

VALUATION RESERVES FOR SECURITIES

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By

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You may recall at a meeting of this group a year ago, some time was devoted to a re-examination of loss reserve practices for securities held by the commercial banks. The guiding principles for loss reserves were expressed in the 1938 agreement and again restated in 1949. It seemed appropriate, therefore, to give some thought to what had been accomplished.

To sum up the discussion of last year very briefly, the bank examining authorities abandoned the market basis for valuing securities and shifted to the lower of book or cost in 1938. This arrangement was designed to stabilize the asset structures of the banks and to put somewhat of a damper on speculative activities. Along with the shift in the basis of valuation was the establishment of reserves to cushion the losses inherent in the investment process. These reserves were expected to be accumulated from the profits on securities as well as from set-asides from earnings each year.

To be sure, the data on reserves are very fragmentary. There has been no improvement in the sources of our information; we are obliged to work with information from the condition and the earnings report forms. Some added details on reserves could be obtained from examination reports, but the information would be non-additive. However, I shall up-date and summarize the details presented last year as briefly as possible because I believe the picture is clear enough for our purposes.

The valuation reserves on securities at the close of 1953 amounted to about \$235 million. This compares with a total securities portfolio of around \$77 billion, composed, of course, heavily of Federal issues--

\$63 billion--and other securities totaling \$14 billion, which included about \$11 billion of municipals. Parenthetically, I am quoting 1953 figures since the information to complete the 1954 picture is not available.

With respect to loans, the showing is quite different. The valuation reserves for loans amounted to \$960 million as compared with \$68 billion of loans. In fact, by the end of 1954 the reserves had grown to over a billion dollars.

The rate of losses and chargeoffs, according to the records, is substantially the same both for loans and securities--and remember losses and chargeoffs are combined--we cannot segregate the actual losses from the chargeoffs and chargedowns. Furthermore, over a period of years, such as 1948 to 1953, the record shows that losses and chargeoffs on loans aggregated about \$560 million as compared with a trifle over \$600 million for the securities portfolios.

The picture of growth in valuation reserves is very interesting. For loans over the period 1948-1953, there was an increase from slightly more than \$400 million to almost one billion dollars. On securities, the amount of reserves at the beginning and end of the period was substantially unchanged, \$233 million to \$235 million, respectively.

Sometimes it is argued, of course, that we need not pay much attention to valuation reserves on securities because there are profits in the form of recoveries on securities, and the profits offset the losses. However, such information as may be found in the reports suggests that the amount of recoveries on securities for the 1948-1953 period was less than losses and chargeoffs. The figures are in the order of \$475 million to

\$600 million, respectively. So the cushion of profits is just not available, or at least it doesn't show up in the best information at hand.

Let me also refresh your memory regarding a development in the life insurance field, which was mentioned a year ago. You may recall that the life insurance companies have adopted the policy of an annual increment to the reserve for the protection of their securities portfolios. To be sure, it is a very small increment--a twentieth of one percent on all of their holdings. The provision for reserves involves additional complexities that I need not bother you with at this time. There is an attempt to classify assets as to basic quality with a higher set-aside on the so-called inferior grade issues, but fundamentally it is a fact that the life companies do recognize the process of attrition in the capital accounts. They make some provision for it each year. Also, there is a ceiling on the total reserve equal to one percent of the total securities portfolios. In addition profits can be used to augment the reserve so that the total actually is building up much faster than the basic provision of one-twentieth of one percent would suggest.

The basis for this valuation reserve policy is some information about capital attrition, developed more or less as a by-product from a National Bureau of Economic Research study in the field of corporate bonds. That study covered the period roughly from 1900 through to the mid-1940's, and the evidence was rather clear that irrespective of the quality of issues at the time of flotation, over the long run, there is a discernible process of capital attrition. That process investors cannot ignore, and the appropriate method to protect against loss is to set up a reserve annually.

With that background, it seems to me that we should recognize that it is impossible to solve problems--such as the one presented by the facts of capital attrition on investment--but it is necessary to learn to live with them. Ignoring them is the important pitfall to avoid. So for purposes of encouraging a bit of discussion, I propose to suggest now that the banks might be well advised to adopt a policy of this sort, namely, to reserve annually an amount equal to one-twentieth of one percent of their investments. As a matter of fact, I would not exclude Federals. To be sure, no one is going to argue that in the aggregate Federal issues will cause a loss to the banks. The fact is that Federal portfolios turn over and banks make mistakes like everybody else. They are bound to run into some capital losses. If they turn over the securities often enough and long enough, I should be inclined to believe that an annual loss rate of a twentieth of one percent would be very modest.

In addition, we must recognize that the municipal portfolio--now the most important segment of the other securities category--is growing very fast. At the end of 1954, it amounted to over \$12 billion, an increase of 17 percent for the year. There are many elements in the municipal portfolio that are reasonably new to the investment community. We are going into volumes and types of financing that present problems, and I am quite confident that many of them have not been solved. The situation is quite different from ten or twenty years ago, when the bulk of the municipal credit tended to be in the form of full faith and credit obligations of relatively small communities.

At this point in the discussion, anyone who has the temerity to make suggestions of this sort is usually waved aside with the statement

that after all there is a tax problem--and that is the end of that. You can't do anything about a tax problem. Well, certainly everyone who looks at the figures will agree that one of the important forces at work to facilitate the accumulation of loss reserve on loans was the favorable tax treatment accorded the annual set-asides. However, it seems to me that sound banking and examination policy stands on its own legs.

The basic policy with regard to reserves on securities was announced almost twenty years ago by the bank examining authorities. No one has ever said that it was a bad policy. It is my guess that no one has paid much attention to it. To stress the tax difficulties more or less puts the cart before the horse. If an annual provision for reserves against losses on securities is warranted, then the appropriate tax treatment will be accorded to set-asides. However, if such reserves cannot be justified on a sound basis--without regard to taxation--then surely one would not expect any special treatment to encourage their accumulation. Here is a case where it may be necessary to apply the stick before the carrot in order to get some action.

You will recall the basic questions in this discussion a year ago: Is it sound to value securities at an amortized cost basis without a valuation reserve program? That seems to be the question that we still need to talk about. If the authorities have abandoned the loss reserve principle--notwithstanding its continued existence in the published policy statements--then are there other steps that need to be taken to restrain speculative trading?--because that was one of the objectives. Furthermore, are there other safeguards that could be used to protect against capital attrition?

Finally, let me stress again that we have a more or less definitive basis for measuring capital attrition. Now we do have a thoroughly respectable study of a very large body of investment data, and the evidence of capital attrition is reasonably clearcut. This is an important development because you will recall that for many years there was literally no peg to use in hanging the hat.

So I will leave those questions with you.

Thank you.