SFAS No. 114. The FASB also amended the standard with the issuance of SFAS No. 118. This allowed the banking industry sufficient time to implement the changes resulting from the new standards, which were responsive to many concerns and comments of the industry and bank regulators.

9. Please discuss your understanding of the issues which the AICPA Task Force on Loan Loss Reserves is intended to address.

The AICPA recently formed the Allowance for Loan Loss Task Force (Task Force) to help clarify and provide additional accounting guidance on accounting for loan losses. Although the Task Force may recommend changes to existing accounting standards to the FASB, it is only permitted to interpret these standards and provide implementation guidance. Any proposed interpretations and guidance developed will be submitted for public comment and are subject to a review and no objection by the FASB. Upon completion of this comment and approval process, the interpretations and guidance formally become part of GAAP.

The OCC is very familiar with the issues that the AICPA Allowance for Loan Loss Task Force plans to address. The OCC's Chief Accountant is a member of the Task Force, serving as the Federal banking agencies' representative. The Task Force is currently finalizing the scope of issues it expects to address and the additional loan loss allowance guidance it intends to develop.

The Task Force recognizes that there are numerous issues that need to be addressed because current guidance on accounting for loan losses appears to lack the degree of clarity and specificity that is needed to ensure that it is consistently applied. One of the major issues the Task Force intends to provide guidance on is how to differentiate a current loss from a future loss. This is an important and difficult issue because GAAP presently only allows a loan loss reserve for a current loss even though the accuracy of the loss estimate will not be known until sometime in the future. Furthermore, SFAS No. 114 requires that a bank estimate "future" cash flows in assessing whether a loan is impaired and the amount of a loan loss reserve that should be provided. Much of the confusion today revolves around this issue, and additional guidance is clearly needed to assist banks in developing loan loss reserves consistent with GAAP.

Other issues the Task Force may address include fundamental questions such as how a creditor should determine that it is probable it will be unable to collect the full amount of the loan and how various credit risk models may be used within the context of GAAP. Additionally, a number of measurement questions will be addressed, including providing guidance on how current trends, future events, and economic conditions should be considered in the measurement of loan losses. The Task Force may also provide additional guidance on disclosure and documentation requirements in cooperation with the work being done jointly with the SEC and banking agencies.

It is obvious the Task Force will have a full agenda, but also a very important task in achieving both a better understanding of GAAP requirements and consistent application in the banking industry. Consequently, we believe banks generally should not make fundamental changes to their processes for determining loan loss reserve adequacy until this guidance and interpretations are available for implementation.

10. The Federal banking agencies closely monitor economic trends on a regional, national and international basis. Please discuss whether you believe that financial institutions should be permitted to establish loan loss reserves for expected future losses based on local or regional market conditions or expected trends.

The line between probable losses presently inherent in the portfolio (current GAAP standards) and expected future losses is difficult to draw since both rely on estimates about the future. As noted in my response to Question Nine, this is one of the issues that the AICPA Allowance Task Force will be addressing.

The OCC strongly believes that banks must include an assessment of local and regional market conditions and trends as well as any other factors that affect credit quality in establishing and maintaining their loan loss reserves. We believe such an approach is consistent with and integral to sound contemporary credit risk measurement and management practices. It is also consistent with our interpretation and application of GAAP.

By its very nature, lending involves an assumption of risk of future losses. Loans are not repaid by historical cash flows or collateral. While the borrower’s financial and repayment history are important elements of any lending or reserving decision, the expectation that the borrower will have the capacity to repay the loan, when due, must be based on careful analysis of the borrower's future business and cash generation prospects, as well as the amount, quality and liquidity of any collateral pledged. In other words, the repayment of a loan made today can only be based on the expectation that the borrower will perform over the term of the loan going forward.

Both bankers and regulators like to think that we learn from our mistakes. And we have both made mistakes in the past. That includes establishing (or accepting) reserves overly dependent on historical performance and ignoring current information that signals the probability of higher loss levels in the future.

11. In connection with the *Viewpoints* article, the SEC indicated that "transition adjustments" for loan reserves should be made prior to the end of the second quarter. Please discuss whether you expect many financial institutions to take advantage of this one time opportunity.

Although we do not know how many banks will take advantage of this "one-time opportunity" to make a transition adjustment, we do know that there is continuing confusion in the industry on this issue. Let me elaborate by recounting some history.

Beginning last fall, many bankers and the bank regulators became concerned when the SEC required a large banking company to restate its loan loss reserves in connection with an acquisition. To allay those fears, the banking agencies and the SEC in November 1998 issued an interagency agreement in which we pledged to work together to develop joint prospective guidance on reserving practices. Unfortunately, the apprehension continued, so in March 1999, the banking agencies and the SEC entered into another interagency agreement, which, among other things, created two working groups to address issues regarding reserving practices of banks.

After FASB staff issued a *Viewpoints* article interpreting SFAS Nos. 114 and 5, the SEC announced that banks that had previously misinterpreted GAAP, as expressed in the article, had until the end of the second quarter of this year to make an adjustment to their reserves. Comments received from banks we supervise indicated to us that this announcement reflected an expectation that significant reductions in reserves were expected. The Chairman of the SEC subsequently made a strong public statement that it was not the SEC's intention to bring about widespread reductions in reserves.

That's where we are today. We continue to work with the other agencies in an effort to reach common ground and to develop clarifying guidance. We have also urged national banks to consult with us if they are considering reducing their reserves in light of the current uncertainty regarding the SEC's application of GAAP.