The 1990s recession was the first post-war recession in which banks did not use an agreed methodology to smooth the impact on profits of bad debts. In previous recessions, in particular of the mid-1970s and early 1980s, banks used a provisioning methodology known as Leach Lawson, which was an unabashed (and undisclosed) mechanism for smoothing the charge to profits.

Leach Lawson was not a statistical process — it required a detailed review of individual loans. The difference between the aggregate provisions produced by this review and what was carried in the specific provision, net of writeoffs and recoveries, was the notional charge or credit to profit. However, that amount was not fully charged or credited to profit. Rather, the average of that amount and the similar calculation for the preceding four years was passed to profit.

In a cyclical downswing, the averaging effect meant that the charge to profit was insufficient to get the specific provision to the level required by the loan review. The shortfall was made up by a transfer from the general provision. The general provision acted as the cyclical buffer.

During the high point of the business cycle (as at present), credits are likely to flow through as the specific provision falls away, particularly if there are good recoveries. Under Leach Lawson, the averaging effect would actually keep the charge to profit at a higher level (because of the experience of the previous four years) and, moreover, where that charge to profit resulted in the specific provision being at a level above that required by the detailed review of loans, the surplus would be credited to the general provision to build it up. Leach Lawson used the general provision to cushion the impact on profits of the downswing of the business cycle and, in return, in the upswing profits were “smoothed” to replenish the provision.

Leach Lawson also required a separate “standard” charge to profit each year to fund the general provision and that charge was related to the level of lending assets. In some Australian banks in the 1970s this charge was more than 1 per cent of average lending assets.

The weakness with Leach Lawson was that in a very severe recession the general provision might be wiped out by the call from the specific provision. This was where in those days the undisclosed contingency reserve came into play: a transfer would be made from the contingency reserve to the general provision to reinstate it to an appropriate level. Profits were not affected. In today’s world, on the other hand, such a top-up of the general provision would come from profits.

Leach Lawson was a model developed by a well respected accountant and a Queen’s Counsel! However, it was essentially an economic model rather than an accounting standard. The IT systems of those days did not allow detailed statistical and portfolio analysis but the model sought to recognise the fact that bank profits, particularly the profits of major banks, were closely linked to the business cycle.

In the mid-1980s, Leach Lawson was discarded. Much pressure existed at that time for banks to comply fully with accounting standards. The Australian accounting bodies essentially saw banks as being no different from other industries. Banks moved to a provisioning
LEADERSHIP

approach based on a detailed review of loans underpinning the specific provision, and the general provision just sat as a reserve, albeit at different levels for different banks. The accounting profession showed no leadership in developing standards for financial institutions and the Reserve Bank was of little help.

The 1990s recession hit with a vengeance and the provisioning approach of the industry was found wanting, as were those associated with it, such as the Reserve Bank and the accounting profession. Lessons were learned, though, and there is now, at the top of the current business cycle, a lot of discussion about what changes need to be made before the next economic downturn.

That leads us to the future and to the recent discussion about so-called "dynamic provisioning". What in fact is it?

Dynamic provisioning is a term to describe a view that provisioning should look to the past (historic loss ratios, etc) and the future (economic forecasting) as well as at the present. Regulators do not like volatility and they are taking a keen interest in the present debate. Brian Quinn, head of supervision at the Bank of England, has stated that banks should consider provisioning policy with a view to smoothing out the differences between reported and actual profits over the life of the loan book. The Reserve Bank of Australia also has provisioning policy on its agenda, following guidelines already issued on impaired-assets reporting and risk-grading of loan books. The present stage of the economic cycle and the healthy profits of banks make the debate very timely and convenient.

A degree of philosophical discussion underpins the debate. Should provisioning take account of future economic events (inflation, GDP growth, etc) or should it be based solely on current knowledge? Does the former inject too much subjectivity into the results of banks? From the viewpoint of one who has seen the recessions of the seventies, eighties and nineties come and go, it is clear on grounds of prudence that provisioning should reflect some key judgments about where the economy is going. If it does not, there could be some nasty surprises ahead.

The focus of the debate in Australia seems to be whether the general provision will play a different role. Westpac has already moved down that track and it is hard now to understand the difference between its general provision and its specific provision. With the other majors, the general provision is still a free provision that counts as Tier 2 capital. Does all of Westpac's general provision really count as Tier 2? If it does, should it continue to do so when bad debts are being written off against it? The Westpac model implies that a part (unknown) of its general provision is in fact earmarked for known credit risk, in the same way that LDC debt general provisions cover LDC debt risk. Such provisions do not count as capital.

An alternative to the Westpac model is to have a provisioning policy that requires a calculated level of additional provisioning, held within the specific provision, for "known" losses, based on past experience, portfolio analysis, economic trends, etc. A good example of this is the Bank of England's methodology for calculating LDC debt provisions. Such provisions are not treated as free general provisions and tend to be included within specific provisions or, if not, clearly disclosed. The key issue is to separate in the financial statements the free general provision (based on some arbitrary percent-

age of risk-weighted assets such as the current "informal" 0.5 per cent) from the earmarked additional provisioning over and above the usual specific provision.

Thus, just as Basle is talking of three tiers of capital to accommodate market and interest-rate risk, we may be moving towards three tiers of provisions: specific (based on detailed loan review), additional specific or earmarked general (this will need a title) and traditional free general. The methodology to be used to calculate the middle tier is the subject of much thought and IT investment. And just as Basle has indicated that it is willing to rely on the internal risk models of banks to calculate capital for market and interest-rate risk, subject to those models being approved by supervisors and specifically audited by internal and external auditors, one would expect a similar approval and audit approach for models used to determine the "earmarked general provision".

Disclosure of the earmarked general provision will be the focus of analysts, regulators and shareholders. The provision should not count as capital but should be tax-effected. It may be that the debate leads to a view that the traditional free general provision should now be written back to reserves, a suggestion that the author would not support until in possession of a very good feel for the robustness of the earmarked general provision.

There does seem to be agreement that provisioning methodologies can benefit from modern IT capacity, that Leach Lawson did have one thing going for it when it sought to have regard to the economic cycle and, last, that provisioning in the 1990s recession was poorly done (for valid reasons such as failure to anticipate the severity and nature of the recession).