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Welcome Address

Conference "The New Bank Provisioning Standards: Implementation Challenges and Financial Stability Implications"/ Banco de España, FSI and CEMFI

Pablo Hernández de Cos
Governor of the Banco de España

Good morning to everyone. It is my pleasure to welcome you all to the conference: "The new bank provisioning standards: implementation challenges and financial stability implications", hosted by the Banco de España and co-organised with the BIS Financial Stability Institute and CEMFI.

Let me first thank these two institutions for their participation and active involvement in the conference. The invaluable work and expertise of the FSI and the ever-necessary academic rigour provided by CEMFI combine perfectly with the Banco de España's long-dated experience in banking supervision and create the sufficient conditions for this event to be a fruitful one. These three elements should be the ideal ingredients to ensure a promising and, hopefully, successful conference.

Furthermore, the presence of leading international figures from academia, the banking industry and supervisory, accounting and auditing organisations as chairs and panelists, are an effective guarantee that a lively and enlightening debate over the next two days will arise and retain the interest of the audience and ultimately meet the organisers' original aspirations for the conference.

As a starting point, we should recall that credit risk is, by far, the most important type of risk universal banks face, as their customary activity is based on granting loans. As a result, the relevance of how credit institutions deal with this type of risk and how they identify and handle it is of paramount importance.

In this regard, the precise calculation of provisions plays a crucial role in how banks manage appropriately their credit risk. An adequate level of provisions according to the risk profile of each bank is the basis for fairly dealing with the expected future losses that are intrinsic to the credit business. To put it bluntly, the recent crisis showed that the way banks traditionally measured their credit risk was far from suitable. In fact, the huge level of credit impairments and the low level of provisions accumulated led to a depletion of capital and created a significant need in many advanced economies for banks' recapitalisation plans. Many of those plans were funded by taxpayers' money.

Looking back, we may remember that the new approach of recognition of credit losses and its materialisation in banks' provisions emerged as one of the responses to the financial crisis. In that respect, G20 leaders urged accounting standard-setters to reconsider and, most importantly, overhaul the then-prevalent incurred loss model by assessing alternative approaches for recognising and measuring loan losses. Accordingly, the FASB and the IASB reacted by issuing two new accounting standards to determine credit impairment and how to measure credit risk. In particular, the IASB issued the IFRS 9 based on the expected current loss model while the FASB issued its own Standard introducing the notion that provisions should cover the whole expected loss of the loan from inception. Regardless of the technical differences between the two, the crucial element is that both use as a key element the expected loss concept to account for credit losses.

In any event, it is fair to say that the new provisioning standards introduce major changes compared to pre-crisis practices. One important change refers to the way that credit loss provisions should be recognised in a timely fashion because it was perceived that the incurred loss model, in force when the crisis took place, considered credit losses "too little and too late in the cycle", and that affected directly the amount of provisions set aside by banks (deemed very small and highly insufficient).

A direct consequence of the implementation of the expected loss model is a more timely recognition of credit losses together with an envisaged improvement in banks' credit risk management. These two elements are expected to positively and significantly contribute to the stability of the banking system. Nonetheless, this assumption largely depends on banks' awareness and commitment in terms of their ability and willingness to appropriately capture the risk embedded in their loan portfolio. All in all, to understand the performance of the loan book, one has first to look at the specific process of granting loans. Here, the following elements are crucial: (i) setting appropriate credit standards, (ii) proper valuation of collaterals and (iii) development of sound credit risk models.

As to credit standards, pricing policies are crucial as they should be oriented to cover, at least, the costs of financing, structure and credit risk inherent to each type of operation. Banks should calculate the cost of the credit risk for different homogeneous risk groups in a manner consistent with their history of recognition of defaults and associated losses and recoveries, as well as with expected economic developments. Data integrity, reliable documentation of losses and adequate modelling to project expected losses ahead all play a key role in this respect.

The setting of global limits to credit as a means of controlling the volume of the risks incurred, their evolution over time, their maturity and the application of conservative conditions whenever refinanced credits are negotiated, are all integral elements of the general lending standards that banks should observe and keep up to date as part of their credit risk management policy.

Moreover, rapid credit growth usually has a negative impact on lending standards which, down the road, translates into increased needs for provisions, as non-performing loans start to pop up. We saw this clearly, and on a large scale, during the lastest banking crisis in Spain[1] and elsewhere, and it is our responsibility to remain vigilant to prevent this from recurring with the appropriate supervisory tools.

Regarding collateral valuation, it cannot be ignored that provisions apply to the uncollateralised part of each loan. Consequently, guarantees pledged to each loan represent a central element in the new approach for measuring credit risk.

To fulfill their role, guarantees have to be effective, that is to say, they need to be validated as a mitigant of credit risk. For this to be true they must subject to strict, rigorous and verifiable valuation criteria. To facilitate this last point, banks should have procedures for the valuation of the collateral with updated information based on revised appraisals adapted to changes in the macroeconomic situation and reliable analysis of trends of market prices, particularly for real estate collateral.

Finally, estimates of credit losses and provisions should rely on credit risk models developed on a sufficiently quantitative basis where prudence should be reinforced. In any case,

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[1] See G. Jiménez and J. Saurina: "*Credit Cycles, Credit Risk, and Prudential Regulation*", International Journal of Central Banking, 2006.

estimates should be based on credible assumptions that are sufficiently justified and consistent over time.

The methodology used must be readily understandable and the results intuitive. Also, consistency should be an objective. Banks should establish procedures for periodically testing the reliability and consistency of the results obtained. The periodic testing of the calculation of provisions should be done regularly through, for example, back-testing the estimated credit losses with those actually observed in finalised credit operations.

For a successful implementation of the new loss-measure approach, banks' forecasting capacity in respect of economic downturns and anticipation of significant deterioration of both credit standards and credit risk are key. As such, banks should strive to apply and use the appropriate procedures to ensure the timely determination of future significant increases in credit risk and, more generally, they should be able to properly adjust their models and predictions to the existing macroeconomic conditions at any time, regardless of how frequently they may change.

Let me briefly review what may be considered the main challenges for this new paradigm of provisioning, rightly following the content of each of the conference panels.

Panel I of the conference will enlighten us with relevant background information to fully understand why and how the new provisioning model has changed, the potential pros and cons of alternative approaches, the differences between models and the reasons behind those differences.

As briefly commented, modelling expected losses is a challenge. In Panel 2, views from academia, practitioners and auditors will no doubt help us to broaden our perspective on issues such as the existing differences between the models needed to calculate the new provisions and those already in use for regulatory purposes, or for internal credit risk management.

Implementation issues, apart from the pure modeling challenges, such as compliance costs, reliable reporting under the new standards, comparability of financial statements across institutions, internal organisation, etc. are highly interesting aspects that will also be presented from the industry and supervisory viewpoint in Panel 3.

The time dimension of bank provisions, particularly potential pro-cyclicality and financial stability implications of the new approach, sets the stage for an exciting Panel 4. Admittedly, there is still little evidence gathered so far, given the short period of time over which the expected loss model has been in force, to arrive at definitive conclusions; intuitively, moving from the incurred loss paradigm to the expected loss model should reduce the pro-cyclicality of provisions in the future. I am sure that this issue will attract interest from academics, supervisors and practitioners not only during this conference but far beyond it as more evidence and data are gathered. Whether provisions are pro-cyclical or not is a key matter for financial stability.

Finally, learning from the implications and interactions between the new provisioning standards and other types of regulations to which banks are subject – most notably financial market regulations and micro- and macro-prudential regulations – will prove a perfect topic for the final panel of the conference. In this regard, the Banco de España experience[2] with the setting-up of so-called dynamic provisioning[3] , which shares many characteristics of the current countercyclical capital buffer and is close to the concept of the expected loss model, serves as a good example of how closely linked provisioning standards, capital and macroprudential policies are.

From a financial stability perspective, the fact that supervisors are given macroprudential tools should allow us to deal better with lending expansions and contractions in order to protect the economy from financial excesses.

In the wake of the financial crisis, the arsenal of macroprudential tools has expanded significantly. Apart from the countercyclical capital buffer we have the systemic risk buffer, the buffers for globally and domestically systemic banks, the possibility to limit large exposures, increase capital or revise risk-weighted assets to residential and commercial real estate exposures. This is a significant improvement that will allow us to develop macroprudential policies that interact with microprudential ones as well as with monetary policy.

But it is not enough to create macroprudential tools. They must be properly allocated institutionally in order to avoid inaction bias by policy-makers and counteract misalignment of incentives with the financial sector, in particular at certain points in the lending/financial cycle where taming is needed. In a sense, the dilemmas and incentives that policy-makers will face regarding macroprudential policy decisions will not be far different from those encountered in the past when setting monetary policy (i.e. interest rates). For the latter, the optimal institutional design is to enshrine monetary policy in an independent central bank. For the former, a very similar solution, intuitively, should prevail, although the theoretical framework and the empirical research to support it is much less advanced than in the monetary field.

Needless to say, macroprudential policy is particularly relevant for a country like Spain, part of a monetary and banking union where, as seen in the past, the financial and business cycles of the member countries may be in different positions. With a common monetary policy and (micro)supervisory policies, and a fiscal policy with almost no room for manoeuvre, the macroprudential policy becomes a much-needed 'degree of freedom' to deal with the lending cycle, a task that traditionally has been allocated to central banks too.

As the recent article IV visit of the IMF made clear, Spain is one of the few countries in Europe still not to have a macroprudential authority. Given the role that macroprudential policy will play in the future, it is probably high time that we all reflect on the optimal design of this authority in order to enhance financial stability.

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[2] See J. Saurina and C. Trucharte: "*The countercyclical provisions of the Banco de España 2000-2016". * Banco de España, 2017, for an account of dynamic provisions in Spain, why they were introduced, their impact and lessons drawn for prudential policy.

[3] See G. Jiménez, S. Ongena, J.L. Peydró and J. Saurina: "*Macroprudential Policy, Countercyclical Bank Capital Buffers, and Credit Supply: Evidence from the Spanish Dynamic Provisioning Experiments*", Journal of Political Economy, 2017, for a thorough quantitative analysis of the countercyclical impact of dynamic provisions in Spain. For a broader discussion of the interaction of dynamic provisions with monetary, fiscal and regulatory policy, see A. Estrada and J. Saurina "*Spanish Boom-Bust and Macroprudential Policy*", Financial Stability Review, Banco de España, May, 2016.

Let me conclude by stressing the relevance of the conference, given the importance of the correct measurement of credit risk. In this regard, the correct calculation of provisions plays a crucial role in the way banks manage appropriately their credit risk. A consistent level of provisions according to the risk profile of each bank will prevent any undesired impact on solvency levels, which would be the final resource to absorb any loss arising from the ordinary activity of banks that has not been eliminated before by the correct application of provisions. In addition, appropriate macroprudential tools in the hands of policy-makers might help reduce the volatility of credit and business cycles.

Allow me to express once again my gratitude to the co-organisers of the event for their excellent work, and to wish all the participants a fruitful conference and a pleasant stay in Madrid.

We are all looking forward to hearing from the experts on the different challenges that the new provisioning paradigm entails, so without further ado I give the floor to Fernando Restoy, Chair of the Financial Stability Institute (FSI), to start with the first panel.