

Opening Statement of Emory W. Rushton
Concerning Loan Loss Reserves
Before The Subcommittee on Financial Institutions
Committee on Banking and Financial Services
June 16, 1999

Good morning, Madame Chairwoman and members of the Subcommittee.

In addition to being the Senior Deputy Comptroller for Bank Supervision Policy, I've also been a national bank examiner for 34 years, and I appreciate this opportunity to present the testimony of the Office of the Comptroller of the Currency on the important issue of bank loan loss reserves.

History has shown us repeatedly that loan losses are awfully hard to forecast before they become obvious. Bad loans have been the primary cause of almost all bank failures. Deficient reserves put an inappropriate burden on bank capital and increase the risk to the federal deposit insurance fund and ultimately, the taxpayer. For that reason, it's critical that we closely scrutinize any action that could have the effect of causing banks to lower their reserves.

We at the OCC do not believe there's a widespread problem with excessive loan loss reserves. Bank examiners, who are the **best-positioned to know**, have not reported such problems. Neither have the certified public accountants who review financial institutions' reserves and statements for compliance with Generally Accepted Accounting Principals. Moreover, we're **especially** concerned that this debate comes at a time when credit risk in the system is **increasing**.

The SEC's primary mandate of investor protection, and the banking agencies' concern with safety and soundness, are not in conflict or mutually exclusive. Indeed, conservative reserving practices that protect a bank's capital also protect investors. The best antidote for concerns about the possible *misuse* of loan loss reserves is clear and consistent guidance by all the agencies on reserve process, documentation, and disclosure.

Loan loss reserves play a critical role in the health of the banking system.

Simply stated, a bank's reserve should be management's best estimate of how much money the bank will lose on the loans it's made.

A bank creates and replenishes its reserve by charging a loan loss provision expense against income and setting that amount aside in a separate account on the bank's books. The reserve does not count as part of the bank's equity capital, and the bank may not use it for any purpose **other** than absorbing loan losses. When a loan goes bad, the bank deducts it from the reserve.

At least quarterly, a bank has to reassess whether the amount remaining in its reserve is appropriate, given the amount of estimated losses it has left. Many factors play into that analysis, including economic trends and other environmental influences. And the whole process is highly subjective.

Madame Chairwoman, it is fair to say that the bank and thrift failures of the 80's and early 90's are still fresh in the minds of most bankers, and as a result, most of them have tilted toward maintaining **healthy** reserves to provide a margin for error. Indeed, the bank regulators have consistently encouraged them to do so.

For example, when I began my present assignment two years ago, one of the very first things I did was send a letter reminding bankers of the need to maintain capital and reserves commensurate with their risks.

But this does **not** mean that banks should engage in pure speculation about losses. Nor should they in any way manipulate their reserves to achieve some predetermined path for earnings or to otherwise deceive investors or regulators.

Because no banking activity is riskier than lending money, our examiners spend a major part of their time evaluating loans and the bank systems that produced them.

These examiners are especially trained in credit analysis, and they include specialists with state-of-the-art skills at analyzing particular forms of lending.

We also have a staff of Ph.D. economists who back up our examiners with computer-based models designed to predict the risk of default and loss in loans.

Our examiners are on-site **full-time** at the largest national banks, and at least once every 12 to 18 months at smaller banks. And while we're interested in the bank's own analysis of its reserve and the work of its outside auditors, we do **not** rely entirely on them to reach our conclusions. That is, we independently test the adequacy of the bank's reserve *ourselves*. We dig into the loan files - analyze financial statements - check loan covenants - and evaluate collateral. We also evaluate the bank's loan loss reserve methodologies and the quality of the documentation.

If we find a bank to be significantly over- or under-reserved or lacking proper documentation, then we carefully discuss that with the bank's management and directors - and we require corrective action.

Based on these direct assessments, our opinion is that national banks, as a group, are not materially over- or under-reserved. That's why we're so concerned about any action that might have the effect, albeit unintended, of applying general downward pressure on bank reserves.

Madame Chairwoman, I've submitted a fuller statement for the record, including answers to the questions posed in your letter of June 8, and I'll be pleased to respond to any additional questions the Subcommittee may have today.