Miguel Fernández Ordóñez: Weiß und Rot – the cycle, central bankers and supervisors

Address by Mr Miguel Fernández Ordóñez, Governor of the Bank of Spain, at the "World Currency Regime – to Float or not to Float" session, 18th Frankfurt European Banking Congress, Frankfurt am Main, 20 November 2008.

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Let me begin by thanking the organisers of this edition of the Annual European Banking Congress for the opportunity to address such a distinguished audience on the subject of the cycle, central bankers and supervisors. I will be talking about "Weiβ und Rot" and not exactly about wines.

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Numerous factors have played an important role in triggering the current crisis: the subprime mortgages, the highly complex securitisation structures, the originate-to-distribute model, the over-reliance on rating agencies, risk valuation models that few could understand, etc. Many of these mistakes have been identified over the past 15 months by the authorities and by financial institutions themselves. Some regulatory reforms are already under way in the EU and overseas, while the financial entities themselves are reviewing their risk management. We can be sure that the next crisis will not be like the current one. But it is naive to believe there will be no further expansions and slowdowns. For 5,000 years now, since the Pharaoh asked Joseph about the meaning of a dream in which he saw seven fat and seven lean cows, we have known that the economy is unequivocally cyclical. Perhaps we have made some progress over these 5,000 years, since it seems that the years of plenty are now somewhat longer than the lean years. But little more than that.

As central bankers and supervisors, we cannot therefore conceive of doing away with cycles. But we may try to reduce their intensity and effects, and I do honestly believe we can.

Each cycle is different, but the severity of recessionary problems arises from two main sources. First, the excessive leverage of economic agents. And further, the weak position from which financial institutions face the downturn. On one hand, due to the problems stemming from excessive credit growth. And on the other, because banks do not take advantage of the years of plenty to build up reserves or provisions. With less leverage, and greater resilience on the part of banks, we will not avert cycles, but we will experience cycles that are less painful for our citizens.

There are two ways in which we can act both as central bankers and as supervisors. As central bankers, we can avoid explosive growth in debt. And as supervisors, we can demand more thrifty behaviour from our banks. I will develop these two arguments in my speech.

The procyclicality of credit and debt is a familiar phenomenon to economists. During cyclical upturns, a breeding ground for excessive optimism and, subsequently, the widespread underpricing of risk tends to develop. The financial markets behave as if risk falls during upswings and grows during recessions. It is curious, for example, to see how the usual indicators of risk premia – such as CDS, bond spreads and so on – tend to touch bottom around cyclical peaks. However, the reality is quite different. During recessions risks do not increase; they simply materialise. And they do so after having built up during the boom.

During expansions, households and firms tend to overestimate the future growth of their income and raise their degree of leverage in an attempt to bring their current spending patterns into line with this expected flow of future income. Banks, likewise short-sighted, also overestimate the ability of their borrowers to pay and their own ability to find, at low cost, the funding needed to meet the growing demand for loans.

When the downturn sharply curtails optimism and borrowers and lenders suddenly revise their expectations, the full scale of the imbalances that have built up emerges, triggering financial pressures that fuel – and are in turn fuelled by – the cyclical slowdown, setting in train a vicious circle that ends in deep crisis.

Admittedly, this harmful effect of real growth on credit growth cannot be avoided; but it can be mitigated by means of a monetary policy that takes it into account. Central banks can help reduce the negative effects of an excess of credit growth if they apply a monetary policy that is oriented to maintain price stability in an horizon long enough as to account for this cyclical behaviour of debt, thereby ensuring that the effects of the crisis are not so devastating for households and firms.

Indeed, this should be of particular concern since we know that a monetary policy successful in containing inflation can also contribute to increase household and corporate leverage. A successful inflation fighting monetary policy manages to anchor agents' inflation expectations. In such a setting, the demand-side excesses that tend to be generated during cyclical upturns do not translate – or do so only very slowly – into inflationary pressures. Consequently, central bankers do not consider it necessary to tighten monetary policy, so that interest rates remain very low and continue to fuel the cycle and the consequent expansion of credit and debt.

White (Weiβ in German), which is not only a type of wine but also the name of the chief economist of the BIS who retired last summer, has been calling in recent years for the introduction of financial stability considerations into monetary policy design and implementation. And we should acknowledge that the latest events have shown the validity of his proposals. In short, he recommends that central banks act against the build-up of financial imbalances even in the absence of inflationary pressures at the usual reference horizons.

But a more conservative monetary policy in expansionary phases would not only have favourable effects on tempering the amount of credit, it would also improve credit quality. Monetary policy also affects how banks assume risks. Researchers at the Bank of Spain have shown that a long period of low interest rates contributes to relaxing banks' credit granting standards. The market pressure to maintain high returns in a setting of low interest rates and, therefore, of lending offering very tight income margins, leads some banks to extend credit to individuals and firms with a greater risk profile. Also, the expansionary monetary policy stance means this greater risk takes longer to materialize, which in turn stimulates ever greater increases in this type of risky investment.

Banks thus increase their risk profile by financing individuals and companies with a history of default, or by increasing the credit extended to new borrowers who, lacking a credit record, entail a greater level of uncertainty and, therefore, of potential risk to the bank. Finally, in an environment marked by low interest rates and the search by banks for yield, the general conditions of risk acceptance and selection are substantially relaxed, which translates into the riskier granting of credit that will materialise once the cycle turns down.

If we add to the foregoing ingredients a strong increase in banking competition, both among deposit institutions and between these and other less regulated non-bank competitors, the pressure to increase the risk profile in order to maintain past profit levels simply heightens banks' incentives to take on more risk in upturns.

Having commented on the problems of excessive credit growth and how a more conservative monetary policy can mitigate them, I would like to move forward to the second part of my speech, and concentrate on the resilience of the banking system and the role of supervisors.

We should acknowledge that the resilience of the financial system in general, and of credit institutions in particular, plays a key role in softening cyclical downturns. Evident in this crisis has been the notable weakness with which many banks have faced the downswing. To increase their resilience, banking regulation policy can perform a pivotal function by curbing the countercyclical behaviour of capital, so that it protects banks and prepares them for the crisis.

And to discuss this, I am bound in this second part of my speech to refer to Rojo (the Spanish for red, and "Rot" in German). Again, this is not only a type of wine but the name of the former governor of the Bank of Spain entrusted with steering and successfully ensuring the Spanish economy's entry into the euro area.

It was also Rojo who, in the final stage of his mandate as governor of the Bank of Spain, designed and put into practice the prudential regulatory mechanism of dynamic provisioning. This has contributed to reinforcing the stability of the Spanish banking system and today commands wide recognition; but, when initially launched, it aroused understandable rejection by Spanish banks and was met with indifference on the part of the international community of banking regulators and supervisors.

Let me give you the background to this prudential and countercyclical regulatory mechanism. The origins of Spanish dynamic provisioning must be sought in credit developments in the late 1990s. Having emerged from the 1993 recession, the worst for 40 years in Spain, the economy, and much more intensely so bank lending, began to expand at an increasingly brisk pace.

The Bank of Spain was led to introduce dynamic provisioning, which came into force in mid-2000, by a combination of factors. These included most notably: the mix of strong credit growth, with the dangers this entailed for the stability of the financial system; heightened competition, which acted to exacerbate these risks given that credit institutions applied increasingly lower risk premia to maintain their market share; the deterioration in the level of loan loss provisions and their extremely high correlation with current default rates; and, finally, the Bank of Spain's past supervisory experience.

In addition to the practical issues I have mentioned, behind dynamic provisioning there lied a conviction, resulting from many years of supervisory experience and, more recently, also from empirical evidence, that credit risk appears in bank balance sheets at the time lending is granted. Risk is an ex ante concept, and default is no more than the ex post manifestation of this credit risk. As I just mentioned, banks commit lending policy errors in upturns, when there is excessive optimism and it is believed that the business cycle has disappeared and that recessions are a relic of the past that will not return, and when bankers, caught up in this wave of exuberance, relax their credit granting standards. By contrast, and as we are all experiencing at the moment, a reaction in the opposite direction occurs in recessionary phases. Banks, pressured by high default rates, which impact their income statement and their level of capital, contract credit significantly, granting financing only to those borrowers whose solvency is beyond all doubt.

The end result is as follows: an overly expansionary credit cycle during the upswing and, by contrast, overly contractionary credit growth during the downswing.

In addition, there may be a perverse effect on institutions' income statements and levels of capital. During upswings, the failure to recognise risk through loan loss provisions results in very high profits. Institutions, very frequently due to the pressure exerted by the market, often decide to distribute these profits to shareholders through generous dividends, which in turn has a negative impact on the institution's capital. When the downswing arrives and the risk assumed in the past turns into bad debts, the income statement is not capable of withstanding the losses. These losses may erode a very significant part or even all of the institution's capital. Recapitalising banks during downswings is not easy, as recent events have so starkly shown.

By the way, I should note here that the current recapitalisation with public funds raises significant challenges in terms of management incentives at the recipient institutions and of competition policy for the entire banking system in question. However, this is neither the time nor the place to go into this in more details.

Accordingly, from the prudential standpoint, there are more than enough arguments to justify the development of regulatory policy instruments that enable credit institutions to recognise during upswings the higher level of credit risk accumulating in their balance sheets. The dynamic provisioning is a way to achieve this recognition. The idea, an extremely simple one, is that banks should set aside provisions for loan losses when the risk is assumed. They will then be able to use these provisions during the downswing, when the risk materialises.

As a consequence, credit institutions see their loan loss provisions to vary more closely in line with the credit risk existing in their balance sheets, and the profit and loss account fluctuates less over the cycle. The main point here is that this strengthens the solvency of each individual credit institution and the stability of the entire financial system.

Before continuing with the background to the dynamic provision, I should like to address a criticism made by accountants. It was said that this provision amounted to a distortion, and sometimes even a manipulation of the income statement. This is far from true. The Spanish regulator required institutions to advise the market of the amount of this provision so that analysts and investors could, if they so wished, "discount" its impact. The mechanism is completely transparent and institutions cannot use it to manipulate their results.

Admittedly, bankers did not welcome the statistical provision as warmly as we supervisors did. In fact they openly opposed it at first, arguing, with some reason, that this provision, by tightening the requirements for Spanish institutions alone, gave rise to an uneven playing field, especially for those institutions most heavily exposed to international competition. With time they came to appreciate that this provision helped strengthen their solvency and, therefore, their medium-term attractiveness and resilience, despite the fact that around 10% of their net income had to be assigned to the statistical provision.

The current scale of the international financial crisis, with credit institutions having an enormous difficulty for recapitalising without public intervention, has revived the interest on procyclicality of accounting standards and capital requirements. The topic has sprung from the academic arena, to which it was confined until very recently, to the forefront of regulatory and financial policy discussions. The Financial Stability Forum, the International Monetary Fund, the Basel Committee on Banking Supervision and certain central banks have, among others, highlighted the need for an in-depth discussion of procyclicality and regulatory mechanisms that may help reduce it.

I believe that the Spanish experience of dynamic provisioning can serve as the starting point for this discussion. I am convinced that these provisions have significantly strengthened the solvency and stability of the Spanish banking system, both on aggregate and at the level of each institution. Clearly, this provision did not insulate Spanish institutions from the global financial crisis, but it had certainly positioned them better to withstand it.

Let me conclude with three thoughts. First, I would like to see the standard-setting agencies, and the IASB in particular, as European law is one of the first to have adopted its guidelines, acting with greater subtlety when setting these standards, and also in their dialogue with other regulators. The present serious financial crisis has shown that fair value is an accounting concept and doctrine that has no better alternative, but that also should not be inappropriately applied. Allowing transparent dynamic provisioning would help to reduce the more harmful effects of credit cycles and, therefore, to produce economic growth with minimal fluctuations.

Second, I believe that regulators and supervisors, and central bankers too, must further discuss procyclicality, the impact of accounting and prudential standards on the credit cycle, and how monetary policy interacts with the credit cycle. Our experience with the statistical provision may be useful, although it is not necessarily either the best or the only solution. The important thing is that we should be ready to discuss countercyclical mechanisms, in provisions, in capital and wherever we believe they might be appropriate and feasible.

Finally, but no less importantly, we should enter into international agreements to ensure that countercyclical mechanisms are applied consistently in all countries. A global banking system requires uniform and internationally coordinated responses. I assure you that applying prudential measures in isolation is not an optimal situation, even if such measures are shown to be the most appropriate ones.

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Behind the ideas of White and Rojo (Weiss und Rot) that I have set out today were many other economists who I have not been able to mention, and who also contributed to help us to smooth cycles and strengthen credit institutions in the future. I have referred to these two because I wanted to pay tribute to all those economists that with their ideas and research, are seeking to make life easier for us and helping us to take better decisions. Now, in the recessionary phase of the cycle, we can see very clearly that it was Rojo and White who were right, and that other economists who underestimated the explosion in leverage and who did not worry about designing regulations forcing banks to strengthen themselves during the upswing were wrong. Today, with the benefit of hindsight, we know who was right. Next cycles will face us with fresh challenges but I hope that this experience will help us to meet them.

Thank you very much and enjoy the wine – red or white (Rot oder Weiβ) – you have chosen.