Nobody likes to be in default on a loan. Yet, even the best-intentioned borrowers are sometimes unable to pay their debts. And when they have difficulty paying their debts, their troubles fall right into the laps of their creditors. No wonder, then, that analysts of banks and the banking system pay particular attention to bank loan losses.

Loan loss rates at commercial banks have been on the rise for some time. And some bank experts say there's apt to be a record volume of loan defaults this year, as recession brings financial misfortune to many. That brings to the fore the issue of bank defenses against potential loan losses.

Analysts generally focus on a bank's "reserves for possible loan losses" as its principal defense against uncollectable loans. Yet, over the past five years banks haven't built up their loss reserves as rapidly as they have increased their vulnerability to loan losses. While this has distressed some observers, there is a line of reasoning which leads to the conclusion that there probably isn't that much real cause for concern. The logic goes something like this: Until recently, bank loan loss reserves have been unnecessarily large. In addition, most banks have substantial earnings streams and capital resources which can also be used to cover...
potential loan losses. Thus, according to this reasoning, loan losses themselves pose much less of a threat to bank soundness than the danger of public overreaction to those losses.

**BANK LOAN LOSSES: BACKGROUND AND FOREGROUND**

When the record books are finally closed on 1975, the year’s loan losses just may set some records. Many bank watchers expect the dollar volume of bank losses to hit an all-time high in 1975. And some argue that the rate of such loan losses, as a fraction of bank loans outstanding, will be higher than at any time since the 1930s. These analysts could turn out to be right. But it’s important to place the current situation in perspective. The rate of bank loan losses is nowhere near its high water mark, set in 1934. At the depths of the Depression, commercial banks “charged off” over $3.40 of every $100 of bank loans as uncollectable. In 1974, by contrast, about 30 cents of every $100 of loans met a similar fate. Whatever may happen to loss rates in 1975, they have little chance of approaching their 1930s levels.

**Upward Pressure on Loan Losses.** In the context of the postwar period, those predictions of record loan losses for 1975 have a lot going for them. Loan loss rates have been on the rise for about 25 years now. And the recession of 1974-75 is quite likely to accentuate this trend.

An upward path of loan losses since 1950 is unmistakable. While loan losses in the 1950s amounted to less than 7 cents per $100 of bank loans, the loss rate rose to just above 16 cents in the 1960s and to about 31 cents for the 1970-74 period (Chart 1). A trend as strong and as long-standing as that is not quickly reversed. While the renewed emphasis on conservatism in banking which emerged in 1974 may eventually lower the loss rate, that won’t happen overnight.

On top of this longstanding trend is the 1974-75 recession. As a downturn cumulatively worsens, the profitability of the business community can seriously erode, forcing many firms to absorb operating losses out of stockholders’ equity. The next step for such firms may be bankruptcy, since some of them may become unable to pay their outstanding debts. Bank loan losses would then rise accordingly. Likewise, as unemployment grows during a downturn, personal borrowers may also fail to meet their debt-repayment obligations.

No one, of course, can be sure about the impact of a recession on bank loan losses. Conventional wisdom dictates that recession and a higher rate of loan losses ought to go together, although that hasn’t been true in all postwar recessions. Nonetheless, the latest recession has been more severe than other postwar downturns. Problems with loans for real estate development, for example, are particularly severe this time around. These forces could mean that loan losses will surge upward this year, as many Wall Streeters say, but this will be known for sure only in hindsight.

**Loan Losses in the Public Eye.** It is only natural, therefore, that public attention is now sharply focused on the loan loss problem. Even banks are forewarning their shareholders about higher losses in 1975. Eyebrows are thus now raised over the question of adequacy of bank defenses against high loan losses. And most of the questioners are concerned with the volume of funds banks have set aside as reserves for possible loan losses.

**SETTING AND SUBDIVIDING THE LOSS RESERVE**

Most firms and individuals maintain reserves of some sort to assist them in managing their financial affairs. These reserves may be only a few dollars set aside in a cookie jar or millions of dollars invested in income-producing assets. But, in either case, they help tide the household or business over any financial rough spots that may occur. Since banks are forever advising the
general public to "put something aside for a rainy day," it is only fitting that most banks do the same. Loss reserves are the device that most banks use to build protection against normal variation in loan losses. Banks usually plan to rely on their earnings and capital accounts to cover extraordinary loan losses.

A bank that adopts the "reserve method" for covering its loan losses makes an addition each year to its loan loss reserve. The bank doesn't earmark particular assets as part of its loss reserve. Rather, the loss reserve becomes a claim upon the assets of the bank generally, as are the bank's liabilities and capital accounts. When a loan held by the bank proves uncollectable, the decline in the value of the bank's loan assets can be "charged off" against the loss reserve. That way, as long as losses don't exceed reserves, the bank's earnings do not have to absorb loan losses directly. Earnings are buffered from the potentially wide swings in loan losses from year to year. And the reserve helps to cushion the bank against insolvency as well.

Taxes and Accounting for the Loss Reserve. Besides offering smoother earnings and an insolvency cushion, the reserve method also offers banks smaller tax bills. A bank may take tax deductions for the funds it transfers to its loss reserves instead of for its actual

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1Banks aren't required to use the reserve method for covering their loan losses. They are also permitted to be on the "direct charge-off method," whereby they use current earnings to meet loan losses as they occur.
BOX 1

THE TAX ADVANTAGES OF BUILDING LOSS RESERVES

U.S. tax laws give recognition to the fact that a portion of the interest received by a bank on its non taxable assets is needed to cover its losses on uncollectible loans. Even prior to 1921, banks have been permitted to deduct from taxable income a "reasonable" volume of transfers to a reserve for loan losses. Of course, since these tax deductions reduce a bank's taxes, it has always proven difficult for banks and the Government to agree as to what is reasonable. For a long while banks were permitted to build a reserve consistent with bank loss experiences during the 1930s. The last vestige of this was a U.S. Treasury ruling in 1965 permitting banks to maintain reserves in an amount up to 2.4 percent of their "eligible loans."* Tax reform has since sent this percentage lower.

The U.S. tax system is heading toward application of the principle that a bank should be able to shelter from income tax only those contributions to a loan loss reserve which are consistent with its recent loss experience. That principle is a part of the Tax Reform Act of 1969, but will not be fully effective until 1988. In the meantime, banks are permitted to shelter a reserve whose ratio to eligible loans is either based on the bank's loss experience or else is subject to a stipulated maximum.** The maximum ratio currently is 1.3 percent, but will drop down to 1.2 percent in 1976. It will drop further to 0.6 percent in 1982. Not until 1988 will banks be required to be on an "experience basis" for their loan loss reserves. Beginning in 1988, under current law, banks will be limited to a tax-free reserve no larger, as a fraction of their eligible loans, than the ratio of uncollectible loans to eligible loans on an average basis over the prior six years.

Thus, under current law, the tax benefit to a bank from handling its loan losses via the reserve method will gradually decline. For a time, however, the size of the tax saving will continue to be substantial. The U.S. Treasury estimates that over one billion dollars of tax receipts will be lost to the Government in fiscal 1975 because of the generous allowance for loan loss reserves at banks and savings and loan associations combined. The tax loss is expected to remain close to that level in fiscal 1976. But it should decline after that, as the maximum ratio of the reserve to eligible loans drops to 1.2 percent on January 1, 1976. That reduction will have its impact in fiscal 1977.

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*According to IRS rules, not all bank loans are eligible to serve as a basis for the reserve computation. The loans which are ineligible include Federal funds sold, loans backed by U.S. Government securities or bank deposit balances, and loans guaranteed by the U.S. Government.

**Regulations limit the size of the deduction for a transfer to the loss reserve during any single year to 0.6 percent of eligible loans.

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loan losses. And the tax law's generous standard regarding the size of the loss reserve permits banks thereby to reduce their tax payments (Box 1).

The tax deduction gives banks the incentive to transfer the maximum amount allowed by law to their loan loss reserves, and most do just that. But they usually don't report all of those tax deductions as operating expenses in their published financial reports. Although it may seem unusual, it's quite legal for a bank to report larger expenses to the Government than to its shareholders. The tax authorities permit a bank to "pay" for a transfer to its loss reserve partly by provisions from operating expenses and partly by provisions from retained earnings. Either way, the bank's transfer to its
loss reserve is tax-deductible. But the bank’s operating earnings aren’t reduced when retained earnings are used to build the reserve.

The Three Parts of the Loss Reserve. In actual practice, most banks charge both retained earnings and operating expenses for transfers to their loss reserves. This leads to a loss reserve which has three components—a valuation reserve, a contingency reserve, and a deferred tax reserve. But the bank can’t cover loan losses out of all of these components.

When a bank charges its operating expenses to provide for estimated loan losses, accountants record the result as an addition to the bank’s valuation reserve. When a transfer is made from retained earnings to the bank’s loss reserve, that’s recorded as an addition to the bank’s contingency reserve. When the bank cuts its tax bill by taking tax deductions for additions to its contingency reserve, its tax saving is recorded in the bank’s deferred tax reserve (see Box 2 for a numerical example). In principle, this account is used only for holding funds that will eventually be paid to the Government as taxes.

Of the three reserve components, accounting principles permit loan losses to be charged only against the valuation portion. While the contingency and deferred tax items are part of the bank’s total loan loss reserve, they represent transfers made for Federal income tax purposes only. If a bank’s loan losses should exhaust its valuation reserve, the bank’s next resource would be its earnings rather than the other loss reserve elements.1

The 1969 Agreement on Valuation Reserves. The principle that the valuation reserve be the only reserve element available to cover a bank’s loan losses is a long-standing accounting axiom. It became a banking rule, however, only after a 1969 agreement among the Securities and Exchange Commission, the Federal banking agencies, and the accounting profession. Under that agreement, the entirety of each bank’s loan loss reserve as of January 1, 1969 became a valuation reserve. Additions to the valuation reserve had to be charged to the bank’s income statement as expenses only beginning with 1969. And only since 1969 have the other elements of the valuation reserve been ineligible to cover loan losses.

Choosing the Size of the Valuation Reserve. The success of the reserve method as a device for handling loan losses depends on a bank’s ability to anticipate its losses. Ideally, a bank should set aside funds which, over time, will just equal the loan amounts that end up being uncollectable. To do this, the bank must accurately assess the risk of loss on each loan it holds. This is quite simple for some kinds of loans—consumer loans, for example, generate highly predictable loss experiences. But some kinds of lending, often involving large loans to business, generate a more erratic flow of loan losses. It’s quite difficult to compute a proper addition to the valuation reserve for such loans.

How large do a bank’s valuation reserves need to be? Obviously, they need to be large enough to cover the normal losses which may be expected on the basis of actuarial principles. In addition, the valuation reserve might include a cushion against unusual losses which may occur irregularly over time. But it would be impractical and unnecessary to make the valuation reserve large enough to cover all the bank’s unusual losses. Current earnings and equity capital are always available to backstop the loss reserve. Translating these principles into action isn’t

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1A bank could regain use of its contingency reserve by restoring that reserve to retained earnings and making a tax payment in the amount of the deferred tax reserve.
BOX 2

THE THREE PARTS OF A LOSS RESERVE

All of the dollars in a bank’s loan loss reserve are not created equally. Instead, each dollar comes from one of three sources—the bank’s revenues, its retained earnings, or the taxes that it owes to the U.S. Government. An example will clarify just how this all happens. But first, it may be useful to know why things need be so complicated.

The answer is our tax laws. It’s already been noted that banks are allowed to accumulate, free of corporate income taxes, more loan loss reserves than can be supported by loan loss experience. While banks are entirely willing to save on their taxes, they want to do so in a way which doesn’t reduce the profits that they report to their shareholders. This requires some financial gymnastics, but it can be done. What it requires is that banks sort their loss reserves into three segments—the valuation, contingency, and deferred tax portions of the overall loss reserve.

An example will help clarify this. Consider the status of the mythical Small-Loss National Bank. Small-Loss National had revenues last year of $1000. Its operating expenses, before any provision for loan losses, were $700. Its loan portfolio equals $10,000, and its average annual loan-loss ratio equals 0.2 percent.

Small-Loss National has decided to “charge” its revenues with a $20 addition to its bad debt reserve ($20 equals 0.2 percent of $10,000). This $20 represents an addition to the bank’s valuation reserve—it meets the test of being “charged” against revenue as a bank expense, and that’s what’s required of funds added to the valuation reserve. The bank thus reports its net income before taxes as $280 ($1000 minus $700 minus $20).

This $280 figure is what Small-Loss National tells its shareholders and the public generally that it actually earned last year. In an effort to use legal means to reduce its tax liability, however, it tells Uncle Sam something else. Remember, the U.S. Government usually permits a bank to add more to its loss reserves—and therefore shelter more income from current taxation—than the bank may need to cover loan losses. Suppose that in Small-Loss National’s case, the Government will permit it a $50 deduction for transfers to its loss reserve this year. Since it’s only willing to take $20 for its loss reserve out of revenues, but it can shelter a total of $50 if it wants to, the bank looks elsewhere for the other $30.

Here’s how the bank does it. Whereas shareholders were told that the bank actually earned $280, the Government hears a different story. Taxable income is reported to the Government as $250 ($280 less $30). That reduces Small-Loss National’s tax obligation by $15 (assuming, for simplicity, that the bank’s tax rate is 50 percent). This $15 tax saving is an addition to the deferred tax portion of the bank’s loan reserve.

Now, only another $15 is needed to make the bank’s total addition to its loss reserve equal to $50. That final $15 is the other half of the $30 the bank is looking for. It represents the shareholder’s half of the difference between the bank’s reported profit of $280 and its taxable profit of $250. This $15 would have gone into the bank’s retained earnings if it hadn’t been added to the loan loss reserve. It is assigned by accountants to the contingency portion of the loss reserve.
simple, of course. And critics have been quite vocal in criticizing the quality of bank judgments about the size of their valuation reserves.

**VALUATION RESERVES FAIL TO KEEP PACE**

Current regulatory rules require each bank on the “reserve method” to make a minimum addition to its valuation reserve during each year, equal to its average rate of loan losses for the last five years, applied to its volume of loans outstanding on average during the current year. This is only a minimum addition to the bank’s loan loss reserve, however. Banks are instructed to reserve more than the minimum amounts if they anticipate loan charge-off rates significantly higher than their five-year average. That is where bank judgment comes into play. And critics quickly point out that bank judgment has produced declining loan loss coverage by valuation reserves over the past several years.

After 1969, when the agreement on expensing of the valuation reserve was reached, and through 1973, most banks provided only the minimum amounts required as an addition to their valuation reserves. In 1974, many banks altered this pattern and provided extra amounts above and beyond the minimum set by bank regulators. Evidence from quarterly earnings reports indicates many banks are continuing to provide extra amounts for loan losses in 1975. In fact, the formula for loan loss provisions seems to be playing a small part in banks’ decisions about how much to provide for their loss reserves this year.

Between 1969 and 1974, while they were reliant on the formula, banks charged off nearly as much in uncollectable loans as they added to their valuation reserves. Hence, the valuation reserve as of year-end 1974 was only about 1 percent larger than it was at the start of 1969 (see Table). This relative constancy of bank valuation reserves contrasts sharply with the rapid growth of bank loans and loan losses. Bank loans have nearly doubled since the start of 1969 while the dollar volume of bank loan losses has risen nearly fourfold (see Chart 2).

How could valuation reserves have fallen relatively so far behind? It’s principally because banks’ entire loan loss reserves were defined as valuation reserves when the accounting rules were changed in 1969. That change left the average bank with valuation reserves of nearly 2 percent of loans outstanding, which was enough to cover ten years of loan losses at the rate at which such losses occurred in the 1960s. Thus, even as loans and loan losses grew substantially after January 1969, few banks felt the need to charge their revenues with more than the minimum required amounts. The valuation reserve cushion that banks had when the ’69 rules change was enacted left them comfortable with the small contributions made from ’69 through ’73.

It is notable that even during 1974, when many banks for the first time reserved more than the minimum amounts required under the ’69 rules, the ratio of valuation reserves to dollar losses continued to decline. And the ratio of these reserves to new loan charge-offs fell off even more. It is thus important to focus on the relative protection against loan losses afforded by valuation reserves and bank’s other defenses, and to assess whether there’s been a material weakening of banking soundness in this area.

**LOSSES OUTPACE LOSS RESERVES: WHAT ARE THE IMPLICATIONS?**

The failure of bank valuation reserves to keep pace with bank loans and loan losses since 1968 is indeed striking. But this development may say more about the meaninglessness of banks’ prior earnings reports than it does about any changes in the
FEDERAL RESERVE BANK OF PHILADELPHIA

LOAN CHARGE-OFFS HAVE NEARLY OFFSET PROVISIONS FOR THE LOSS RESERVE BY INSURED BANKS. THUS, THE VALUATION RESERVE HASN'T RISEN APPRECIABLY SINCE 1969

(States in Billions of Dollars)

<table>
<thead>
<tr>
<th>Year</th>
<th>Valuation Reserves At Start of Year</th>
<th>Loan Charge-offs During Year</th>
<th>Provision for Loan Losses during Year</th>
<th>Valuation Reserves At Year-end</th>
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</thead>
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<tr>
<td>1969</td>
<td>$5.22</td>
<td>$.49</td>
<td>$.52</td>
<td>$5.25</td>
</tr>
<tr>
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<tr>
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<td>4.94</td>
<td>1.95</td>
<td>2.29</td>
<td>5.28</td>
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</table>

TECHNICAL NOTE: The valuation reserve as of January 1, 1969 is the total loan-loss reserves of all banks as of December 31, 1968. This is pursuant to the regulatory assignment of all loan-loss reserves to the valuation reserve in 1969. Data on the valuation reserve as of successive year-end dates have not previously been published. These data have been computed for the purpose of this article as follows:

Year-end Valuation Reserve = Start-of-Year Valuation Reserve + Provision for Loan Losses during Year - Loan Charge-offs during year

DATA SOURCE: All data from columns (2) and (3) and for the first entry in column (1) are from the FDIC

industry’s vulnerability. Bank valuation reserves smooth out a bank’s earnings record and make that record more meaningful to investors in the face of irregular loan losses. But, as guarantors of bank solvency, they are quite limited. A bank’s earnings and equity capital are more significant defenses against unusual loan losses.

Effects on Earnings. When a bank employs the reserve method, its earnings in any year are considerably insulated from its actual loan loss experience during that year. The bank’s reported earnings each year are reduced by that year’s contributions out of revenues to its valuation reserve. As long as the bank follows the regulatory formula to compute its current minimum provision for loan losses—that is, if the bank bases its loan loss provision upon its latest five-year rate of charge-offs—a given year’s loan loss will have an effect only 20 percent as large on the bank’s earnings in that year.4 Actual losses in

4 An example may help here. Suppose a bank has had loan charge-offs equal to 20c per $100 of loans during each of the past five years. Imagine that its current year charge-off rate was $1 per $100. Then its latest five-year average would equal:

\[
4 \times 0.20 + 1 \times 1.00 = 3.60
\]

The bank would have to boost its valuation reserves this year by .36c for every $100 of loans outstanding. That’s only 16c per $100 higher than last year’s requirement of 20c per $100. And it’s only 20 percent of the 80c per $100 runoff in this year’s loss ratio.
CHART 2
VALUATION RESERVE "COVERAGE" OF RISK EXPOSURES HAS FALLEN SHARPLY SINCE 1968 RULES CHANGE.

<table>
<thead>
<tr>
<th>Percent</th>
<th>Ratio</th>
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<td></td>
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<tr>
<td></td>
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</table>

Note: Year-end data: insured commercial banks.
SOURCE: FDIC Annual Reports and previous Table.
a given year may be above or below the year’s addition to the valuation reserve; if so, the valuation reserve will absorb the difference between the year’s loss provision and the year’s actual losses. In this way, annual variations in a bank’s loan loss experience which will end up offsetting one another within a five-year period have their biggest impact on the valuation reserve rather than on earnings.

The valuation reserve does more than just smooth out a bank’s earnings record. The reserve also helps make that earnings record more meaningful as a statement of the bank’s underlying profitability. That is, the buffering function of the valuation reserve helps to prevent erroneous signals about bank profitability from being conveyed to the public because of a one-time change in the charge-off rate. But this only holds when banks adhere rigidly to the principle of the reserve method. Suppose a bank boosted its interest revenue by extending more risky loans. Since the loans are riskier than those the bank had been issuing, the fraction of those loans likely to prove uncollectable a year or two hence is higher than the bank has been charging off recently. If the bank takes proper account of this, it will provide extra amounts for its valuation reserve concurrent with its receipt of higher interest payments. That is, it will reduce its reported net income to reflect more meaningfully the profitability of its current operations.

Has this feature of the reserve method actually worked in the past few years? Apparently not. Until recently, banks have not felt compelled to build up their valuation reserves in order to handle their growing loan losses. The 1968 rule change left them with plenty of loan loss coverage. Now, to the extent that many banks have since used up the valuation reserve cushion that the rule change gave them, income statements will now begin to reflect relatively larger charges for the loan loss reserve than in the past. That is, banks’ net operating earnings apparently have been somewhat overstated since 1969 because funds that might ordinarily have been “spent” to build loan loss reserves have not been expended. Crude estimation suggests that during 1969-74, banks were spared enough loan loss expense to boost their net earnings after-tax by nearly 8 percent (Box 3). Now that valuation reserves seem no longer to be inflated, bank profits will no longer contain this bonus.

This may hold some implications for the success that banks will have in raising funds in both the debt and equity markets. While lenders and shareholders are, of course, concerned with bank soundness per se, they are also keenly interested in bank profitability. For one thing, sustained profitability is itself an indicator of bank soundness. For another, bank profits are a measure of the bank’s ability to make additional interest or dividend payments. Thus, to the extent that banks lose the profits advantage they held in the years after 1969, they may also now lose some of their attractiveness to investors. Of course, investors may have previously recognized any overstatement of bank earnings and entered into that into their analyses. If so, elimination of the artificial boost to profits from loss reserve provisions won’t significantly affect bank fund-raising efforts.

### Loss Reserves as Solvency Insurance

While there is no substitute for loss reserves as an earnings stabilizer, earnings and equity capital are effective substitutes for loss reserves as solvency insurance. A bank with uncollectable loans runs the risk of insolvency. But if a bank should “run out of” valuation

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1Continuing with the above example, suppose the bank has $1000 in loans outstanding. Its charge-offs this year are 1 percent of $1000, or $10. Its contribution to the valuation reserve is .36 percent of $1000, or $3.60. Thus, the valuation reserve will decline this year by $6.40.

2Bank profits were overstated before 1969 as well. The focus here is on considerations following the 1969 rule change, however.
BOX 3

1969 RULING ON VALUATION RESERVES
BOOSTED BANK PROFITS

Computing the "right" volume of loan loss reserves for a bank to maintain is a very tricky procedure. But let's take an intellectual "giant step." Suppose that, for the banking system as a whole, valuation reserves ought to equal—as they did at year-end 1974—about 1 percent of loans outstanding. Many banking observers think a valuation reserve ratio of 1 percent is about right for the industry as a whole, so the assumption may be all right. We'll come back to this assumption shortly.

The valuation reserve ratio which the banking system held as of the start of 1969 was just under 2 percent. This high ratio was attained because banks were permitted to classify their entire loan loss reserve as a valuation reserve on January 1, 1969. This gave them $5.22 billion of valuation reserves as of that date.

Over the years since 1969, banks have added a net of only $0.6 billion to their valuation reserves. That is, additions to bank valuation reserves have exceeded loan charge-offs against these reserves by only $0.6 billion. This small addition to bank valuation reserves was concurrent, of course, with substantially increased loan and loan loss volumes. Banks got away with so small a net increase only because they had so much in valuation reserves to start with.

Now, back to that assumption. Imagine that banks had been assigned the "right" volume of valuation reserves back in 1969. Instead of $5.22 billion, they would have had only $2.65 (1 percent of $265 billion in loans) billion at that time. Then, banks would have had to work harder in order to reach the "correct" level of valuation reserves by year-end 1974. The banks would have had to charge their earnings with—and reduce their profits by—a total of $2.57 billion more than they actually did over the 1969-74 period. This amounts to nearly 6 percent of bank operating earnings, pre-tax, and nearly 8 percent of bank net earnings, after-tax, during 1969-74. If valuation reserves are now at the "right" ratio to loans, then this profit bonus will no longer be available to banks.

tion reserves in meeting a calamitous loan loss, its earnings and capital accounts could still absorb the loss.

A bank's net operating earnings would be its next line of defense should its valuation reserves be exhausted. And, for the banking system as a whole, there's a lot of room to cover loan losses out of earnings. Earnings, before tax, in 1974 were over four times as great as charge-offs. This meant that valuation reserves and earnings together were over 7.5 times as great as charge-offs. Furthermore, the banking system's equity capital represents an amount 30 times as great as 1974 charge-offs. And equity capital is what a bank turns to if its earnings are exhausted. While each of these multiplies is substantially less than their values of a few years ago, it's difficult to argue that they aren't now high enough.

Thus, the combination of loan loss reserves, operating earnings, and equity capital appears sufficient to protect most banks from loan losses well above those they've been experiencing. Of course, those defenses may not be adequate to keep all banks afloat, should loan losses jump. But judgments about the adequacy of reserve
provisions shouldn’t rest solely on whether each individual bank is sound. A more important issue is whether the banking system as a whole is safe. If too many individual banks got into trouble from loan losses, that could endanger the entire system. But the dimensions of the capital, earnings, and loss reserve protection now existing render this most improbable.

Capital as the Ultimate Insurance against Loan Losses. It’s good to know that the banking system is well buffered from loan losses. But it’s troublesome to consider all of the attention that’s been placed upon loss reserves by students of this issue. Loss reserves are one of the guarantors of bank solvency, but their role is small in comparison to that played by bank capital. The real issue surrounding the industry’s ability to withstand higher loan losses is the same as that surrounding its ability to withstand higher losses in other areas—the adequacy of bank equity capital. True, there’s lots of controversy over how much bank capital is needed. But that’s where there ought to be controversy, for loss reserves are just a variation on the bank capital theme.

Appearances Are Deceiving

As banks have expanded their roles as department stores of finance, their exposures to the risk of loan losses have also grown. With a severe recession on the books for 1975, the likelihood of particularly high loan losses at banks this year has raised questions about the ability of the industry to handle such losses.

While a recession needn’t necessarily bring higher loan losses to commercial banks, the issue of adequate loan loss coverage is still meaningful at this juncture. Valuation reserves—the loan loss reserves out of which a bank normally “covers” loan losses—have grown very little over the past five or six years. Meanwhile, the volume of bank loans and loan losses has risen substantially. Thus, the degree of loan loss coverage which valuation reserves can provide has fallen substantially.

Banks are aware that they must have the resources to absorb loan losses internally. Otherwise, they realize, they can get into the same kind of financial hot water as their defaulting borrowers. Do banks need to cover more than three years’ worth of losses with valuation reserves? That’s how much coverage they had at year-end 1974, and it may be enough for all but a few institutions. Besides, loan loss reserves may not be the best measure of a bank’s ability to remain solvent in the face of unusual losses. Loan loss reserves help stabilize a bank’s earnings and are the bank’s first line of defense when faced with loan losses. But the bank’s earnings and equity capital are typically far more meaningful than loan reserves as resources in the battle against unforeseen loan losses. These resources must be available to cover a wider set of contingencies than just a bank’s loan losses. But their sheer size relative to the historical experience which commercial banks have had with loan losses is reassuring indeed. Potential loan losses don’t appear as overwhelming when viewed in the perspective of what they would be if loan loss reserves were a bank’s principal defense.

Federal Reserve Bank of Philadelphia