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Re-Examination of Loss Reserve Practices

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The objective for this discussion.

In these remarks it will be my purpose to encourage your consideration and review of the current situation with regard to loss reserves for securities in the commercial banking system. The guiding principles in this area were established in 1938 when the bank examining authorities developed a uniform policy covering the treatment of securities for bank examination purposes. Sixteen years have passed since the adoption of that agreement. Now it may be provocative to ask some pointed questions both as to the facts and the theory of loss reserves.

Brief review of the principles regarding loss reserves on securities, stated in the 1938 agreement and reaffirmed in 1949.

Pursuant to the terms of the agreement among the bank examining authorities in 1938, investment grade securities have since been valued in bank examinations at amortized cost or book, whichever is lower. When this valuation rule was adopted, the departure from the market basis for valuing securities was recognized as necessary in order to discourage speculative trading and to stabilize the asset structure of banks. But the fact that losses are inherent in the investment process was also clearly understood. Furthermore, there was general appreciation of the need for cushioning the inevitable losses when investments are made in securities. As a consequence, two avenues of approach were indicated by the 1938 agreement:

(1) The policy of maintaining reserves against the securities account was announced, and

(2) Profits from the sales of securities were earmarked for the purpose (a) of writing off losses in the securities account, and (b) the establishment of adequate reserves.

Throughout the entire period since 1938, the bank examining authorities have evidenced no disposition to abandon these firmly established principles governing the reserves on the securities holdings of banks. Moreover, these years have been mostly prosperous ones with good markets for securities and generally profitable banking. Accordingly, one would now expect to find evidence of progress in building up loss reserves along the lines indicated by the policy statement.

Review of the essential facts.

When we endeavor to talk about losses, chargeoffs, and valuation reserves for securities, the factual picture is clouded by several knotty statistical problems. For example, the Earnings and

Dividend reports as now constituted do not enable us to isolate the amount of realized losses. While the examination reports disclose more information on the subject, such data are non-additive.

So as to point up this discussion, however, a few bits of information concerning valuation reserves for securities have been assembled from the reports of Earnings and Dividends covering all insured commercial banks for the past five years. Here is a brief of the facts:

(1) The data suggest that valuation reserves to absorb losses and chargeoffs on loans are much higher than the corresponding reserves for the securities portfolios. At the close of 1952 such reserves on loans and on securities were $905.5 million and $242.8 million, respectively. As points of reference, the 1952 average Loans and Discounts totaled about $60 billion, U. S. Government obligations amounted to $61 billion, and Other Securities comprised approximately $13.6 billion of assets. Parenthetically the great difference in the volume of reserves is usually explained by reference to tax regulations. While that may furnish an adequate explanation of the facts, it certainly is not a justification.

(2) Over the five years, 1948-1952, the amount of losses and chargeoffs on loans has been almost the same as the comparable figure for securities. Respectively, these amounts totaled $436 million and $411 million. Furthermore, the statistics reveal a surprising correspondence between the rates of losses and chargeoffs for these two categories of assets. The data are as follows:

Losses and Chargeoffs per $100

Year	All Securities	Loans
1948	$0.12	$0.20
1949	0.06	0.24
1950	0.06	0.17
1951	0.14	0.16
1952	0.17	0.15

(3) Most of the losses and chargeoffs on loans have been absorbed by the reserve accounts, but this is not true for the securities portfolio. Specifically, for 1948-52 $306.6 million, or about 70% of the losses and chargeoffs on loans were covered by the reserve account. For

securities, the comparable figure is $73.7 million, or only about 18% of the losses and chargeoffs.

(4) Not only have the valuation reserves on the loan portfolio absorbed the bulk of the losses and chargeoffs arising out of these assets, but the reserve balances have grown rapidly. Between 1948 and the close of 1952, total reserves for loans increased from $409.8 million to $905.5 million, or about 121%. In 1948 valuation reserves on securities totaled $233.4 million as compared with $242.8 million at the close of 1952, a five-year increase of only about 4%.

(5) The amount of profits and recoveries on securities is sometimes interjected as a relevant fact in the discussion of losses and chargeoffs. For the period 1948-1952 price fluctuations in the securities market were substantial. For the first three years profits clustered about the $100 million total, ranging from a low of $92.2 million in 1949 to a high of $108.8 million in 1950. Thereafter the amount faded rapidly to a 1952 low of $49.4 million. However, for the period as a whole the profits and recoveries virtually offset the losses and chargeoffs.

These data may furnish support for the contention that profits and losses from trading in securities tend to balance. But at this time there is no evidence to show that the profits in the early portion of the period under discussion were available to absorb the much greater volume of losses at a later date because the profits did not augment the reserve accounts. In short, the commonsense view of the matter suggests that the banks really in need of profits to absorb losses and chargeoffs probably did not have them. On the other hand, banks which succeeded in making profits on securities transactions when the market trend was favorable, probably were able to minimize or avoid losses when market conditions turned for the worse.

Central questions for discussion.

A review of the data concerning loss reserves on securities against the background of the 1938 agreement raises several fundamental questions.

(1) Is it sound to value securities on an amortized cost basis without the protection of a valuation reserve program?

(2) Have the bank examining authorities really abandoned the guiding principles on loss reserves which were enunciated in the 1938 agreement? If the answer is affirmative, then: What can be substituted as a restraint on speculative trading? and What can be done to protect against capital attrition?

(3) Do the facts support the conclusion that we now have an emergent theory of capital margin in banking? This is evidenced by a tendency to combine the items making up the differential between assets and liabilities in the so-called capital accounts. There would be no reserves against specific classes of assets.

(4) If the principles of the 1938 agreement pertaining to the valuation of securities and the reserve program are accepted as valid, then it would seem appropriate to consider a recent development in the life insurance field. This development may point a way out of the predicament which results from the present conflict between theory and facts.

The life insurance companies, like the banks, value securities for balance sheet purposes at amortized cost. These companies also recognize that valuation reserves are a necessary part of any program which books securities at a basis other than market quotations. Recently the companies have adopted a policy of setting aside a small portion, namely 1/20th of 1% of the total investment account for a valuation reserve each year. This set-aside applies to all investment grade securities, including United States Government obligations. Reserving is at a higher rate for securities which do not measure up to top quality and for equities.

The Corporate Bond Study completed by the National Bureau of Economic Research a few years ago furnishes a more or less scientific justification for the 1/20th or 1% addition to the valuation reserves for securities. This study covered all corporate issues of substantial size floated during the period 1900-1944. It revealed a loss ratio of 1/20th of 1% on the entire volume of flotations.

(5) Finally, is the plan adopted by the life insurance companies at all practical in banking?