

# Monetary Trends



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## High Loan Loss Reserves: Virtue or Vice?

Banks, like other firms, set aside reserves to cover expected losses on assets. Basically, banks hold two types of assets: loans and investments. Since the vast majority of bank investments consist of default-risk-free U.S. Treasury securities, credit losses are concentrated in the loan portfolio. Banks maintain an account called the allowance for loan and lease losses (also called the loan loss reserve, or LLR) that is supposed to represent management's best estimate of the credit losses imbedded in its loan (and lease) portfolio. By subtracting the LLR from total loans, investors, analysts and regulators can better gauge the underlying value of a bank's assets.

In recent months, the Securities and Exchange Commission (SEC) has questioned the size and determination of several banks' loan loss reserves, even though for the banking system as a whole, the ratio of reserves to total loans is in line with its historical average. The SEC is concerned that high reserves may reflect "earnings management," a prohibited accounting practice. Firms that maintain "excess reserves" can smooth their earnings by drawing down on the reserve (by reducing loan loss provisions—an expense that flows into the balance sheet) to bolster core earnings in times of financial distress. While this practice is of benefit to firms, the Commission worries that investors will be misled about a company's true financial health and its earnings prospects in future periods if reserves are over- or understated.

In addition to looking for earnings management, the SEC also is investigating firms for other prohibited accounting tactics, including inflated restructuring charges and premature recognition of revenue. SEC Chairman Arthur Levitt believes the climate is ripe for this sort of manipulation since public companies—including banks—are under increasing pressure to meet Wall Street earnings forecasts and expectations.

Bankers complain that they are getting mixed messages from regulators. The SEC is worried about over-reserving at the same time banking regulators have been warning banks to prepare for a possible economic slowdown by meticulously examining their loan portfolios for likely losses and maintaining appropriate reserves. From a safety and soundness perspective, which is banking regulators' overriding responsibility, higher reserves would tend to be preferred over lower reserves, all else equal.

In response to the SEC's investigations, representatives from the Federal Reserve and the Office of the Comptroller of the Currency met with SEC officials to make sure the regulators were sending a consistent message to banks. At the conclusion of these meetings, the agencies issued a joint statement reaffirming that reserves should be linked to specific loans that are not expected to be repaid, plus an estimate of probable credit losses in the remainder of the loan portfolio, at the balance sheet date.

While the ratio of nonperforming loans to total loans is currently at its lowest point since year-end 1982 (the earliest date at which comparable data are available), anecdotal reports suggest many banks have loosened underwriting standards at a time when U.S. economic growth is widely expected to slow. Federal bank guidelines direct banks to take into consideration national and local economic and business conditions and developments in assessing the probability loans will not be repaid. The message from bank regulators always has been to err on the conservative side. This conservatism is consistent with the notion that banks are special because of deposit insurance and that "investor protection" extends to all taxpayers, who ultimately pick up the tab for bank failures. Banks are under pressure to satisfy two sets of regulators with different responsibilities. Whether a true meeting of the minds will occur is an open question.

—Michelle Clark Neely

*Views expressed do not necessarily reflect official positions of the Federal Reserve System.*

