Sample Letter Sent to Public Companies on MD&A Disclosure Regarding Provisions and Allowances for Loan Losses

In August 2009, the Division of Corporation Finance sent the following illustrative letter to certain public companies identifying a number of disclosure issues they may wish to consider in preparing Management's Discussion and Analysis.

August 2009

Name
Chief Financial Officer
XYZ Bank
Address

Dear Chief Financial Officer:

Clear and transparent disclosure about how you account for your provision and allowance for loan losses has always been critically important to an investor's understanding of your financial statements. While generally accepted accounting principles regarding how to account for these items have not changed in recent years, the current economic environment may require you to reassess whether the information upon which you base your accounting decisions remains accurate, reconfirm or reevaluate your accounting for these items, and reevaluate your Management's Discussion and Analysis disclosure.

Item 303 of Regulation S-K requires you to discuss, in your Management's Discussion and Analysis, any known trends, demands, commitments, events or uncertainties you reasonably expect to have a material favorable or unfavorable impact on your results of operations, liquidity, and capital resources. Set forth below are a number of common Management's Discussion and Analysis disclosure suggestions we have provided to financial institutions that you should consider if they are relevant and material to you.

Higher-Risk Loans

Certain types of loans, such as option ARM products, junior lien mortgages, high loan-to-value ratio mortgages, interest only loans, subprime loans, and loans with initial teaser rates, can have a greater risk of non-collection than other loans. Additional information about higher-risk loans may be useful to an understanding of the risks associated with your loan portfolio and to evaluating any known trends or uncertainties that could have a material impact on your result of operations. With regard to your higher-risk loans, consider disclosing:

- the carrying value of your higher-risk loans by loan type, for example, junior lien mortgages, and, to the extent feasible, allowance data for these loans;

- current loan-to-value ratios by higher-risk loan type, further segregated by geographic location to the extent the loans are concentrated in any areas. Disclose how you calculated the ratios and identify the source of the underlying data you used;

- the amount and percentage of refinanced or modified loans by higher-risk loan type;

- asset quality information and measurements, such as delinquency statistics and charge-off ratios by higher-risk loan type;

- your policy for placing loans on non-accrual status when a loan's terms allow for a minimum monthly payment that is less than interest accrued on the loan. Discuss how this policy impacts your non-performing loan statistics;

- the expected timing of adjustment of option ARM loans and the effect of the adjustment on future cash flows and liquidity, taking into consideration current trends of increased delinquency rates of ARM loans and reduced collateral values due to declining home prices; and

- the amount and percentage of customers that are making the minimum payment on their option ARM loans.

Changes in Practices

Changes in the practices you follow to determine your allowance for loan losses can impact that amount and an understanding of the credit quality information you present. If you changed your practices, please discuss why you made the change and, to the extent possible, quantify the effect of those changes. Also, consider disclosing and discussing changes in:

- the historical loss data you used as a starting point for estimating current losses;

- how you incorporated economic factors affecting loan quality into your allowance estimate;

- the level of specificity you used to group loans for purposes of estimating losses;

- your non-accrual and charge-off policies;

- your application of loss factors to graded loans; and

- any other estimation methods and assumptions you used.

Declines in Collateral Value

A decline in the value of assets serving as collateral for your loans may impact your ability to collect on those loans. Consider disclosing:

- the approximate amount (or percentage) of residential mortgage loans as of the end of the reporting period with loan-to-value ratios above 100%;

- how you take into consideration housing price depreciation, and the homeowners' loss of equity in the collateral, in your allowance for loan losses for residential mortgages. Discuss the basis for your assumptions about housing price depreciation; and

- discuss the timing and frequency of appraisals and identify the sources of those appraisals for collateral-dependent loans.

Other

To the extent relevant and material, consider whether investors would benefit from disclosure in your Management's Discussion and Analysis regarding:

- any risk mitigation transactions you used to reduce credit risk exposure, such as insurance arrangements, participation in the U.S. Treasury Home Affordable Modification Program, credit default agreements or credit derivatives. Discuss how these transactions impact your financial statements;

- the reasons why key ratios (such as your non-performing loan ratio) changed from period to period, and how you considered this information and other relevant credit statistics in determining whether your allowance for loan losses was appropriate; and

- how your accounting for an acquisition under SFAS 141R or your accounting for loans under SOP 03-3 affects trends in your allowance for loan losses, including non-performing asset statistics, charge-off ratios, and allowance for loan loss to total loans.

Finally, although determining your allowance for loan losses requires you to exercise judgment, it would be inconsistent with generally accepted accounting principles if you were to delay recognizing credit losses that you can estimate based on current information and events. Where we believe a financial institution's financial statements are inconsistent with GAAP, we will take appropriate action.

Please contact me if you have any questions.

Sincerely,

Senior Assistant Chief Accountant