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Counter-cyclical capital: building buffers against the next crisis. A round-table discussion with Charles Goodhart (LSE), Ian Mackintosh (ASB), Jesús Saurina (Banco de España) and Mark Rhys (Deloitte). Held on Tuesday, March 16, 2010 at Brewers' Hall, Aldermanbury Square, London, EC2V 7HR, from 12:30-2:15pm.

At a recent and very busy round-table on counter-cyclical capital, one member of the panel pointed to the pro-cyclical effects of Basel II and mark-to-market accounting rules. He felt there was a need for counter-cyclical regulations; requiring increased provisioning from banks in the good times that could be relaxed in the bad times.

The difficult question was how to put those principles into practice. He noted that government policy could run counter to the market but this was difficult. Using the example of sub-prime mortgages in the US, he highlighted the problems that the authorities might encounter in 'taking away the punch bowl'. Sub-prime mortgages, although much demonised now, had then been the darling of the US government – aiding the disadvantaged on to the housing ladder – and had been a much lauded financial innovation. Although it would have been possible to step in, who would have wanted to?

Alternatively, it was easy to intervene during a downturn, for example, to relax requirements, but would the market let you do it? Wouldn't the market react to prevent any action to increase lending if market conditions were giving very different signals?

Also, how would the cycle be measured; bank by bank or sector by sector or country by country? Economic cycles were not in sync across the world. Taking the housing cycle, for example, Germany had not experienced a housing bubble in recent years, unlike the UK, Spain and Ireland. If you cannot take counter-cyclical measures on a regional/world scale, how would you deal with the level playing field argument? Given intervention on a national level, without exchange controls, borrowers could simply go elsewhere (abroad) and take out loans.

The features of dynamic provisioning as implemented in Spain were described and discussed by the panel. In Spain a fully transparent, rules-based mechanism had been devised that incorporated extensive research on the lending cycle and historical loss information.

During the recent financial crisis it had proved to be a useful mechanism although, as a speaker noted, it was not a silver bullet. While there were still challenges to the banking system, he felt that most of the banks had found it useful.

The incurred loss system had failed to deliver enough provisions to deal with a sudden increase in losses. Provisions were made 'too late'. Profits, dividends and bonuses were always too high in an upturn. In addition, one panelist claimed, the biggest mistakes were generally made during an upturn when lending standards declined. Dynamic provisioning served to decrease profits and bonuses in the good times through better incentives and built up a buffer that could be depleted in bad times.

Other members of the panel agreed that increased provisioning was a good idea but had different views as to how it should be accounted for. One speaker, for example, favoured a non-distributable economic cycle reserve (which would also affect dividends and bonuses) but would not affect profit and loss. This, he felt, would be more transparent as stated profits in the accounts should reflect what had actually happened. In a downturn when the buffer was put back in it would appear that profits had increased when in reality that would not be the case. The reserves, he felt, should be put below the line

Another panelist pointed out that banks used to have general provisions but that the IASB had changed the rules, allowing for provisioning only when the loss was incurred. He agreed that this was in fact pro-cyclical because the big losses came when everything was going wrong, exacerbating an economic downturn. He agreed that an expected loss model made more sense and that expectations could be built into the interest rate charge. Provisioning would happen earlier, although not necessarily through the cycle. He agreed with another of the speakers that these reserves should be reported below the line as investors needed to see what was happening at a particular bank. But he felt that it took decision-making power (on dividends and bonuses) away from the board.

In response to a question regarding the goal of counter-cyclical provisioning, one of the speakers noted that its intention was not to tame lending cycles (which fell into the domain of monetary and fiscal policy) but to enhance the stability of individual banks and, therefore, of the whole banking system. He also noted that it had not impeded the competitiveness of Spanish banks.

The discussion briefly moved to the subject of liquidity – an issue that some felt had been neglected due the increased emphasis on capital. One panelist pointed to an IMF global finance report that suggested that there were no big differences in the capital held between banks that failed and those that did not.