

# THE IMPORTANCE OF SECRET AND INTERNAL RESERVES FOR THE BANK

by

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1. The object of this paper is to discuss the significance of „undisclosed reserves” (as I prefer to call them) in the world of banking. In this connection we are entitled to confine our attention to commercial banks. Other types of banking house — savings banks, coöperative banks, mortgage banks and so on — may have occasion to accumulate reserves which do not appear in their published balance sheets. But there is no ground for supposing that conduct of this sort plays any considerable part in their business policies: from the present point of view they are rather to be classed with ordinary industrial companies, commercial concerns, transport undertakings and the like than with the banks here specially to be considered.

By a „commercial bank” I mean a bank which is primarily engaged in the business of short-term lending and borrowing. Commercial banks in addition, however, may hold or deal in long-term securities, they are certain to do business in the foreign exchange markets, and they may also take part in financing and underwriting new capital flotations and even (in some countries) in the control of industrial enterprises.

We shall also confine attention to the large joint-stock banks, leaving on one side the smaller „private” banks. Not merely are the latter of far less importance than the former (both in respect of influence on market conditions and in respect of the volume of business transacted), they are also free from the necessity of publishing annual accounts and reports, and therefore the distinction between „disclosed” and „undisclosed” reserves has no meaning for them.

That the large commercial banks do in fact pursue the policy of accumulating more or less substantial undisclosed reserves is a familiar and indeed universally admitted fact. It is also possible to describe with reasonable certainty both the main forms which these reserves may take and the purposes which they are designed to fulfil. On the other hand since the whole point of undisclosed reserves is that their amount, if not their existence, shall not be revealed to the general public we cannot expect precise information as to either the proportion of such reserves to the banks’ total resources, their distribution among the various forms they may take, or the extent to which they are liable to fluctuate from year to year. If in what follows we are forced to rely upon somewhat vague generalisations we may nevertheless achieve a reasonably clear picture as to the „qualitative” significance of undisclosed reserves for the business of commercial banking.

2. It can be said of commercial banking both that it requires undisclosed reserves more urgently than do most other types of business and that it is peculiarly well situated for accumulating and holding them.

Undisclosed reserves are important for any firm or company when and to the extent that two conditions are fulfilled at the same time. First, the business on which the firm is engaged must be „speculative” — not necessarily in the sense of involving grave risks of ultimate loss from a long-run point of view, but in the sense of being subject to more or less serious fluctuations in profitability *from year to year*. Secondly, the firm must require for successful operation to have the *reputation* of being stable and unspeculative.

(Notice that it is the *combination* of these two circumstances which is decisive from the point of view of undisclosed reser-

ves. Neither is sufficient without the other: for if a business is non-speculative in the sense of not being subject to annual fluctuations it hardly needs to accumulate „reserves” at all; while it, being speculative, it does not need to conceal this fact, then the reserves it accumulates will fulfil their functions better if they are plain for all to see than if they are concealed from view.)

Now it is at once evident that these two conditions are pre-eminently realised when the business in question is that of commercial banking.

(i) Banking is a „speculative” business. Everybody is aware, of course, that it endeavours not to be in any bad sense. All reputable bankers do what they can to avoid entering upon transactions which are recognisably hazardous: they are averse to making loans except on first-class security, they will not buy or discount bills of doubtful origin, in many countries they refuse to participate in enterprises by owning industrial common stock, they dislike long-term commitments in the form of even the most reliable debentures or mortgages — in a word their prime object is to be conservative, liquid and safe. Nevertheless theirs is a business which is peculiarly susceptible to fluctuations, and their profits cannot help varying greatly from year to year.

Some of the functions they fulfil are in themselves bound up with risk and uncertainty — e.g. they cannot avoid the possibility of losses in the field of foreign exchange business, while those of them are prepared to assist in floating new capital issues must always face the danger that securities they have underwritten will be left on their hands. Again they are not safe against fraud; more than one recent case is painfully in the memory of all of us in which banks have advanced large sums to unscrupulous financiers on the strength of securities deposited with them which have turned out to be forged and worthless. Finally, over and above and more important than these specific hazards, we have to remember that the profitability of banking is no less sensitive than that of other types of business to the ups and downs of general economic conditions. A slump in trade will characteristically hit banks in at least three ways: (a) by reducing the *volume* of profitable business; (b) by reducing the profit on each unit of business undertaken (owing to lowered interest rates); and (c) by raising the incidence of bad debts.

So that however prudently a banker carries on his work he cannot possibly hope to achieve stability in his annual returns: his profits are *bound* to display wide variations from year to year.

(ii) But these variations must not be allowed to shew themselves to the outside world. For in the present state of public opinion if a bank were to admit in its published accounts that it had passed through a bad year — if it were to lower dividends or to maintain them by drawing at all substantially on declared reserves — it would run a grave risk of losing the confidence of depositors; and once that happened it would have to close its doors.

There is here a clear difference between commercial banks and most commercial or industrial concerns. In the case of the latter an appearance of stability is as a rule not much more than a matter of convenience. It enables them to obtain credit rather more easily, it eliminates unnecessary fluctuations in

the market value of their shares, it conduces to peace and good temper at the annual shareholders' meetings — but the work of production and the volume of business done need not be vitally affected by such considerations. In the case of banks, on the contrary, a reputation for stability constitutes a prime necessity. The banker *dare* not risk arousing questions as to his financial standing. He must not appear, therefore, to have done badly in any year, because a declared net loss on the year's working — or even a substantial reduction in declared net profits — though *in fact* neither endangering his financial soundness nor reflecting on his business prudence might yet lose him his most vital asset — the confidence and good will of the public.

So it comes about that undisclosed reserves represent an indispensable part of commercial banking equipment. They are the means — the only possible means — whereby the inescapable fact of fluctuations can be made to wear the appearance of security and stability.

3. With this we come to our second main topic. Not merely are undisclosed reserves more important for banks than for most other types of enterprise; banks have also at their disposal a far larger variety of methods whereby such reserves can be accumulated.

Outside the banking world undisclosed reserves naturally tend to take the form of writing down fixed assets: non-depreciating assets are treated as though they required depreciation allowances, depreciating assets are written off at an unnecessarily rapid rate. Other methods are of course available, but these may be regarded as the most typical and universal.

But now consider the case of banks. They too have expensive buildings and fixtures which they can undervalue in their balance sheets. But in addition they have at their disposal at least three other methods of accumulating and holding reserves without appearing to do so. (i) They can undervalue their investments — e.g. by carrying at par in their books securities which stand at a premium in current market quotations. (This method is of course also available to industrial and commercial holding companies.) (ii) They can make over-provision for bad debts and other contingencies. Provisions for these purposes must in any bulk large in a bank's affairs, and it is easy to make them larger than is actuarially necessary without that fact's becoming apparent to the outsider. (iii) They can write up and exaggerate their deposit liabilities.

The above list by no means exhausts the devices open to banks for building up undisclosed reserves, but it may be taken as representative and as including the most important methods actually employed.

Now from the bank's point of view the traditional method of writing down fixed assets has one great disadvantage as compared with at least the first and the third of the alternative methods above listed. It is well enough to *accumulate* a secret reserve by undervaluing your buildings, your sites and your fixtures. But suppose that you wish to draw upon these reserves! You must then write up the value of the fixed assets you have previously written down; and anybody comparing your new balance sheet with previous balance sheets may begin to ask how it comes about that buildings etc. valued at (say) £ 1,000,000 last year have recovered to £ 1,500,000 this year. The answer of course might be that in the intervening months new branches have been opened or extensions have been effected in the Head Office. But activities of this sort would hardly be passed over in silence in the Directors' Report, and in the absence of an enthusiastic account of the way in which developing business has required and justified more extensive premises no serious student of the Balance Sheet

could fail to draw his own conclusion when observing a sudden increase in the book value of the bank's fixed assets.

So far as banks at least are concerned, therefore, undisclosed reserves in this particular form are perhaps less useful than might at first sight be supposed. A bank must be able not merely to accumulate and hold such reserves, it must also be able to draw upon them (when the need arises) without revealing that this is happening: secret reserves are of no use unless they are capable of secret utilisation.<sup>1)</sup>

In the light of this consideration we may venture to cast doubt on the appropriateness of the most familiar and often quoted of all allegedly „secret” bank reserves. In the published accounts of the Bank of England, we all know, no mention is made of the immensely valuable site occupied by the Bank itself in the City of London or of the building standing thereon. A magnificent secret reserve? Formally, yes. But if the Bank were to seek to utilise this reserve by adding a few million pounds to its balance sheet assets in respect of „buildings and real property” the shock to public confidence would certainly not be less than if it were to reduce its dividend disbursements or eat into its „Rest” (declared reserves).<sup>2)</sup>

greater or less extent escape this difficulty. Over-providing for bad debts and contingencies is perhaps a little dangerous from the present point of view, since a sharp drop in such provisions might (like writing up fixed assets) give rise to the very suspicions as to the soundness of the bank's position which the existence of „secret” reserves is designed to avoid. But if the balance sheet (and/or the profit and loss account) is drawn up in such a way as to scatter the various provisions in the form of not separately stated deductions from credit items a good deal can no doubt be done to utilise such reserves without allowing this to become generally known.

So, too, and even more clearly, with the undervaluation of investments and the overvaluation of deposits. If a bank owns securities which stand on its books at less than the current market price it can at any time sell off a block of these equivalent to the difference between the book value and the market value of its total holdings, without having to admit any change in this item in its balance sheet. (In fact banks may never adopt this method of secretly drawing upon secret reserves, but I can see no objection to it provided at least that (a) the bank can prevent the fact that it is selling securities from becoming generally known, and/or (b) there is no ground for fearing that the selling of securities will itself be regarded as unorthodox and a sign of weakness.)

The method of writing up deposit liabilities is (from the present point of view) the simplest and most flexible of all. Here all the bank has to do is to set up some account or other — let us say a „guarantee account” — which it credits with sums of the desired amount, these credits being then included among its liabilities in the balance sheet. It can then draw upon this account whenever the need arises, its declared deposit liabilities will automatically fall to the corresponding extent, and nobody who does not have access to the bank's ledgers and account books can possibly be any the wiser.

It seems clear that the use of this device has been growing during the last twenty years, and it perhaps by now represents the main method of holding fully available undisclosed reser-

<sup>1)</sup> This proposition has been disputed but seems to me incontrovertible.

<sup>2)</sup> The question of valuing the Bank of England site and building is of course rendered appallingly complicated both by the position of the Bank as a „central bank” and by the fact that the value of the Threadneedle Street site (as of adjacent sites) is in no small measure due precisely to the fact that that is where the Bank of England has its headquarters. But these problems lie far outside our present theme.

ves, at any rate among British banks, (The balance sheet item commonly reads nowadays: „Deposits with accrued interest and other credit items.”)

4. Finally a word or two may be said as to the wider significance of undisclosed bank reserves. I am not competent to discuss how far the various devices above listed can be defended or justified from an accounting point of view. But one or two broad economic considerations are worth referring to.

In the first place we are sometimes told that building up undisclosed reserves is of importance for banks not merely as a means of concealing net losses or reduced profits in bad years but also as a means of understating profits in exceptionally good years. The ground for this view is that if a bank admits having made really high profits in any one year its customers may conclude that it is charging too much for its services and may therefore demand lowered interest rates etc., even though *in fact* the high profitability of the year in question proves to be a purely temporary phenomenon. Such an argument is, however, two-edged. Under modern conditions banks cannot escape a certain amount of more or less ill-informed criticism whatever policy they pursue. They certainly do not render themselves immune from such criticism by concealing the fluctuations in their annual profits; for by regularly declaring comparatively high dividends in times of slump no less than in times of boom they may and in some quarters do incur obloquy as profiteers and Shylocks who insist upon their pound of flesh no matter what the economic situation of their debtors may be!

It can be argued, in fact, that banks tend to be too sensitive to public opinion and as a result carry too far their policy of concealing the fluctuations in the volume and profitability of their business. After all there is no discredit in not making exactly equal profits every year — and what are *declared* reserves for if not to even out the fluctuations in net annual profits and so to maintain a reasonable degree of constancy in dividend disbursements? If undisclosed reserves are used for this purpose then the declared reserves degenerate into mere ornaments: they may serve to maintain the illusion of stability but are not in fact available for their proper purpose.

And this raises a still wider issue. The mere fact that banks are *known* by everybody to hold undisclosed as well as open reserves may of itself be sufficient to destroy much of the usefulness of the former. Any member of the general public studying the published balance sheets must then be

aware that these do not represent the true financial position of the banks concerned; and if he is really concerned to know about that position, whether as a potential investor in the banks' shares or simply as a depositor, he will be inclined to dismiss the published figures as mere „window-dressing” and rely upon more or less ill-informed general market opinion. In this way public confidence in the banks may come to be subjected to precisely those rumours and scares which undisclosed reserves are intended to withstand and deprive of influence.<sup>3)</sup>

When it is generally known that a bank has sunk several millions of pounds in irrecoverable loans to a fraudulent financier what is the public to think on finding no apparent traces of this loss in the bank's published profit and loss account? At least one reaction is certain: that the published accounts, however correctly drawn from a strictly auditing standpoint, are yet designed to conceal rather than to display the bank's real strength — or its real weakness.

I have deliberately stated these points in a somewhat one-sidedly extreme form. Their practical significance must not be placed too high. But they serve to underline the important conclusion that in the last analysis to accumulate reserves without disclosing them is a form of misrepresentation. No doubt they misrepresent on the right side: it is better from the point of view of society that if there must be concealment it should be concealment of strength rather than of weakness! No doubt, too, the object of the misrepresentation is in itself perfectly reasonable and defensible — for so far as banks are concerned we need not take into account the possibility of undisclosed reserves' being used as a means of facilitating illegitimate speculation in their shares. Nevertheless they bring it about that the published accounts of the companies accumulating them falsify the financial position of these companies. A complete defence from a social-economic standpoint of the policy of accumulating undisclosed reserves would have at the outset to controvert the view that where companies offer their shares for subscription and purchase by the public (and where banks declare themselves ready to accept funds on deposit from customers) the public (and the customers) have the right to know *as accurately as possible* the financial position of the company (or the bank) in question.

<sup>3)</sup> Window-dressing is of course a common if not universal feature of periodically published bank returns. It probably does no harm by now — but only because everybody knows about it and it is therefore no longer capable of exercising any influence at all. If it did have an influence the latter would be in the direction of misleading the public.

## DE STILLE RESERVE EN DE NEDERLANDSCHE FISCUS

door

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Oud-Inspecteur der Dir. Bel. enz.

Ongetwijfeld zullen in dit nummer een of meer auteurs er-naar streven de begrippen stille en geheime reserve zoo zuiver mogelijk te omlijnen, zoodat ik mij in de inleiding ertoe bepaal, even het terrein te verkennen, dat zal moeten worden geëxploreerd.

Een stille reserve ligt verscholen in een waardeering van het activum beneden zijn werkelijke waarde of in een te hooge waardeering van verplichtingen en risico's. Of men al dan niet een stille reserve aanwezig acht hangt dus uiteraard af

van de werkelijke waarde, die men aan de bezitting toekent. En dan komt de vraag of en in hoeverre de vorming van stille reserves kan worden aanvaard.

Van fiscaal standpunt beschouwd dienen wij te onderscheiden de stille reserves die door den fiscus voorloopig zullen worden aanvaard en eerst bij realisatie van het actief of bij de afwikkeling van de verplichting de winst zullen verhoogen; daartegenover staan dan die vormen van lagere waardeering dan de werkelijke waarde, waarop door den fiscus een cor-