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Procyclicality in the banking activity

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Good morning ladies and gentlemen. First of all I would like to welcome you to the Bank of Spain. Also, let me thank you all for your presence here today to discuss on one of the most difficult and relevant topics affecting financial regulation: pro-cyclicality in banking activity.

Let me also thank the BIS Financial Stability Institute, and in particular its Chairman, Mr. Josef Tošovský, for all the support and good advice received during these last few weeks during the preparation of this event that we have co-organized.

We are very pleased to have as speakers in this conference a large group of excellent professionals who are directly involved in financial supervision and regulation. A high level meeting like this one is a major opportunity to start building up a common and efficient framework in order to face the pro-cyclicality issue.

Cyclicality can be considered an inherent part of economic activity. Banking activity is no exception; it is also affected by the upswings and downturns of the real sector cycles. Not only history proves this, but current events do also. Any doubt about this has been violently resolved after the summer of 2007. But even if we accept that little can be done to avoid economic cycles, this should not be an excuse for us, central bankers and supervisors. Our responsibility is to develop macro-prudential approaches and the appropriate regulatory measures to help banks reduce the impact of future economic cycles and diminish their pro-cyclical behaviour. This should be achieved for the sake of financial stability with the minimum economic and social costs, which is the main objective of supervisory authorities

In fact, banking behaviour can be not only cyclical but pro-cyclical, that is, it can exacerbate the cyclical behaviour of the real economy. As it has been said many times, there is nothing more pro-cyclical than a badly managed bank. In good times it incurs in more risks than it reasonably should through, for example, excessive lending with poor standards. In bad times it changes its lending policies reducing drastically the loans to the economy and exacerbating the downturn.

There are several causes that explain this pro-cyclical behaviour but I will focus on the one that affects us most and towards which all of our work should be devoted: banking regulation and supervision.

Basel II was seen as a major step towards a better alignment between credit risk incurred by banks and regulatory minimum capital requirements. This link between risk and capital has forced supervisors to better understand the main drivers behind credit risk and the idiosyncrasy of banks' credit models, their risk pricing and general portfolio management. Basel II, in this way, has motivated supervisors to analyse more deeply all that surrounds banks' main business with the benefit of a clearer understanding of the underpinnings of banks' risks.

Needless to say, the introduction of a risk sensitive capital framework is based on the idea that, as credit conditions deteriorate, minimum requirements must increase and consequently, more cyclicality is added into the system. Particularly, under the internal ratings based approach (IRB), capital requirements are an increasing function of the main credit risk drivers, probability of default

(PD), loss given default (LGD), and exposure at default (EAD), obtained for each loan. The problem is that this formulation may have distorting consequences in the evolution of regulatory requirements along the economic cycle. That is, in downturn conditions these risk parameters would deteriorate, leading to greater capital requirements, whereas in upswings these risk indicators would improve, resulting in lower regulatory needs.

Nevertheless, the new Basel II Framework itself offers specific guidance that may soften the cyclical fluctuations in capital requirements. The calculation of risk parameters consisting on **long run averages** and the inclusion of a **downturn bias** in certain estimates would provide more stable parameters and requirements without abandoning the advantages of a risk sensitive scheme across different banks. This approach has been the one mostly implemented in Spanish IRB banks.

This is the guidance Basel II itself offers to mitigate pro-cyclicality but one might think that it is insufficient. In this case, one of the many additional possibilities currently under discussion to reduce the potential undesirable effects of Basel II is to scale the capital requirements obtained through the IRB function by using **a countercyclical multiplier**.

In order to make this multiplier countercyclical, it would be built as a function of a reliable economic activity variable (for instance GDP growth rate). As it happens with other alternatives, its main pros and cons should be carefully assessed. The multiplier is easy to obtain, transparent (as depends on a reliable macro variable), it has a low implementation cost and, finally, it would be of a uniform and wide applicability. Among its drawbacks we found that, first, it implies undertaking an external modification on the capital requirement figure and, second, that the multiplier is built using a domestic variable, which may make international comparison very difficult.

No matter what the result of the previous debate is, either the use of counter-cyclical risk estimations or the use of a capital multiplier, we should explore the use of **complementary measures** to attain our final goal of financial stability and to minimise the social costs of pro-cyclicality; for example, **dynamic provisions**.

As most of you already know, this type of provision uses historical information on credit losses to estimate a general provision for homogenous loan portfolios. It reflects a collective assessment of credit losses at the balance sheet date (i.e. it covers incurred losses not yet identified in specific individual loans). This provision builds up a buffer during the benign part of the cycle, which starts to be released when recession comes knocking on banks' doors.

Counter-cyclicality is intrinsic to dynamic provisions and part of its usefulness can be seen in the resilience shown so far by Spanish banks in the current crisis. Furthermore, its direct impact on the profit and loss account (reflecting losses at a time when these losses are really being built up in balance sheets) constitutes a way to make banks more aware of how credit must be priced, reducing the underestimation of loans risk premia and, to some extent, compensating the relaxation of credit granting standards in good times. It also delivers the right information to investors about the financial position of the bank. In all, dynamic provisioning allows a proper recognition of credit risk.

I must also admit that there are voices raised by some institutions that do not agree with this view, and particularly, accounting standard setters. In this respect, we should call for further dialogue between accounting rule setters and supervisors as well as a clarification regarding roles and objectives of each of them. I really think that our objectives are compatible and that delivering the relevant information to investors should not be an impediment for supervisors to ensure the stability of the banking sector by promoting the most adequate measures that experience and results have proved to be useful.

Very much in line with dynamic provisions, the buildup of **capital buffers** also deserves room in our discussions. These buffers, created in periods of good economic conditions and necessarily associated with the adequate mechanisms to draw them down during recessions, may come in the form of **non-distributable reserves** to compensate economic-cycle losses. Nevertheless, the possible advantages and disadvantages of such a measure should be accurately calculated and appropriately compared to those coming from other tools that act in the same way but affect the profit and loss account.

We should not forget the **interconnection that exists between valuation, leverage and procyclicality** and how these issues should be properly managed under a macro-prudential perspective. The introduction of supplementary floors to capital requirements under a risk-sensitive approach, could be a safety net,. Setting **limits on the build-up of leverage** in periods of rapid credit growth can be seen as a way of strengthening the incentives for correct risk pricing of institutions, as well as a deterrent of excessive risk-taking. Furthermore, the development of **valuation reserves** should also be under our consideration as a way to mitigate the cyclicality inherent in risky and illiquid securities.

Improvement of general **stress test practices** and their wide implementation, particularly during the most favorable part of the economic cycle, should also be included in our toolbox approach to fight against procyclicality. Solid stress test frameworks will allow assessing the adequacy of buffers, both in their construction and in their applicability over the cycle.

Finally, **remuneration schemes** may be another tool for dampening the undesired cyclical fluctuations of banking activity. The assessment of different alternatives for appropriate remuneration schemes, on the basis of correct incentives and horizons, constitutes the right starting point from which to explore how excesses or bad alignments may have contributed to accelerate or amplify disorders within the financial system.

As you have seen, we are not lacking ideas on how to reduce pro-cyclicality. Rather, our main problem is to select what are the best tools to include in our toolbox. In this sense, I am sure that your contributions in this seminar will be extremely useful for this purpose.

Now, let me give the floor to Mr. Josef Tošovský, with whom I have the honor to chair this opening session and to whom I personally thank his presence in this conference.