

## THE COUNTERCYCLICAL PROVISIONS OF THE BANCO DE ESPAÑA, 2000-2016 (\*\*)

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**Abstract**

This article contains the discussion made by Pedro Duarte Neves at the first Conference on Financial Stability, jointly organized by the Banco de España and the Centro de Estudios Monetarios y Financieros (CEMFI), on 24 and 25 May 2017. After the presentation provided in the panel based on the book *The Countercyclical Provisions of the Banco de España (2000-2016)*, the author started his intervention by addressing the comparison between the key features of the Spanish countercyclical provisions, the countercyclical capital buffer and the new provisioning framework, IFRS 9. The most important message is that countercyclical provisions anticipated the purpose and the key characteristics of those more recent instruments. Then the author emphasized the aspects that, in his opinion, could not have been achieved by the use of the Spanish countercyclical provisions, discussed its design and its smoothing role in the recent financial crisis and, finally, concluded that they constituted a remarkable contribution to the regulatory and supervisory community.

**1 Introduction**

Let me start by thanking the organisers for having invited me to participate in this First Conference on Financial Stability. It is always a pleasure to be at the Banco de España and it is a privilege to be a discussant of this book. I really find it fascinating and I congratulate the authors – Jesús Saurina Salas and Carlos Trucharte Artigas – for having developed this work. Let me also make it clear from the outset that I am going to disappoint those of you that expect me to be very critical on this macro-instrument since, as a matter of fact, I view the development and use of countercyclical provisions by the Banco de España over the period 2000-2016 extremely favourably.

Just as preliminary background, it is important to recall that there was a deep Spanish banking crisis at the beginning of the nineties and some lessons had to be drawn by the Spanish authorities. In my view, these were indeed drawn and the countercyclical provisions are likely to be the most outstanding example, as they have simultaneously a macro motivation, i.e. a genuine concern regarding the credit cycle, and a micro motivation, i.e. a focus on prudent evaluation by imposing more demanding provisioning requirements.

But there are other important examples to be remembered. For example, that referring to the fact that the Banco de España had started to have permanent supervisory teams inside the largest credit institutions, which is also one particular innovative approach in the European space that the Banco de Portugal followed from 2008 onwards. An additional background consideration has to do with the fact that, as I will stress throughout this intervention, countercyclical provisions somewhat anticipated the aim and the characteristics of two new instruments recently added to the regulatory toolkit: the CCyB (Countercyclical Capital Buffer) and the IFRS 9 (International Financial Reporting Standard).

My intervention is in two parts. First, a preliminary comparison between the Spanish countercyclical provision, the CCyB and the IFRS 9; and second, an ex-post assessment of the use of the countercyclical provisions.

**2 Comparison between the three instruments**

A preliminary comparison between the key features of the Spanish countercyclical provisions, the CCyB, which is still at the phasing-in stage, and IFRS 9, which will be implemented from 1 January 2018 onwards, is provided in Table 1.

	Spanish countercyclical provisions	CCyB	IFRS 9
Type of tool	Provisioning (direct impact on P&L)	Capital buffer	Provisioning (direct impact on P&L)
Responsibility	Prudential authority	Macroprudential authority	Accountants/Auditors
Calibration	Fixed formula (bank level)	Time-varying (country level)	Time-varying (exposure level)
Rules versus discretion	Rules based	Guided judgment	Substantial discretion (bank's internal models)

SOURCE: Author's elaboration.

As concerns the type of tool, the Spanish countercyclical provisions are a provisioning instrument like IFRS 9 – and therefore with a direct impact on the P&L – whereas the CCyB is a capital buffer, with limited effects on the distribution of profits. The Spanish countercyclical provisions were intended to deal with expected losses based on past statistical evidence, whereas additional requirements of capital are intended to cover unexpected losses.

Regarding the final responsibility of the decision, Spanish countercyclical provisions were a decision of the prudential authority (as at the time there was no distinction between micro and macroprudential authorities) and the CCyB is, of course, a decision of the macroprudential authority, whereas IFRS 9 is determined by accountants.

In relation to the calibration (i.e. the quantitative effect of the decision), there is a fixed formula at the bank level in the case of the countercyclical provisions, whereas the CCyB is time-varying at the country level and IFRS 9 is also time-varying, but at the exposure level.

Finally – as far as the distinction between rules versus discretion is concerned – the Spanish provisions are ruled-based, the CCyB follows a judgment by the macroprudential authority, and IFRS 9 provisions have substantial discretion as they largely rely on own internal models developed by individual banks.

Table 2 shows the forward-looking approach feature (expected-losses motivation) of the three instruments under discussion. It is a remarkable inherent characteristic of the Spanish countercyclical provisions, were they to exist today, and is also present in the computation of IFRS 9, whereas this is not the case of the CCyB.

Regarding the “too-little-too-late” factor, Table 2 has three ticks – one for each instrument – because all of them are supposed to avoid, in one way or another, the too-little-too-late issue.

#### MAIN ELEMENTS OF THE INSTRUMENTS

TABLE 2

	Spanish countercyclical provisions	CCyB	IFRS 9
Expected loss/Forward looking approach	✓	x	✓
Avoid “too-little-too-late”	✓	✓	✓
Anchored on the aggregate evolution of credit (macro perspective)	✓	✓	x
Anchored on idiosyncratic risk	x	x	✓

SOURCE: Author's elaboration.

	Spanish countercyclical provisions	CCyB	IFRS 9
Cyclicality:			
i) Expected behavior in booms	↑	↑	?
ii) Expected behavior in busts	↓	↓	↑
Overall effect	countercyclical	countercyclical	?

SOURCE: Author's elaboration.

However, this is perhaps somewhat less clear in the design of the CCyB, where the concept of expected loss does not play a clear role. The buffer should be built up when credit is growing excessively and though this also contributes to avoiding the “too-little-too-late” problem, it is not the main explicit goal of this mechanism.

As far as being anchored in the aggregate evolution of credit (i.e. a macro perspective) is concerned, that is of course one of the most remarkable features of the Spanish countercyclical provisions and it is also a core feature of the CCyB. This macro perspective is completely ignored by IFRS 9, as the corresponding provisions are calculated using information on individual loans [i.e. on Probability of Default (PD) and Loss Given Default (LGD)] and, as a result, aggregate developments are not taken into account.

Moving to the idiosyncratic risk of a particular loan, this is an element completely ignored in the computation of the CCyB and it is also not present in a direct way in the calculation of the Spanish countercyclical provisions, although it is somewhat indirectly addressed by the identification of a set of risk categories. In contrast, the idiosyncratic nature of credit is directly dealt with in detail in the case of IFRS 9.

Table 3 summarises the cyclicality properties that one would there to be in these instruments. Counter-cyclicality is, of course, the very nature of the Spanish provisions and of the capital buffer, and in such a noticeable way that it is explicitly incorporated into their designs. Therefore they are clearly countercyclical, which is the intended property required of both. This is not so clear in the case of IFRS 9 which, on one side, will tend to mitigate the pro-cyclicality present in the current accounting framework, as what is involved is a move from an incurred to an expected credit loss approach. However, it is not very clear whether or not IFRS 9 will be pro-cyclical, as the pillar underlying the international reporting standard is the estimation of expected losses relying on the calculation of PDs and LGDs, which have an inherently pro-cyclical nature. Of course, this could lead us into a more in-depth discussion of technical subtleties concerning provisions in stage 1, stage 2 and stage 3 in the calculation of IFRS 9, but that is beyond the scope of this discussion. The key point is that the pillar underlying IFRS 9 is the calculation of PDs and LGDs which, as we know, have a pro-cyclical nature.

From Tables 1, 2 and 3 it is possible to conclude that – when making one-to-one comparisons – the Spanish countercyclical provisions have some relative advantages over the CCyB. It is also worth mentioning that Jorge Ponce -in a paper presented at this conference (Ponce (2017))- concluded that dynamic provisions were more effective in smoothing the cycle than the CCyB, which is an additional element in favour of the Spanish countercyclical provisions. Compared with IFRS 9 – and, once again, making one-to-one comparisons – the Spanish countercyclical provisions also have distinctive advantages. It is therefore natural to conclude that, even today, the Spanish countercyclical provisions would be a very useful prudential instrument.

### 3 Assessment of the Spanish countercyclical provisions

To make an ex-post assessment, I will provide answers to three questions concerning aspects which, in my opinion, could not have been achieved by the use of those countercyclical provisions.

#### **Could we have expected countercyclical provisions to be a key element in limiting credit growth?**

This would not have been possible at all. Before speaking about macroprudential policy, or more precisely on a particular macroprudential measure, it is very important to bear in mind the nature of the shock that affected the Spanish economy after the creation of the euro. When an economy is hit by a shock characterised by a very strong reduction in interest rates (nominal and real alike), which then remain at low levels for a long time, we are indeed witnessing an unprecedented event, i.e. a huge monetary policy shock that will impact enormously the functioning of the economy in any event.

Jesús Saurina made this point very clearly before, by mentioning that interest rates were some 300-400 basis points below what would have been suggested by a Taylor rule for Spain. Therefore, before speaking about macroprudential policy one should wonder what the role of fiscal policy could have been in limiting aggregate demand and, therefore, reducing the impact on the economy of such a huge interest rate shock. On that particular aspect, it is important to recall that Spain ran a fiscal surplus for several years as well as a declining debt-to-GDP ratio. This basically suggests that the magnitude of the euro shock, on aggregate demand and, in general, on the functioning of the economy, had no precedent at all. Then, before requiring the Spanish countercyclical provisions to moderate demand growth, one should have in mind that microprudential and conduct supervision could be better positioned to play that role. Therefore, the countercyclical provisions could have not played by themselves a key role in limiting credit growth.

#### **Could we have expected countercyclical provisions to be a key element in affecting lending policies or credit standards?**

The paper presented at this Conference by Gustavo Suárez et al. (2017) provides empirical evidence that low interest rates affect the quality of credit, in the sense that lending spreads are lower when interest rates are lower, and that was definitely the Spanish case. Consequently, it seems difficult to counterbalance that with the use of a particular macroprudential measure. Once again, conduct supervision could be better positioned to play such role, by ensuring that all relevant information is provided to clients when granted loans, that no lending to potential insolvent clients takes place, that appropriate simulations of the likely effects of changes in interest rates are considered or by making sure that sellers do not have the wrong incentives. On top of that, microprudential supervision would also be better positioned to affect lending standards, by promoting an appropriate collateral value assessment, adequate risk and governance functions of the banks, or by adopting a predominantly forward-looking supervision approach taking into account the sustainability of business models. It is fair to say that microprudential supervision was very restrictive in the approval of internal models – in the same way as happened in Portugal – thereby contributing to a better quality of banks own funds.

#### **Could we have expected countercyclical provisions to have worked alone without the use of other macroprudential measures?**

Two quotes will help me in answering this question. One is by the ECB Vice President Vitor Constâncio who, in a recent speech, said that higher capital requirements, which are similar to

higher provisions in this case, will increase banks' resilience, but may add little to the cost of loans. Such measures may therefore do little to restrain excessive credit demand. Credit limits, such as the Loan to Value (LTV) ratios, are more likely to work as long as there are many borrowers who will be affected by them. Curiously, and this leads to my second quote, Ayyagari, Beck and Martínez-Peria (2017) today provided empirical evidence suggesting that the impact on lending growth will be higher for all these LTV/DSTI (Debt Service to Income) measures than for other types of measures (like countercyclical provisions). This allows me to conclude that countercyclical provisions could have had stronger effects if they had been combined with other macroprudential measures which, as a matter of fact, are better designed to moderate credit demand.

Having discussed what, in my opinion, could not have been achieved by the use of countercyclical provisions, it is now time to move on to what has effectively been achieved reached by this very innovative prudential measure.

#### 4 Ex-post assessment of the Spanish provisions

It is always very delicate to make an ex-post assessment, but I'll try to do so by answering an additional set of three questions:

##### **Were countercyclical provisions designed in the best possible way (calibration and risk categories definition, for instance)?**

On the one hand, the Spanish provisions were calibrated bearing in mind the previous economic cycle and the previous banking crisis, and that provided an average loss rate of 0.9%. Of course, no one could have guessed that the Great Recession would take place and that Spain would be hit by a double-dip recession unprecedented in recent economic history. It was probably not clear at that time that there was a difference between this euro area shock and the EU shock provided by participation in the EU. The latter had a predominant nature of a volume effect on the economy, whereas Spain's participation in the euro area is much more like a financial shock, a huge reduction in interest rates, i.e. an extremely intense relative price effect.

On the other hand, we could say that probably some additional categories of real estate risk could have been considered. And of course it is very easy to say today that it would have been better not to halve the 0.9 historical mean. However, the most relevant comparison to make is to recall what has been done in other European countries to incorporate cyclical considerations into supervision and, from that perspective, it is easy to conclude that the Banco de España has probably done better than any other EU supervisor.

##### **Did countercyclical provisions contribute to building a sizeable buffer in the Spanish banking sector?**

The answer is a categorical yes, as the book by Saurina and Trucharte makes it very clear. The use of those Spanish provisions led to the creation of a €26 billion buffer, which was gradually released as the crisis progressed. And this means that some banks avoided the need for a recapitalisation. In one case or another, bankruptcy was avoided, and all of this means that less money was demanded of Spanish taxpayers vis-à-vis a hypothetical situation in which no countercyclical provisions had existed.

##### **Were countercyclical provisions an innovative and relevant contribution to the international regulatory and supervisory community?**

Here the response is a definite yes since this instrument compares extremely well, from almost all points of view, with the recent macroprudential and accounting tools. It has been

one of the most remarkable supervisory measures of the decade prior to the financial crisis. These provisions became an inspiration for the CCyB and were probably the first attempt to avoid the ‘too-little-too-late’ provisioning of the banking sector.

## 5 Final remark

Let me conclude this intervention by paying tribute to the Banco de España and the staff involved for having designed and developed the Spanish countercyclical provisions; to Jesús Saurina and Carlos Trucharte for making the case for the Spanish countercyclical provisions and writing such a readable and fascinating book; and finally to Governor Linde for his wish to have this book written and therefore for preserving for future memory such a remarkable contribution from the Banco de España to prudential policy.

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