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Loan-Loss Provisioning

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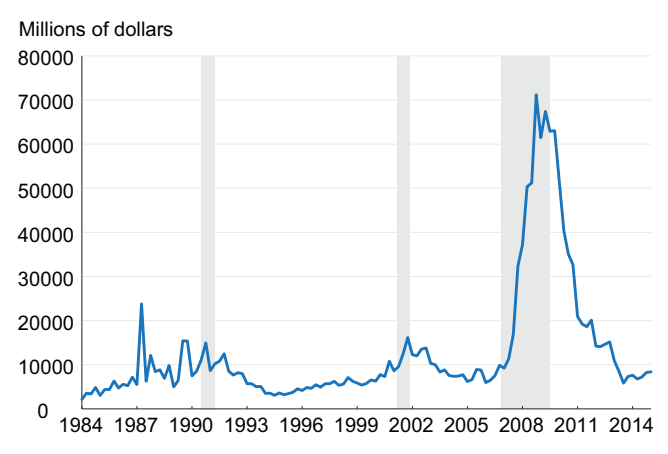
Banks maintain reserve accounts to offset losses they incur on defaulted loans. How banks determine the level of these reserves, and how reserves are accounted for on the balance sheet, is guided by accounting standards that became the subject of debate during the recent financial crisis. One issue discussed is the provisioning approach by banks; does it lead them to under contribute to reserves during good times, consequently forcing them to build up reserves during economic downturns? In this article, we document this timing problem with a look at some data for US banks over the past few decades.

The reporting rules that banks follow are designed in part to prevent managers from using reserve accounts to adjust the level (or timing) of the earnings they report. The balance of the reserve account, commonly known as the allowance for loan and lease losses (ALLL), does not have any impact on the bank's earnings. However, when banks add to the reserve account, in a process called loan-loss provisioning, it reduces reported earnings and consequently shareholders' equity. The accounting profession prefers this approach because it produces financial statements that reflect companies' current situations more accu-

Provision for Loan and Lease Losses
(All FDIC-Insured Institutions)



Note: Shaded bars indicate recessions.
Source: Federal Deposit Insurance Corporation/Haver Analytics.

rately. But financial regulators, who are more focused on the safety and soundness of banks, prefer an approach that helps banks accumulate an adequate supply of reserves before they are needed.

The number of problem loans typically rises during economic downturns, as do provisions for loan losses. For example, during the Great Recession of 2008 to 2009, the level of net charge-offs rose to historically high levels, amounting to over $50 billion. Provisions for loan and lease losses spiked sharply during the recession, going from under $20 billion in 2007 to over $70 billion in 2008. In all likelihood, banks were increasing their loan-loss provisions at a time when it was more difficult and costly for them to do so.

Loan-loss provisions represent the bank's expectation of future loan losses, while net charge-offs are actual losses. During the 2008 financial crisis, loan-loss provisions as a percentage of net charge-offs hovered around 187 percent. In the 10 years prior, it had averaged 110 percent. Though elevated during the Great Recession, the level does not compare to that of the savings and loan crisis from 1986 to 1995. In 1987, the ratio was well over 500 percent.

One measure that has returned to pre-crisis levels is the ratio of end-of-period annualized loan-loss provisions to assets, which gives an idea of asset quality. In the years leading up to the 2008 financial crisis, this ratio was between 0.4 percent and 0.8 percent. During the financial crisis, it rose to over 2.1 percent. Since 2013, it has been 0.2 percent.

The Financial Standards Accounting Board (FASB) is in the process of introducing new rules for loan-loss provisioning. The old approach (incurred loss), which does not allow banks to recognize loan losses until the actual default has occurred, will be replaced with a forward-looking, expected loss approach. While the size of the losses will not likely change, the timing of their appearance on the balance sheet will. The new expected loss approach will entail more discretion on the part of bank managers.

References

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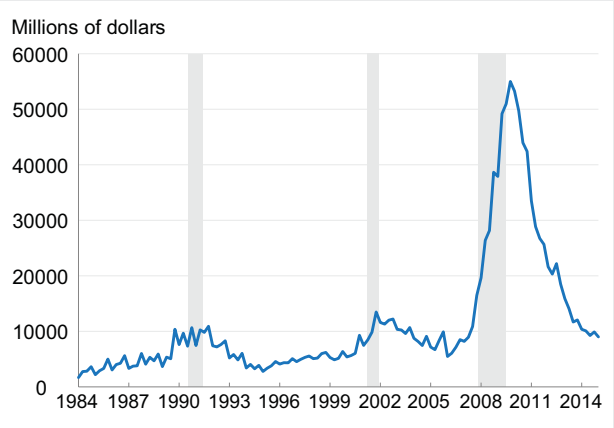
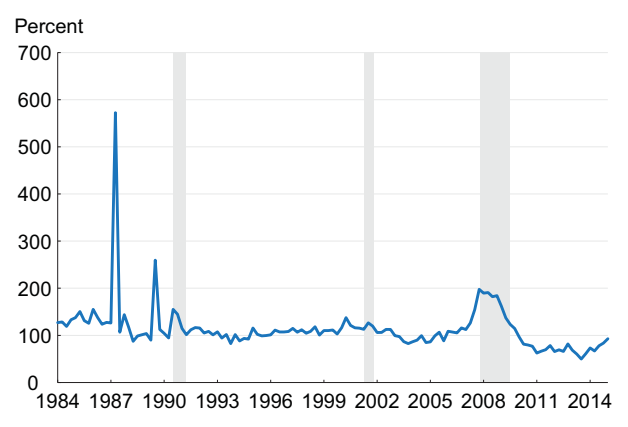
Net Charge-Offs
(All FDIC-Insured Institutions)



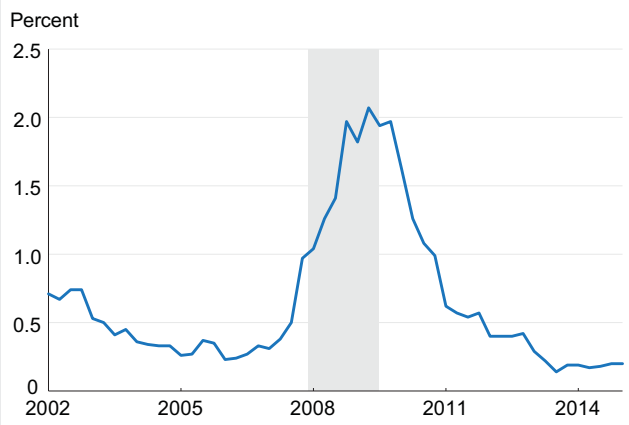
Note: Shaded bars indicate recessions.
Source: Federal Deposit Insurance Corporation/Haver Analytics.

Loss Provision as a Percentage of Net Charge-Offs (All FDIC-Insured Institutions)



Note: Shaded bars indicate recessions.
Source: Federal Deposit Insurance Corporation/Haver Analytics.

End-of-Period Annualized Loan-Loss Provisions as a Percentage of Assets (FDIC-Insured Community Banks)



Note: Shaded bar indicates a recession.
Source: Federal Deposit Insurance Corporation/Haver Analytics.

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