Underwriting, expected credit loss recognition and procyclicality

Pablo Pérez (Madrid, 19 October 2018, Banco de España-CEMFI-FSI High Level Conference on "*The new bank provisioning standards*")

QUESTION

<u>What can make the new accounting standards on provisioning PROCYCLICAL?</u>

There is a link between deferral of credit loss recognition and procyclicality

but

Accounting standards are not to blame

Simple facts about financial information

Reliability / Uncertainty

Judgment / Incentives

Estimation

Bank financial statements

Underwriting

Defaults / Credit risk / Provisioning policy

Forecasts: *forward-looking* vs *available* information… to infer the likely impact of credit risk drivers

Procyclicality

Lenient underwriting → deferral of credit loss recognition → procyclicality

G20 vs the concerns of banks and auditors

ECL standards: timelier recognition of losses… with substantial room for judgment (*eg* SICR)

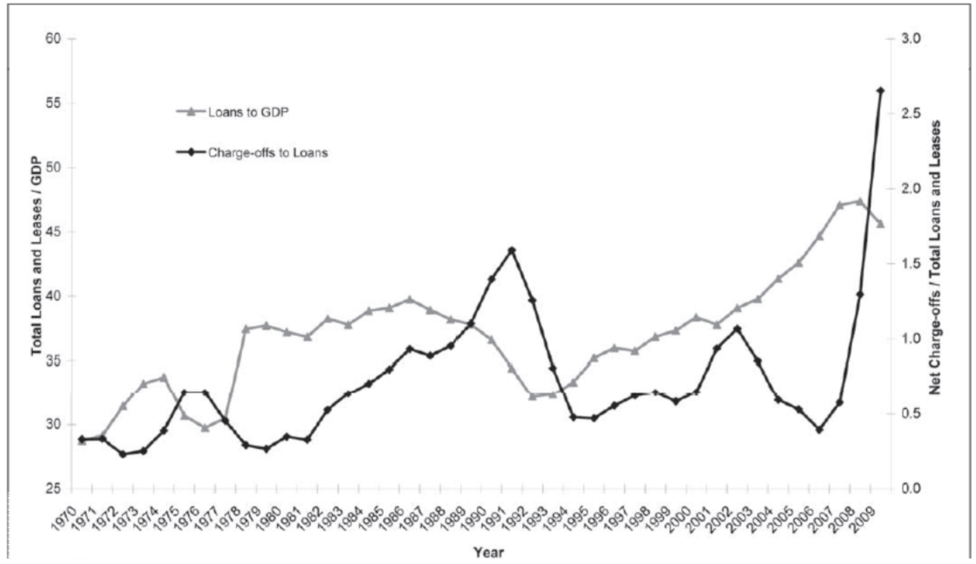
Accrual of credit losses

Information to estimate the impact of defaults…

… including on the effects of underwriting

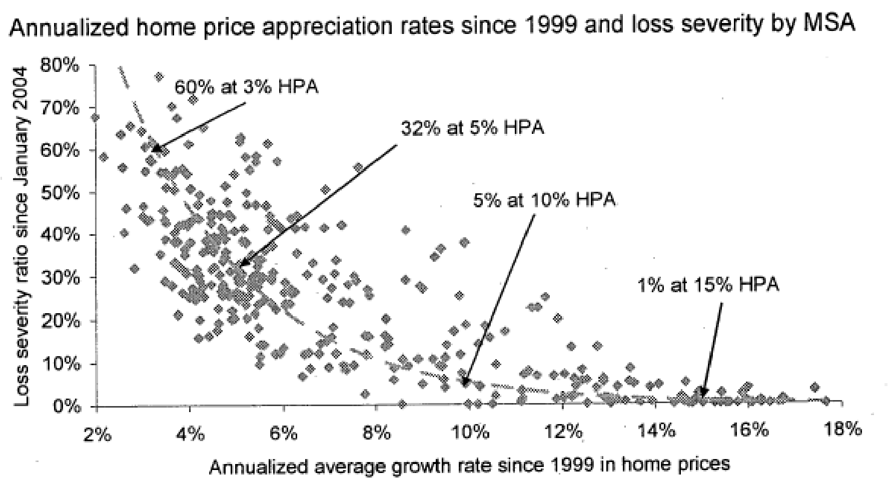
$$LLP_t = BV_t - \left[\frac{\sum_{s=1}^{n} PD_s \times ECF_s^{t+1}}{(1+ie)} + \frac{\sum_{s=1}^{n} PD_s \times ECF_s^{t+2}}{(1+ie)^2} + \ldots + \frac{\sum_{s=1}^{n} PD_s \times ECF_s^{t+z}}{(1+ie)^z} \right]$$

Loans to GDP / Charge-offs to Loans – US commercial banking - 1970-2009



Source: *Stevenson (November 2010), FDIC*

There is a strong negative correlation between home price appreciation and loss severity



HPA data as of end of third quarter 2006, mortgage data as of October 2006

Note: See the next page for more details

Source: *LoanPerformance, OFHEO, Deutsche Bank*