AMERICAN BANKER®
THE FINANCIAL SERVICES DAILY

Thursday June 28, 2012

BANKTHINK

Let Banks Err on Side of Caution to Prepare for Next Downturn

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Moody's made headlines last week for its downgrade of 15 large banks. But as drastic as it seemed, the announcement was only one part of an ongoing discussion about how banks can survive the next serious downturn.

Greg Bauer, Moody's managing director for global banking, said the ratings changes reflected the "shock absorbers" that each company had. It's no surprise that Moody's and the markets are focused on shock absorbers - bankers and their regulators are focused on it, too. But given the agreed-upon need for a good buffer against downturns, it's baffling that we continue to let accounting orthodoxy, rather than sound banker judgment, drive loan-loss reserves.

I have repeatedly argued - including on these pages - that banks should have flexibility in setting loan-loss reserves. Regulators should set a minimumrequired cushion against losses on nonperforming loans, and then stand back, letting bankers use their best judgment on whether to put more in the kitty.

Until the early 1990s, this was roughly the way that depositories set their allowances for loan and lease losses. Under regulatory accounting principles, bankers applied their judgment to their loan books, and supervisors then did the same. Supervisors focused on whether reserves were sufficient, and did not take issue with bankers who wanted to err on the side of caution.

Then, in a well-intentioned attempt at reform, the rules of the road changed. Regulatory accounting principles went the way of the dinosaur, and loan-loss reserves had to be justified by strict formulas, not managerial common sense.

As one who was part of the "RAP to GAAP" decision, I never appreciated how far generally accepted accounting principles and the standard-setters would go to restrict bank reserves. If I had, I would have never agreed to the conversion to GAAP.

The 2008 financial crisis showed the costs of this approach. During the boom years, many banks wanted a bigger buffer against future losses on their credit portfolios. But they were stopped by new accounting rules, which only let them boost reserves for loans that had sustained "incurred losses." This approach was another symptom of mark-to-market fever, and it effectively capped the amount banks could add to their reserves to address the suspicion that banks were attempting to "smooth out" their quarterly results.

American banks would have been far stronger in 2008 had reserves been higher, rather than being beaten down in the name of an academic preoccupation with income management. The Financial Accounting Standards Board and International Accounting Standards Board recognized this problem, and in 2009 (at the urging of the Group of 20 Finance Ministers and Central Bankers), they started a debate to reform the ALLL process.

The core notion was that reserves should reflect "lifetime expected" losses, rather than "incurred" ones. But that debate has stalled, primarily over a dispute about when to record those reserves on bank balance sheets.

Even then, the debate among accountants doesn't address the main obstacle to proper ALLL management: the premium placed on formulas over judgment.

Bank regulators and bankers understand that bigger reserves are often better, and that banks shouldn't be kept from taking precautions against loss. But bankers are loath to take steps that might upset the people who set accounting standards, including securities regulators.

Furthermore, the FASB/IASB process still encourages bad habits in reserve allocation. On its own, the process is pro-cyclical. In good times, when potential losses are less identifiable and optimism is high, there is an incentive to draw down reserves. In bad times, when incurred losses are visible, banks are expected to increase reserves.

These are the wrong medicines at the wrong points in the process. As policymakers try to wring pro-cyclicality out of the financial system, reserve-setting is the perfect place to start.

Banks are constantly criticized for their failings, but they can only do as well as public policy lets them. We should give banks the discretion to raise their loan-loss reserves above a reasonable floor.

Bank balance sheets are transparent, and analysts and the public alike can clearly see what institutions do with their loan-loss reserves. With a close eye from supervisors and a healthy capital buffer, banks should be allowed to keep their own house in order, and exercise judgment on an enormously important area of prudential management.

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