Remarks by

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"Loan Loss Provisioning and Pro-cyclicality"

It's always a pleasure to be here with the members of the Institute of International Bankers. Needless to say, the issue that is front and center for banks around the world is the financial crisis. In particular, banks today confront the reality of large looming credit losses in a variety of asset classes, including mortgages, credit card loans, commercial real estate loans, and many others. In addition to capital, the critical resource that banks have to absorb these credit losses is the loan loss reserve, which is the focus of my remarks today.

We banking supervisors love the loan loss reserve. When used as intended, it allows banks to recognize an estimated loss on a loan or a portfolio of loans when the loss becomes likely, well before the amount of loss can be determined with precision and is actually charged off. That means banks can be realistic about recognizing and dealing with credit problems early, when times are good, by building up a large "war chest" of loan loss reserves. Later, when the loan losses crystallize, the fortified reserve can absorb the losses without impairing capital, keeping the bank safe, sound, and able to continue extending credit.

In theory, the loan loss reserve can have an important macroeconomic benefit as well. By allowing banks to recognize losses early, it should result in charges against earnings (and possibly capital) during the part of the economic cycle when times are good, as banks anticipate higher future losses when the cycle turns negative, and less such charges when times are bad, as banks anticipate lower future losses when the cycle turns positive. In other words, the loan loss reserving process can have the important economic benefit of being "counter-cyclical."

Unfortunately, while that's the theory, I fear the reality has been considerably different. Perversely, as the banking industry experienced a prolonged period of rising and record profits in the booming part of the economic cycle in the earlier part of this decade, the ratio of loan loss reserves to total loans went <u>down</u>, not <u>up</u> – even though there was broad recognition that the cycle would soon have to turn negative. Conversely, when the turn finally did come, and the tidal wave of losses began hitting shore, banks have had to recognize losses through a sudden series of increased provisions to the loan loss reserve, which in turn has more than offset earnings and eaten into precious capital. Stated differently, rather than being counter-cyclical, loan loss provisioning has become decidedly pro-cyclical, magnifying the impact of the downturn.

Now let me be clear: I am not suggesting that banks should refrain now from making provisions to the loan loss reserve as a way to help the economy. As painful as it may be, timely provisioning to the reserve now is critical to staying ahead of losses that are plainly projected to rise; failing to do so would only make future problems much worse.

Instead, I am raising a different set of questions: Why did our loan loss reserving system produce such a low level of reserves at the beginning of this downturn? And what credible changes should we consider to avoid that pro-cyclical outcome in the future?

As to the first question, I think there are several reasons why reserve levels declined as much as they did. One is that some bankers were lulled into an unwarranted sense of complacency by the prolonged period of benign conditions; they did not want to reduce current profits with provisions based on pessimistic indicators of the future. Of course, part of our job as supervisors is to lean on banks to remove their rose-colored glasses when they make reserve decisions, and I can assure you that we did just that.

But there was another, more fundamental constraint that was also at work. Current accounting standards for loan loss provisioning, both here and abroad, are based on the so-called "incurred loss" model. Under this model, a bank can reserve against a loan loss through a provision to the loan loss reserve only if that loss has been "incurred," which means a loss that is probable and can be reasonably estimated. To meet that standard, banks have to document why a loss is probable and reasonably estimable, and the easiest way to do that is to refer to historical loss rates and the bank's own prior loss experience with the type of asset in question. Unfortunately, using historical loss rates to justify significant provisions becomes more difficult in a prolonged period of benign economic conditions when loss rates decline. Indeed, the longer the benign period, the harder it is to use acceptable documentation based on history and recent experience to justify significant provisioning. When bankers were unable to produce such acceptable historical documentation, auditors began to lean on them either to reduce provisions, or, in some circumstances, to take the extreme step of reducing the loan loss reserve by releasing so-called “negative provisions” that counted as earnings.

Needless to say, banking supervisors, loving loan loss reserves as we do, did not like that result. We conferred repeatedly with auditors and accountants in the United States, who assured us that banks were not limited to using historical experience in deciding the appropriate level of the loan loss reserve. In addition, they said, in making these determinations bankers could use their judgment that takes into account other, forward-leaning factors, such as changes in underwriting standards and changes in the economic environment that would have an impact on loan losses.

We repeatedly conveyed these same messages to our banks, with some success. The savvier institutions that worked hard with the process found ways to exercise and document judgmental factors that allowed them to take provisions that were higher than historical experience would imply. Nevertheless, it is clear to me that a number of banks and their auditors have not been adequately aware of the degree to which judgmental, forward-looking factors may be used to justify provisions. It is also clear to me that a number of other banks have felt constrained in their ability to adequately document the use of such judgmental factors. Moreover, when I talk to supervisors and bankers from other countries, it sounds as if, in many cases, that feeling of constraint is even more pronounced, and the use of forward-looking judgment even more circumscribed.

Of course, it’s fair to say that, even using judgmental factors, no banker could have foreseen just how severe the current financial crisis would be or how quickly it would develop. But I suspect if you tried to tell that to the average person who isn’t a banker or an accountant, and who thinks that setting aside money for a rainy day is just a matter of common sense, you'd get very little sympathy. That would have been the case two years ago, when the industry still seemed healthy, but it's especially the case today when taxpayer money is being funneled into banks as capital.

Obviously, the situation involving banks is different and more complicated than a family's financial planning. Still, I think we may have made it more complicated – and perhaps more theological – than it needs to be. If we've learned nothing else from the current crisis – let alone the experience of the eighties and nineties – we should never forget that a loan loss allowance that looks adequate when the economy sustains a long period of growth will look meager when it turns down.

I know that some of you probably are thinking that regulators have never met a loan loss reserve that was large enough, and there is some truth to that. We do frequently find ourselves in the position of pressing for higher reserves than the accountants and bankers would like. I won't apologize for our emphasis on the importance of a strong allowance for loan and lease losses. There is no activity in banking that is riskier than extending credit, and history has shown us time and again how difficult it is to predict loan losses in advance, before they become obvious and before they begin to put a strain on the bank.

At the same time, let me say that I do understand the traditional concerns of the accounting standard setters that, without strict adherence to the incurred loss model, banks might use the proverbial "cookie jar" of loan loss reserves to manage or smooth earnings over time, and in particular, to make unexpected losses look less bad to investors. If distorted in this manner, the loan loss reserve would indeed impair transparency and reduce market discipline, and would be unacceptable to both securities regulators and banking supervisors.

I wonder, however, whether a slavish adherence to a cramped interpretation of the incurred loss model is really necessary to prevent unlawful earnings management. It seems to me that there are other constraints to this practice that can be enhanced to prevent problems, especially in the area of disclosure. If the issue with earlier-in-the-cycle loan loss reserving is ultimately one of transparency, then more robust disclosure of bank reserving methodology and practices is surely one straightforward measure for providing an accurate picture to investors – and bank supervisors have broad authority to require enhanced disclosure. Another constraint is continual scrutiny by bank supervisors to make sure that the loan loss reserve is not being abused for purposes other than appropriate loss recognition. The plain fact is that bank supervisors spend as much time on the adequacy of reserves as they do on just about any other safety and soundness factor when examining banks. That process ought to provide another meaningful check on unlawful earnings management.

In sum, given where we are in the credit cycle, and taking into account all the competing considerations, I think it's high time to ask and answer some hard questions about loan loss provisioning. Does the current interpretation and implementation of the incurred loss model result in the adequate use of forward-looking judgmental factors to permit appropriate early-in-the-cycle loss provisioning? Or does the model itself, by its very nature, prevent that result by allowing loss recognition only when a loss has somehow been "incurred"? If so, is it appropriate and feasible to make changes to the basic approach to allow loss recognition at an early enough stage in the economic cycle to be counter-cyclical?

Right now, a Financial Stability Forum working group is exploring these and similar questions. I believe this focus on reserves is a significant and much welcomed development. The working group, which I co-chair along with Commissioner Kathleen Casey from the Securities and Exchange Commission, includes representatives from international supervisory bodies such as the Basel Committee on Bank Supervision, the Financial Accounting Standards Board, the International Accounting Standards Board, and banking and securities regulators. I am hopeful that the work of this group will ultimately help inform standard setters, supervisors, and policymakers as they continue to focus on the appropriate use of the loan loss reserve, and the appropriate interaction between loan loss provisioning and pro-cyclicality.

While I am not here today to speak for the group or preview its work product, I would like to describe some of my own views. I think we would be considerably better off today if there had not been so many impediments to building larger reserves. Had banks built stronger reserves during the boom years, they would not need to reserve as much now; they wouldn't need as much additional capital now; and they would be in a stronger position to support economic growth. I think there are ways to remove at least some of those impediments while maintaining the integrity and transparency of bank financial reporting.

For example, I think we need to do a better job of telling banks and their auditors, both in the United States and elsewhere, about the degree to which banks are permitted to use non-historical, forward-looking judgmental factors to justify provisions to the loan loss reserve. We also need to clarify that the documentation requirements for doing so are not a case of "mission impossible." While some may believe that this message is already out there, I can assure you that many banks and their auditors thought otherwise when we were at the height of the last credit cycle.

I also think that disclosure of bank reserving methodology and practices, for the reasons I've previously mentioned, should become more robust. If banks believe they need more flexibility to use their expert judgment to recognize losses in the credit cycle, then that judgment should be able to withstand the glare of investor scrutiny as an important check on the process. Pillar 3 of Basel II would appear to be an appropriate forum for developing a consensus on this subject that would have a broad and consistent impact on bank financial reporting around the world.

And speaking of the Basel Committee process, there are currently some regulatory capital disincentives to building reserves. Like capital generally, loan loss reserves serve the important basic safety and soundness function of absorbing losses. Indeed, loan loss reserves are a front line of defense for absorbing credit losses before capital must do so. The current Basel Committee rules recognize this fact to a limited extent by allowing loan loss reserves to count as Tier 2 capital, but only up to 1.25 percent of risk-weighted assets. That's too stingy. Given their primary, capital-like loss-absorbing function, loan loss reserves should get greater recognition in regulatory capital rules, a result that would help remove disincentives for banks to hold higher levels of reserves.

Finally, we should also examine more broadly whether there ought to be changes made to the incurred loss model itself. I think there are particularly strong arguments for a more forward-looking "life of the loan" or "expected loss" concept, where permissible provisions would focus on losses expected over a more realistic time horizon, and would not be limited to losses incurred as of the balance sheet date, as under the current regime. Others have pointed to the so-called "dynamic provisioning" model that has been used in Spain to permit more mechanical increases to loan loss reserves based on loan growth rather than measures of projected loss. While we need more details about how the dynamic provisioning approach actually works in practice, and whether it can really be squared with the fundamental concept of loss recognition, it certainly has the initial appeal of creating greater reserves earlier in the cycle. Still others have suggested that we ought to eliminate accrual accounting altogether and move to fair value accounting for all bank assets as a way to address this issue. While that's not an approach I would favor – indeed, given current experience, I think it would likely produce even more pro-cyclicality – I think all ideas should be aired as we have a vigorous debate to improve the current standard.

Let me close today with one final and important point. Today's news about provisioning isn't all bad. It is a fact that provisions to the reserve are a drag on earnings, and given heavy current and anticipated credit losses, heavy provisions are often leading banks to report significant quarterly losses and material reductions in Tier 1 and tangible capital equity ratios. While none of us likes to see that outcome, I would urge you to focus on the extent to which banks, as they make these large provisions, are not merely offsetting current charge-offs, but are <u>building</u> the loan loss reserve to ever higher levels. As with capital, every dollar of loan loss build is there to absorb future losses to maintain the bank's solvency and stability. And many banks, at least those in the U.S. that we supervise, have built and are building very substantial reserves to supplement their capital base – in some cases amounting to tens of billions of dollars.

We recognize that criticized and classified assets are also increasing at a rapid rate, in some cases outpacing increases to the loan loss reserve. Yet too often critics focus only on the problem assets, and fail to recognize the full extent to which banks have taken steps to address those problems – not just through capital raising, but through reserve building as well. In discussions about the condition of the banking industry, I often hear about levels of Tier 1 capital, or tangible capital, or the leverage ratio, but seldom do I hear total loan loss reserves discussed in the same breath. That should change. We ought to be talking about capital <u>and</u> reserves, and we ought to be recognizing the fact that, where quarterly losses are caused by reserve-building, that's a net result that is positive, not negative. When a bank takes a loss to build a reserve, it is appropriately recognizing problems they see on the horizon, which is all to the good.

The loan loss reserve is a critical resource for maintaining the safety and soundness of banks so that they can fulfill their basic function of financial intermediation. We can improve its usefulness, and we ought to do so now.

Thank you very much.