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Procyclicality of the financial system and regulation*

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* The views expressed are purely personal.

Introduction

As the most insightful paper by Ashley Taylor and Charles Goodhart (2005) that has provided the background for our session clearly demonstrates, there are concerns both in academia and in the banking sector regarding the potential costs of greater procyclicality that could come together with Basel II and IAS39. The question is to what extent these concerns are really well founded, and I aim to address this issue. I will start with a discussion of cyclicality, both in general and in the financial system in particular. I will next go on to explain what the main likely consequences of Basel II are regarding the volatility of the financial cycle and procyclicality. I will turn then to discussing how excessive procyclicality can be fixed –if it were to eventually arise– and will conclude with some remarks on the likely impact of IAS39 on procyclicality and on how restrictive the new accounting standards are concerning the implementation of some of the best remedies for the procyclicality problem, should it finally arise.

What is cyclical?

When discussing cyclicality, it is very important to remember that this is by no means a concept that just applies to the financial sphere. Indeed, the economy is also cyclical and, going further, one can confidently say that human behaviour is cyclical and that –as we are all well aware– even life is cyclical.

In the financial sphere, a certain degree of procyclicality is a natural, sensible and desirable outcome as it reflects the extent to which the financial sector is influenced by developments in the real economy and viceversa. The issue is nevertheless to what extent there is an excessive degree of procyclicality. The financial system is excessively procyclical when it unnecessarily amplifies swings in the real economy and/or reduces the stability and soundness of the financial sector. As Borio, Furfine and Lowe (2001) have explained, since shifts in risk attitudes initiated by the state of the economy are inherent in the nature of human behaviour, there is a tendency for economic agents –both lenders and borrowers– to systematically misperceive risks over the cycle. This leads to over-optimism in booms which tends to be followed by over-pessimism in downturns. This, in turn, sets in motion the well-known financial accelerator, where the real and financial cycles tend to reinforce each other through the traditional interactions between asset prices and credit, thus planting the seeds for financial instability and their associated economic and social costs (Bernanke, Gertler and Gilchrist, 1999).

In light of the above, it is clear that even without regulation there will be excessive procyclicality both in the financial system and in the real economy. Yet regulation has, in principle, the potential for either increasing or decreasing procyclicality. If so, how should the financial and economic impact of Basel II be assessed in this regard?

A framework for assessing the consequences of Basel II

The main goal of Basel II is to enhance financial stability by introducing incentives for banks to better measure and manage risks, to hold appropriate, more sensitive capital and to improve the transparency of their risk profile.

From the viewpoint of a central banker it is interesting to note a certain parallelism between modern thinking in monetary policy and the framework depicted for financial stability in Basel II. In particular, the modern approaches to monetary and financial stability have three key characteristics in common. First, they are both forward-looking in nature and have a medium-term horizon, all of which departs from the backward-looking, myopic behaviour observed in the past. Second, as a result of the above, they both have an anticipatory character that seeks prevention rather than cure. And, finally, both attempt to incorporate market views through the role played by expectations and market discipline.

When assessing the value added of Basel II, and in order to put the analysis of procyclicality into perspective, we must take into account its impact on both 'financial output trend' and 'volatility'. For instance, Figure 1 provides an impressionistic description of the potential impact of Basel II compared to Basel I. It tries to convey the now generally accepted idea that by introducing risk-sensitive capital requirements, Basel II can enhance the efficiency and the stability of the banking system relative to Basel I. This is represented by a higher and faster growing 'financial output' in Basel II relative to Basel I, as shown by the two 'trend' lines in the Figure. Despite this significant improvement, there is a heated debate about whether Basel II will increase financial volatility and, as a result, procyclicality with the real economy, as shown by the two alternative oscillating lines around the 'trend' corresponding to Basel II.

Does Basel II add to procyclicality?

In the discussion about the impact of Basel II on procyclicality, there are several views. A first view, neatly put forward in the paper by Taylor and Goodhart (2005), is that a close scrutiny of Basel II and of the available empirical evidence suggests that, overall, Basel II is likely to exacerbate procyclicality although it is unclear what the size of this effect would be.

Figure 2 illustrates the several causal links that have to be followed for Basel II to increase procyclicality. Namely, Basel II would increase the risk-sensitiveness of minimum capital requirements which, in turn, would lead to higher cyclicality of the overall regulatory capital and to more procyclical capital. Consequently, this would be reflected onto more procyclical lending and onto a higher degree of procyclicality in the real economy. Clearly, for Basel II to ultimately result in higher real procyclicality, none of the causal links in the chain has to be broken.

A different view is the so-called 'neutrality' view, which considers that some of the causal links in the chain are most likely to be broken. Specifically, while there is almost no discussion that the minimum capital requirements will be more procyclical –through Pillar 1–, and while regulatory capital might admittedly still be more procyclical under Basel II –in spite of the mitigants provided by Pillar 2–, it must nevertheless be recognised that lending practices are much more closely linked to economic capital than to regulatory capital and, therefore, are not likely to be significantly influenced by Basel II, since economic capital should not be much affected. Indeed, according to proponents of this view what Basel II will do is to align regulatory capital more closely to current banking practices and thus to economic capital, thereby not affecting lending policies. Moreover, banks hold significant capital buffers that although moving procyclically lead to an overall moderate effect (Ayuso, Pérez and Saurina, 2004).

But one could go even further and argue that Basel II will not only not raise procyclicality but will actually help reduce it since there is nothing more procyclical than a poorly run bank. By contributing to a better assessment and management of risks, Basel II should reduce the scope for surprises and thus for procyclicality. This is, for example, the view taken by the Basel Committee on Banking Supervision as clearly stated by its Chairman: 'When banking systems are adequately capitalised, well-managed and risks are correctly assessed within the appropriate time horizon, the financial system becomes more stable, less procyclical, better able to promote sustainable growth, and more resilient during periods of stress.' (Caruana, 2004).

I think it is fair to say that, given the uncertainties posed by the Lucas critique, we are not likely reasonably to know what the effects of Basel II on procyclicality will be until the system has actually been up and running for some time. Still, I think that it is important to stress that it is by no means clear that Basel II will exacerbate procyclicality and, if it did, that this effect would be significant.

How to fix excessive procyclicality?

Since central banks and banking regulators are paid to worry, it is always necessary to be prepared for the worst even if this is not the most likely scenario. Let me thus come to the issue of how to fix excessive procyclicality arising from the financial system.

A first line of defence -and an important one- has to do with macroeconomic policies. Specifically, a stability-oriented monetary policy and a fiscal policy that can be made to work in a countercyclical fashion around a trend-path of fiscal rectitude are powerful tools for combating excessive procyclicality, both by preventing financial instability from arising and by allowing greater room for manoeuvre to deal with episodes of instability should they materialise.

Let me focus, however, on the prudential policies and, in particular, on the role that can be played by what I consider to be a first-best remedy for excess procyclicality: namely, the introduction of forward-looking or dynamic provisioning, as practised in Spain over the past few years (Fernández de Lis, Martínez-Pages and Saurina, 2000).

Without going into too much detail, the key purpose of such a system is to correct the basic market failure mentioned earlier whereby risk tends to be underestimated in good times and overestimated in bad times. The underlying philosophy of forward-looking provisioning is not that risk arises in bad times but rather that risk increases in good times but only materialises in bad times (Crockett, 2001). As a result, it is useful to build up provisions in times of plenty (i.e. when risk increases through the expansion of credit but is underestimated) that can be drawn on in downturns (when risk materialises).

Accountants have often criticised forward-looking provisioning arguing that setting up a provision when credit is granted implies that credit is priced below its face value. This –accountants claim– distorts the book value of banks' assets and results in losses in accuracy and transparency. These criticisms have led to proposals (Borio, Furfine and Lowe, 2001 and Goodhart, 2004) to have –as a second-best option– some sort of countercyclical capital charges that share the basic philosophy of forward-looking provisioning. However, as I will presently argue, even taking into account potential accounting issues should not lead to the abandonment of forward-looking provisions as the first-best solution to procyclicality.

The new international accounting standards and procyclicality

Let me tackle, albeit rather briefly, the issue of the relationship between IAS39 and procyclicality.

I cannot agree more with the basic conclusion of Taylor and Goodhart (2005) that IAS39 adds to procyclicality in the financial system through the introduction of fair-value accounting, notwithstanding its virtues in terms of transparency and market discipline. Unlike the case of Basel II, where –as I have argued– its procyclical impact is not so clear, the procyclical consequences of IAS39 are quite evident. Consequently, it is an irony that, even if the introduction of IAS39 will have far-reaching repercussions for the financial system, so little analysis has been made to date of the potential efficiency and macroeconomic impact of the new accounting rules.

There is also a serious risk that, if the new rules are interpreted too rigidly, they could discourage, complicate and even prevent the implementation of some solutions to the procyclicality problem such as forward-looking provisioning. Consequently, IAS39 might not only exacerbate procyclicality but also make it more difficult for regulatory policy to deal with procyclicality. In particular, Basel II is mainly about capital (to cover unexpected losses) and thus does not deal in depth with provisions (e.g. to cover expected losses, as in the case of forward-looking provisions). In turn, IAS39 contemplates only 'incurred losses' as far as provisions are concerned. Hence, under a rigid interpretation, IAS39 would not be compatible with a system of forward-looking provisions.

However, while IAS39 contemplates only 'incurred losses', it leaves some margin for manoeuvre that can be used to implement a system of forward-looking provisioning. Specifically, homogeneous group provisioning is possible even if individual losses are not yet individually identified, and provisioning can be made for all groups of loans and not only for those affected by incurred and already identified losses in an individual loan. Finally, it is pertinent also to recall that Basel II stipulates that the difference between total expected losses and total provisions be reflected in regulatory capital, thus squaring the circle.

Conclusions

There are several conclusions I would like to draw concerning the impact of regulation on the procyclicality of the financial system. First, while procyclicality is certainly an important issue, it is not just due to regulation. Second, a certain degree of procyclicality is natural, sensible and desirable as it reflects behaviour that is risk-sensitive. Third, when assessing the overall impact of regulation, one should look both at trend (efficiency effects) and cycle (procyclicality). In this respect, while most would agree that Basel II is clearly better in terms of trend –given its effects from the standpoint of efficiency, transparency, stability, etc.– its cyclical impact is still subject to debate. Indeed, it is not clear whether Basel II will add to procyclicality or, even if it did, what the size of the effect would be. Fourth, contrary to Basel II, the 'case for procyclicality' is very clear for the new accounting standards (in particular, IAS39). And finally, the authorities in charge of financial stability should, in any case, be ready to counter excessive procyclicality. For this purpose, I have advocated forward-looking provisioning as a first-best option from the regulatory viewpoint and made the case for avoiding too rigid an interpretation of the new accounting standards that could hinder the implementation of such an effective measure to deal with procyclicality.

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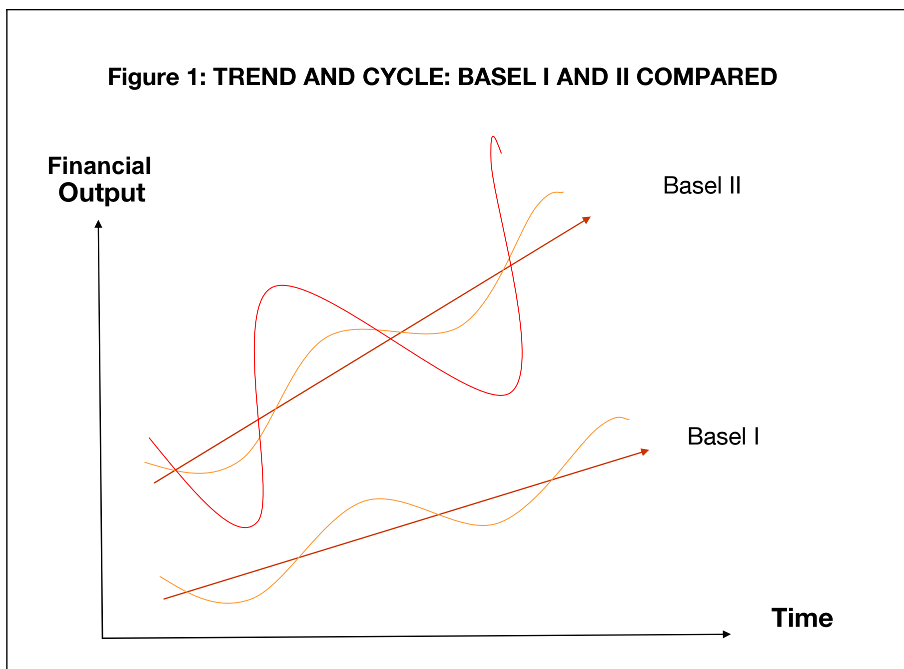
Figure 1: TREND AND CYCLE: BASEL I AND II COMPARED
Financial Output
Basel II
Basel I
Time

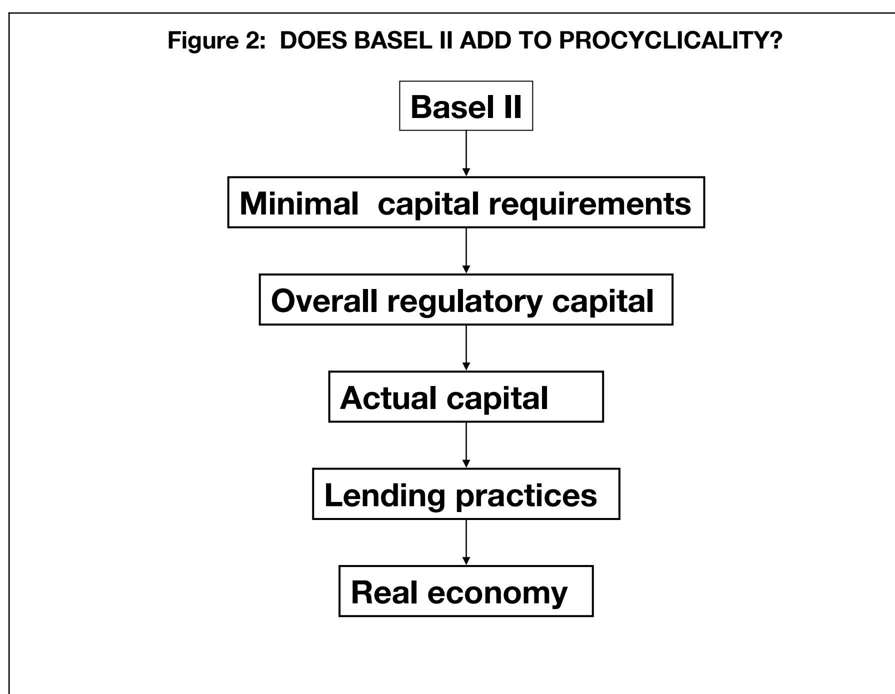
Figure 2: DOES BASEL II ADD TO PROCYCLICALITY?
Basel II
Minimal capital requirements
Overall regulatory capital
Actual capital
Lending practices
Real economy