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Bank loan loss reserves are high. What that means for the economy and earnings

Banks spent much of 2023 bolstering their balance sheets for a recession that never came. If the economy keeps holding up, that could turn into a win for investors in the year ahead.

Loan loss reserves have perked back up in recent quarters and are at roughly 1.75% of loans outstanding, according to MRB Partners. That's above a pre-Covid average level of between 1.20% and 1.25%.

"From some prodding from the regulators, as well as some conservatism from the leadership of many banks, they pre-provisioned on the risk that there might be more substantive loan losses. And those just largely haven't materialized," said Bob Elliott, CEO and chief investment officer at Unlimited Funds and former investment committee member at Bridgewater.

Banks set aside an estimated amount of loan losses ahead of time, which decreases their earnings in the quarter that the provision is made.

If the economy only modestly slows, as many economists expect, new loan loss reserves could be smaller in the future. In that case, a bank could even roll back its prior allocation, improving quarterly earnings.

"Banks could even draw down their reserves as charge-offs materialize if they become confident that the worst of the loan losses associated with office real estate are behind them and there is no significant contagion to other property markets," MRB strategist Salvatore Ruscitti said in an April 25 note to clients.

This situation comes as bank earnings were generally better than expected for the first quarter. Bank stocks struggled in April but have found their footing in May, with the SPDR S&P Bank ETF (KBE) up 7.5% month to date.

"In our view the market's initial focus on the lack of upside surprises in [net interest income] was shortsighted and missed the more important takeaway, which is that the outlook for overall bank earnings is one of ongoing resiliency," Ruscitti added.

Lauren Goodwin, chief market strategist and economist at New York Life Investments, agreed that a potential slowing or reversal of loan loss reserves would be positive for bank earnings but said she is cautious about bank profitability more broadly.

The yield curve is still inverted, meaning short-term interest rates are higher than longer-term ones. That’s tricky for banks that typically borrow short to lend long.

“It’s hard to know what enough [reserves] is. I think the challenge for banks is that as long as the yield curve is inverted, it’s just really hard to be profitable,” Goodwin said.

To be sure, banks may need to increase their loan loss reserves if the economic outlook gets worse. The ratio of those reserves to total loans is still well below the levels it reached in the last two U.S. recessions, according to MRB.

“Even though banks are overprovisioned in general, they’re not highly provisioned relative to say a meaningful economic downturn,” Unlimited’s Elliott said.

Pressures on the commercial real estate sector, and in particular office buildings, also cloud the outlook for banks. Some regional banks have heavy exposure to that market, which has seen buildings in major city centers sell at significant markdowns in recent months.

“If anything happens in commercial real estate, it won’t happen the way we think,” Goodwin said.

Commercial real estate could be less of a concern for the biggest banks and the so-called super regionals, which is the preferred way to play the sector for MRB, Ruscitti wrote.