Loan Losses Surge in 1975

by John M. Godfrey

Loan losses at District member banks increased sharply in 1975 and are the most visible sign of banks' most recent loan problems. While there is no way to measure some of the other problems, such as the lost income from reduced or suspended interest payments on some substandard loans that have not been written off, these losses are also undoubtedly large. Faced with heavy losses, banks have stepped up provisions for loan losses in an attempt to insure that their loan loss reserves are sufficient to cushion them against additional losses, and these additional provisions have had a major impact on bank earnings. Since banks have had several years now to properly identify all their problem loans and make sufficient provisions for any eventual losses, they should be able to hold the line on future provisions and improve their earning outlook

District member banks charged off a post-Depression record volume of uncollectable loans during 1975. In 1975, these banks reported loan losses of $305.5 million, up from $200.6 million in 1974 and $101.6 million in 1973 (see Table 1). Loan losses as a percent of total loans also surged. Banks charged off 1.19 percent of loans in 1975, an increase from 0.76 percent in 1974 and an average of only 0.49 percent from 1970 through 1973 (see Table 2).

The dollar volume of loan losses increased $104.9 million last year and was concentrated in several groups of banks. The large Tennessee banks accounted for $30.8 million of the $69.1 million increase (45 percent of the total) in loan losses among the large District banks. The small- and medium-sized banks in Florida accounted for a disproportionately large part of the increase among these District banks. Of the $35.8-million rise in losses among these banks, the Florida banks added $25.3 million, or 71 percent.

Sixth District member banks had losses proportionately greater than banks in general over the last several years; nationally, they were half as large. District banks accounted for 11.2 percent of all U. S. member banks' loan losses in 1975 and 12.6 percent in 1974, while they held only slightly over six percent of all member bank loans. As a result, the losses at all member banks were 0.65 percent of loans in 1975 and 0.39 percent in 1974, just about one-half of the loss rate experienced by District banks.

In the District, loan losses were heaviest in Florida, Georgia and the District portion of Tennessee; losses were much lower in Alabama and the District parts of Louisiana and Mississippi. Member banks in Florida, Georgia and Tennessee accounted for 79 percent of the District's losses, although they had only 67 percent of the District's loans.

The larger District banks generally have the higher rate of loan losses. This was true in 1975. Increased losses at the larger banks are attributed to their more active involvement in lending involving real estate, especially apartments, condominiums, commercial properties, and land development, and the real estate investment trusts. Also, they have not been immune to increased losses on their primary customers, commercial and industrial business firms, and consumer loans. They charged off 1.34 percent of their loans, compared to the remaining banks' 1.05 percent charge-off. While loan loss rates rose for all size banks in 1975, the 48 large banks (defined here to include all Sixth District member banks with total loans of $100 million or more as of December 1974) continue to report loss rates approximately one-third higher than other banks.

Seven large Tennessee banks charged off an average of 2.04 percent of their loans, the

TABLE 1

LOAN LOSSES
Sixth District Member Banks
($ millions)

		All Banks	Large Banks*	Other Banks
District	1973	101.6	63.6	38.0
	1974	200.6	130.8	69.8
	1975	305.5	199.9	105.6
Alabama	1973	13.6	6.0	7.6
	1974	21.1	10.3	10.8
	1975	26.2	12.2	14.0
Florida	1973	25.2	7.4	17.8
	1974	58.2	23.5	34.7
	1975	95.2	35.2	60.0
Georgia	1973	32.7	27.3	5.4
	1974	68.7	56.9	11.8
	1975	87.2	69.0	18.2
Louisiana**	1973	9.7	7.0	2.7
	1974	15.6	10.3	5.3
	1975	24.8	20.5	4.3
Mississippi**	1973	6.1	4.7	1.4
	1974	8.8	7.0	1.8
	1975	11.7	9.4	2.3
Tennessee**	1973	14.3	11.2	3.1
	1974	28.2	22.8	5.4
	1975	60.4	53.6	6.8

*Banks with loans of $100,000,000 and over as of December 1974
**Sixth District portion

highest loss ratio for this group of banks in the District. Tennessee's situation was strongly influenced by two large banks that had reported losses in excess of 3.5 percent of total loans. One of these banks subsequently failed because of additional loan losses. The seven large banks in Georgia also had a high average loss ratio of 1.69 percent.

The small- and medium-sized banks in the District portion of Mississippi and Louisiana had the lowest loss ratios. Compared with other states in the District, the medium and small banks in Alabama had higher loss ratios than the large banks in the state.

RECOVERIES

When banks charge off a loan as a loss, they generally make a conservative estimate of the loss. That is, banks are more apt to overstate than to understate the actual amount of the loss rather than to have to make a second adjustment. In this way, they may eventually recover more from a loan than the reduced value that is carried on their books. When banks make these recoveries, the proceeds are credited back to their reserves for loan losses.

From 1970 through 1973, District banks typically recovered from $20 to $30 million a year in loans that had previously been charged off (see Table 3). These recoveries amounted to between one-fifth and one-third of total gross loan losses and sharply reduced the overall rate of loan losses.

During the last two years, the dollar amount of recoveries has increased but not nearly as much as gross loan losses. In 1975, recoveries totaled nearly $50 million but represented only 16 percent of gross loans losses. While the ratio of recoveries to gross losses has declined, this change may be a reflection of banks' more realistic estimates of what the actual losses are when the loan is charged off. Or, the lower rate of recoveries may be symptomatic of types of loans being written off. To the extent that these loans involve foreclosures on real estate or asset swaps and banks are unable to quickly sell the property that they have taken possession of, several years may elapse before banks can sell property and establish their exact losses. In these cases, and if they have taken overly conservative write-offs, they may be reporting increased recoveries in the future.

BANK SIZE AND LOAN LOSSES

Although there was an increase in loan losses last year, most District member banks did not

TABLE 2

LOAN LOSSES AS A PERCENT OF TOTAL LOANS

Sixth District Member Banks

		All Banks	Large Banks*	Other Banks
District	1973	0.41	0.43	0.38
	1974	0.76	0.84	0.65
	1975	1.19	1.34	1.05
Alabama	1973	0.42	0.34	0.51
	1974	0.57	0.51	0.65
	1975	0.67	0.58	0.78
Florida	1973	0.31	0.25	0.34
	1974	0.68	0.76	0.63
	1975	1.18	1.28	1.13
Georgia	1973	0.59	0.66	0.39
	1974	1.22	1.34	0.87
	1975	1.61	1.69	1.35
Louisiana**	1973	0.33	0.31	0.43
	1974	0.50	0.42	0.78
	1975	0.79	0.86	0.58
Mississippi**	1973	0.45	0.45	0.46
	1974	0.63	0.72	0.43
	1975	0.83	0.94	0.55
Tennessee**	1973	0.42	0.43	0.38
	1974	0.74	0.81	0.53
	1975	1.63	2.04	0.63

*Banks with loans of $100,000,000 and over as of December 1974
**Sixth District portion

write off an unreasonably large amount of loans. The high rate of loan losses was caused by a relatively small proportion of the District banks. While the District average rate of loan charge-offs was 1.19 percent last year, 70 percent of the banks had losses of less than one percent (see Table 4). Furthermore, nearly one-half of the banks had losses of less than one-half of one percent. While this was a deterioration from previous years, loan losses at most banks appear quite manageable.

Most banks were not confronted with large loan losses, but some banks were quite hard-hit. The number of banks with losses exceeding one percent rose sharply in 1975. In 1974, only 107 of 646 member banks (17 percent) reported losses of over one percent, but during 1975, 198 of 658 banks, or 30 percent were in this category. In addition, 12 banks had severe losses of over five percent in 1975 and one moderate-sized Florida bank, with reported losses of nearly eight percent, subsequently failed. In contrast, there were only four banks with losses over five percent in 1974.

Most District banks with high loan loss ratios are smaller banks. Of the 198 banks in the District with losses exceeding one percent, 127 have loans outstanding of less than $25 million, and they appear to represent the greatest problems. And of the 12 banks with losses over five percent, nine have less than $25 million in loans, with eight of the nine having less than $10 million in loans outstanding. One of these small banks, located in Georgia, reported losses in excess of 12 percent and was later merged into another bank to prevent its outright failure.

A higher proportion of the large banks did have losses exceeding one percent, but none reported severe losses of more than five percent. Nineteen of these 44 large banks had losses over one percent. Furthermore, two-thirds of the very largest District banks—loans of over $500 million—wrote off over one percent of their loans last year.

RESERVES FOR LOAN LOSSES

Reserves for loan losses help banks absorb the impact of loan losses and reduce the impact of losses on earnings and the capital structure of banks.[1] For this reason, it is beneficial that reserves rose not only absolutely but relatively last year. Reserves as a percent of loans equaled 1.60 percent at the end of 1975, up from 1.48 percent at the end of 1974. This change marks an improvement over the

[1]See: "Accounting for Loan Charge-Offs," this **Review**, August 1975.

TABLE 3

RESERVES FOR LOAN LOSSES

Sixth District Member Banks
($ millions)

	1970	1971	1972	1973	1974	1975
Beginning Balance	261.6	266.9	277.9	311.0	358.8	392.8
+Provision for Loan Losses	51.4	55.5	60.4	78.3	175.5	302.7
+Recoveries	18.6	25.4	30.4	29.8	36.1	48.6
+Other Transfers to Reserves	25.5	20.1	27.8	41.9	28.2	0.2
Total Reserves	357.1	367.9	396.5	461.0	598.6	744.3
−Gross Loan Losses	88.8	83.9	82.7	101.6	200.6	305.4
−Other Transfers from Reserves	1.4	4.5	2.9	2.3	8.0	27.4
Ending Balance	266.9	279.5	310.9	357.1	390.0	411.5
TOTAL LOANS	**14,090**	**16,082**	**20,151**	**24,597**	**26,322**	**25,632**
Reserves as % of Loans	1.89	1.74	1.54	1.45	1.48	1.60
Gross Losses as % of Loans	0.63	0.52	0.41	0.41	0.76	1.19
Net Losses*	70.2	58.5	52.3	71.8	164.5	256.8
Net Losses as % of Loans	0.50	0.36	0.26	0.29	0.63	1.00

*Gross losses minus recoveries

Note: Structural changes account for the difference between the ending balance in one year and the beginning balance in the following year.

low of 1.45 percent in 1973, but the coverage is still substantially below that experienced in the early 1970s. As a longer-run measure of protection against capital impairment, the ratio of reserves to loans is probably the most meaningful measure.

Banks typically provide for loan losses by allocating part of their income (a provision for loan losses) to a reserve for loan losses. The provision for loan losses is an expense item for the bank even though it does not necessarily involve any direct outlay by the bank at the time it is made. When a bank actually experiences a loss when a loan is charged off, that loss is charged to the loan loss reserve. While increased provisions for loan losses directly reduce profits, loan losses do not since they are charged against the loan loss reserve.

At the end of 1975, reserves for loan losses at District banks totaled $411.3 million, up from $392.8 million at the beginning of the year (see Table 3). Loan loss reserves actually increased last year, in spite of record loan losses being charged against these reserves, because banks made provisions of $302.7 million to the reserves and had recoveries of $48.6 million. Other minor transfers involving these reserve accounts explain the remaining difference. If banks expect to experience higher loan losses, they generally increase their provisions for losses. In 1974, gross loan losses exceeded provisions for losses by $25.1 million, but in 1975 gross losses were nearly equal.

Some of the relative improvement in the coverage of reserves to loans, however, resulted from a decline in loans rather than the increase in reserves. In two of the states with large loan losses—Florida and Georgia—one-half or more of the relative improvement occurred because loans declined. In the other state with large losses, Tennessee, there was a relative improvement in reserves because reserves rose 12 percent and loans rose only slightly.

While the protection afforded by loan loss reserves has improved as measured by the ratio of reserves to loans, by another measure they have deteriorated rather sharply. In the early 1970s, reserves exceeded net loan losses by approximately five times in any one year. By 1974, the coverage had dropped to only two and one-half times and in 1975 to even less, about one and one-half times. This deterioration shows that without massive provisions in a year like 1975 when losses are large, loan loss reserves would be nearly depleted.

Making these massive provisions for loan losses in order to maintain adequate reserves had a major impact on District bank earnings.

TABLE 4

DISTRIBUTION OF DISTRICT MEMBER BANKS BY LOAN-LOSS RATIO AND SIZE OF LOAN PORTFOLIO

1975

Loans ($ millions)	Loan-Loss Ratio: Under .25	.25 - .50	.50 - .75	.75 - 1.00	1.00 - 5.00	Over 5.00	Total
Under 10	102	55	26	17	65	8	273
10 - 25	45	48	33	13	53	1	193
25 - 50	23	23	18	11	37	0	112
50 - 100	6	6	6	3	12	3	36
100 - 500	1	5	9	7	13	0	35
Over 500	1	1	0	1	6	0	9
TOTAL	**178**	**138**	**92**	**52**	**186**	**12**	**658**

TABLE 5

RESERVES FOR LOAN LOSSES 1975

Sixth District Member Banks ($ millions)

	District	Alabama	Florida	Georgia	Louisiana*	Mississippi*	Tennessee*
Beginning Balance	392.8	58.5	129.0	83.7	49.0	21.8	50.8
Provision for Loan Losses	302.7	22.8	92.3	92.5	24.1	10.3	60.7
Recoveries	48.6	6.2	14.3	13.1	4.4	2.2	8.4
Transfers to Reserves	0.2	0.0	0.1	0.0	0.1	0.0	0.0
TOTAL	**744.3**	**87.5**	**235.7**	**189.3**	**77.6**	**34.3**	**119.9**
Gross Loan Losses	305.4	26.2	95.2	87.1	24.8	11.7	60.4
Other Transfers from Reserves	27.4	.2	8.1	15.6	.7	.3	2.5
Ending Balance	411.5	61.1	132.4	86.6	52.1	22.3	57.0

*District portion

In 1975, earnings, as measured by income after taxes but before securities gains or losses, totaled $296 million, down from $373 million the year before. This $77-million drop in earnings was more than offset by the $127-million increase in one expense item, provision for loan losses. The overall drop in bank earnings was partly tempered by a sharp savings in income tax liabilities from net payments of $53 million in 1974 to net credits of $6 million in 1975.

PROSPECTS FOR FUTURE LOAN LOSSES

District member banks were hit hard by loan losses in 1975. In making provisions for loan losses in order to maintain adequate loan loss reserves, banks experienced sharply lower earnings. The outlook for the southeastern banks does look brighter, however. After two years of exceptionally heavy loan charge-offs, most banks have probably identified their most serious loan problems and made adequate provisions for most subsequent charge-offs. Tight credit standards and an improving economy should boost the quality of new loans they are making. If this is true, banks should not be faced with the need to make massive provisions in 1976. In the future, banks may not need to make large additions to their reserves for protection against loan losses. Reserves can expand in line with the growth in loans and reduced provisions for loan losses in turn should have a positive impact on future bank earnings. ■