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LETTER OF COMMENT NO. 1A

The Editor
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To the Editor:

Building Loss Reserves in Good Times

Comptroller of the Currency John Dugan forcefully proposes that we need “stronger reserves during the boom years” (“Dugan: Turmoil Shows Need for Reserve Leeway,” March 3). Former Comptroller Gene Ludwig points out that “accounting rules caused many banks to enter this down cycle with inadequate reserves” (“Crisis Demands Flexibility on Accounting,” February 25). Thus they both enter the jousting with the SEC and the FASB over whether during credit expansions, when current delinquencies and losses are low and everybody is feeling happy, that indeed precisely because of this happiness, greater loss reserves are necessary. In the wake of the global bust, this has become a global debate.

To put the whole issue in perspective, just imagine the crusty old chief credit officer pronouncing to the aspiring young banker (me): “*Bad loans are made in good times.*”

This eternal financial truth is all you need to know in order to understand why Messrs. Dugan and Ludwig are right and the accounting theoreticians of the SEC and the FASB are wrong yet again. When the latter oppose building reserves in the aforementioned good times, they claim this would mean “cookie jar accounting” during periods of bumper profits. But the essential point is that the “bumper profits” of the credit expansion are not real—they are an illusion of the good times.

This illusion then turns into real cash outflows: big bonuses, dividends, and outsized stock repurchases, thus higher leverage. It reflects the human tendency noted by Henry Thornton in his 1802 classic on the “Paper Credit of Great Britain”: “A high state of confidence contributes to make men provide less amply against contingencies.” Nothing has changed in the intervening 200 years, including the fact that banking always faces plenty of contingencies to be provided against.

The real profit is much less than the illusion because of the inevitable losses the good time loans will create, even though you can’t see them yet in particular. Not to reserve against them is as foolish as not reserving against a life insurance policy because the insured didn’t die this year.

George Champion, the Chairman of Chase Manhattan Bank in the 1960s, recommended in 1978 that banks “increase the reserve for bad debts to a point of having at least 5% of total loans. This would not be out of line with the enormous losses that had to be written

off in the last few years,” he observed three decades ago, and continued, “Don’t apply for privileges in Washington. You lose your strength. You lose your independence. Don’t get in a position where you are going to have to rely on the government to bail you out.”

Well, with more old-fashioned reserves, we can do better in the next cycle.

Yours faithfully,

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