BANCO DE ESPAÑA

Macroprudential approach: the Banco de España experience

Session 10: Making Macroprudential Supervision Work – What should Supervisors Do?

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Outline

- The current debate on the macroprudential framework
- The Banco de España approach
- Some relevant topics from the macroprudential point of view
- Final remarks

The current debate

- **Today there is an intense debate about the macroprudential orientation of regulatory and supervisory frameworks. Under discussion is its scope, its objectives, the instruments available and its implementation**

- **Apart from the specific details of the debate there are two relevant stylised facts:**

  – **There is a general agreement about the need to strengthen the macroprudential orientation of financial regulation and supervision**

  – **There is a lack of specificity regarding the macroprudential framework: the term remains ambiguous and the available instruments are not well-defined**

The current debate

- **Putting together these two stylised facts results in something of a clash: that we should analyse something that is not well-defined, but at the same time that there is general agreement about its relevance**

- **In this context, there are at least two main risks:**

  – **Promoting some institutional arrangements with certain responsibilities but without the necessary instruments to achieve the requisite goals**

  – **Due to the absence of a clear definition together with the urgency of the moment, asking for huge information requirements that would not pass the simplest cost-benefit test**

The current debate

- **Which are the available options?**
  - Option A: to intensify intellectual debate on the concept in an attempt to define a comprehensive and adequate theoretical framework …

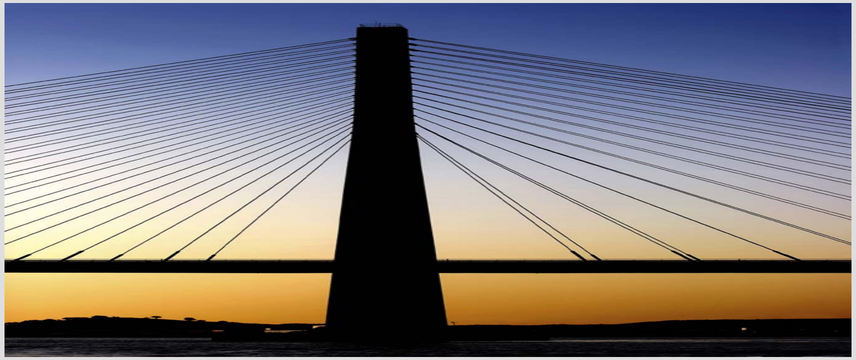
    … which risks us getting lost due to the complexity of the debate
  - Option B: to adopt a practical approach consisting of finding solutions to relevant problems that we all recognise
- **I advocate option B, i.e. to follow a practical approach in tackling the issue of macroprudential regulation and supervision**
- **In fact, Banco de España has been practical in implementing a macroprudential approach to regulation and supervision. This has been the case for the past 10 years at least, so this concept is not a novelty in my institution, either in the type of analysis or in the instruments available**
  - For instance, in the year 2000 Banco de España introduced a dynamic provision. I will came back to this later.

Banco de España approach to the macroprudential framework

- **The practical approach chosen by Banco de España to strengthen the macroprudential orientation of financial regulation and supervision is simple, but at the same time powerful**

Macroeconomic Analysis:

- Monetary policy
- Fiscal Policy
- Structural policies



Microprudential Supervision:

- Solvency of individual institutions

Macroprudential Analysis:

It is important to assess the level of risk of the financial system as a whole, because if this risk materialises it could negatively affect the real economy

Banco de España approach to the macroprudential framework

- **The elements of this approach to the macroprudential framework are basically two:**

  – **The analysis and assessment of risks from a system-wide perspective, as well as the resilience of the system to withstand these risks**

    - ***The typical output of these analyses are Financial Stability Reports***

  – **Once the risks are identified and if they are considered dangerous to the system as a whole and, as a result, to the real economy, the next step is to design regulatory and supervisory instruments to address these risks**

    - ***The Spanish dynamic provision in an example of this type of instrument***

Banco de España dynamic provision: a macroprudential tool

- There is ample theoretical and empirical evidence to demonstrate that banks' lending mistakes are more prevalent during upturns
  - Borrowers and lenders are overconfident about investment projects
  - Over-optimism implies under-pricing of credit risk…
  - … which results in lower lending standards
- During recessions, banks suddenly turn very conservative and tighten lending standards
- Lending cycle with impact on the real economy
- This should be a cause of concern for banking supervisors
- There is a need for a tool to cope with the potential problems due to rapid credit growth/under-pricing of risk

One answer is dynamic provisions

Banco de España dynamic provision: a macroprudential tool

- **Institutions recognise in good times, as impairment, loan losses that, according to past experience, will appear later in the business cycle**

- **Dynamic provisions mitigate the fact that, in good times, risks build up but are only disclosed with a delay in the P&L account**
  - **It is not reasonable that investors should be surprised in the future by what is already known is going to happen**

- **They take into account the transition from collective assessment of impairment to individually identified losses**

- **In other words, dynamic provisions, which are objective and transparent, offer a truer and fairer view of financial institutions…**

- **… and they contribute to reducing the procyclicality of accounting rules**

Banco de España dynamic provision: a macroprudential tool

- **It is fair to recognise that this mechanism causes some problems to accountants, but the answer should not be to remove it: there are ways to bring together prudential supervisors' and accountants' views**

- **A possible way forward:**

    - Differentiating in a transparent way between "regular profits" and "distributable profits"

        - ***The difference has to appear in the Annual Accounts***
        - ***Included in IFRS***

    - Difference would be a set of publicly reported compulsory reserves that would not interfere with regular profits

        - ***It could include a TTC reserve earmarked against future losses built up along the lines of the Spanish dynamic provision***

        - ***Details to be worked out, but fast progress is possible if there is strong consensus on the substance of the matter***

Other relevant macroprudential issues

- By adopting a practical approach to the macroprudential framework, it is possible to identify relevant issues that we should address …
- … avoiding the risk of paralysis that arises if we lose perspective as a consequence of devoting our best efforts to defining a very complex issue such as the macroprudential concept
- For practical purposes, I will illustrate these relevant topics with some examples

1. The structure of the financial system is relevant, as is the type of institution that operates within it
   - Some institutions are not big enough to be considered systemic, but they are deeply interconnected with other players in the system (e.g. Bear Stearns, Lehman Brothers, AIG, monolines etc.)
   - This should be a cause of concern for regulators and supervisors if we adopt a macroprudential approach

Other relevant macroprudential issues

2. **Financial innovation is not only a question of new products, but also of traditional and well-known products that are sold to new business segments**

    - When banks are marketing traditional products but are moving into unknown segments of activity or new geographical regions, the well-known characteristics of such products may change

3. **In banking, to be boring is a good quality**

    - When banks (and bankers) start to have fun (excessive growth, design of complex products, complex operational structures…), problems normally arise

4. **Is size relevant?**

    - Too big to fail, too big to be rescued, too big to be managed…
    - should we place a limit on the size of financial institutions?

Final remarks

- **There is a huge difference between the conceptual frameworks of macroeconomic and macroprudential analysis**

  – Macroeconomic analysis:
    - *There is stability in terms of the available analytical tools and in terms of the indicators*
    - *Admittedly, there are different schools of thought; but there are well-defined models and a set of commonly agreed tools and indicators*

  – Financial Stability / Macroprudential analysis:
    - *There is no common framework and these concepts remain ambiguous*
    - *There is no clear consensus on the type of indicators that we should look at*
    - *All in all, there is a lack of consistency and completeness in the framework*

Final remarks

- **The practical approach that I propose today must be compatible with another more medium-term approach devoted to closing the gap between the conceptual framework currently available in macroeconomic analysis and financial stability analysis**

- **But, importantly, this second approach, which is as I said necessary, should not invalidate the practical approach**

Thank you for your attention