

Counter-cyclical capital requirements: A round-table discussion on alternative approaches to setting bank capital standards, including dynamic provisioning. With Sir John Gieve (Bank of England), Jesus Saurina (Banco de Espana) and Clifford Smout (Deloitte). Held on Thursday, February 5, 2009, at Brewers Hall, Aldermanbury Square, London, EC2V 7HR.

Counter-cyclical capital requirements – do we need them, what are we going to use them for, and what form will they take, asked the first speaker. He believed that one of the key lessons of the last five years is that achieving stable consumer inflation, earnings and output, has not prevented the build up of huge imbalances in assets and credit. He felt the authorities could have had a tighter policy which might have held down the growth credit and asset prices - but would in the process have held down output and earnings. He also pointed to Germany's example; it didn't really have a credit boom yet the forecast for their growth is very similar to our growth; we are facing a synchronised downturn across the world. He said that we should use tools which have been devised and used mainly in prudential purposes for a macro purpose, to prevent the regulatory and indeed accounting systems from exacerbating the cycle. He suggested a change to capital requirements in a counter cyclical way and said, "you can also achieve much the same by instituting a liquidity regime."

Speaker two said that there was nothing in the P&L accounts to recognise this recent increase in the credit risk. So, he said, probably we will have to revisit factors including risk management at the bank level, incentives, the compensation policies, the scope of regulation, the enforcement of regulation, and the accounting frame. He said that fair value needs some improvement, via improvements in IFRS or IAS 39 through dynamic provisions (DP). He showed how DP works: you increase loan loss provisions in good times, when credit risk is building up in the balance sheet, and reduce them in bad times when this credit risk is materialising. He stressed the point that it is a transparent mechanism as well as a rule-based mechanism. The Bank of Spain runs a credit register which means any loan granted in Spain for any bank operating in Spain above 6,000 euros. He said experience as supervisors shows that lending mistakes happen in good times, so you have to build up a mechanism that covers these. These mistakes basically mean lower lending standards and the pricing of risk. In Spain, like in any country in the world, there is a specific provision closely tied to the amount of non-performing loans; as non-performing loans increase, you increase the amount of specific provisions. In good times, non-performing loans are very low, specific provisions are very low, so the difference between this beta parameter, the average of the cycle of the specific provisions and the current specific provision is positive, and in bad times the opposite happens. This is the mechanism.

The third speaker wanted to know whether these requirements would apply institution by institution, or by country; should it be the regulator or central bank that oversees them; and whether it is enacted by means of a formula or by discretion. He quoted Charles Goodhart's

view that “it is rather difficult to remove bottles from a teenager’s party and it is better therefore to have a rule which is entirely formulaic.” He also suggested a leverage ratio because of off balance sheet items, which were complex and high risk. The Japanese experience, he added, suggested that these requirements would not be a cure all and a situation where cross border banks operate in different countries at different stages of the credit cycle and with varying capital requirements could damage a “level playing field”.