The time dimension of bank provisions - Financial stability and pro-cyclicality

Introductory remarks

by

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The new provisions: Pros

- Under proper implementation, the expected credit loss (ECL) approach will imply a fuller & more timely recognition of losses for credit instruments measured at amortised cost
- Benefits from a financial stability perspective include:
  - A larger buffer of loss absorbing capacity in good times
  - A more prudent assessment of financial health at times of distress
  - Enhancing the credibility of the solvency associated with regulatory capital ratios
  - Making investors and analysts better informed to exercise market discipline on financial institutions
  - Providing stimulus for prompt corrective action, prudent lending practices & careful risk management

The new provisions: Cons

- However, the list of cons is also long...
  - Implementation challenges are paramount
  - Task for external enforcers is very hard
  - Comparability of accounting numbers across institutions will diminish

and, most relevant for the topic of this panel:

The higher reactivity of the new provisions to shifts in macroeconomic conditions (given PIT & long-term features of ECL approach), which might exacerbate the procyclicality of bank lending

Bad news $\Rightarrow$ $\uparrow$ Provisions $\Rightarrow$ $\downarrow$ Profits $\Rightarrow$ $\downarrow$ Capital $\Rightarrow$ $\downarrow$ Lending capacity

Quantifying the concerns: Abad and Suarez (2018)

- Abad, J., and J. Suarez (2018) "The Procyclicality of Expected Credit Loss Provisions" (www.cemfi.es/~suarez) aims to quantify the importance of these effects

- Quantitative assessment based on calibration of recursive ratings-migration model:

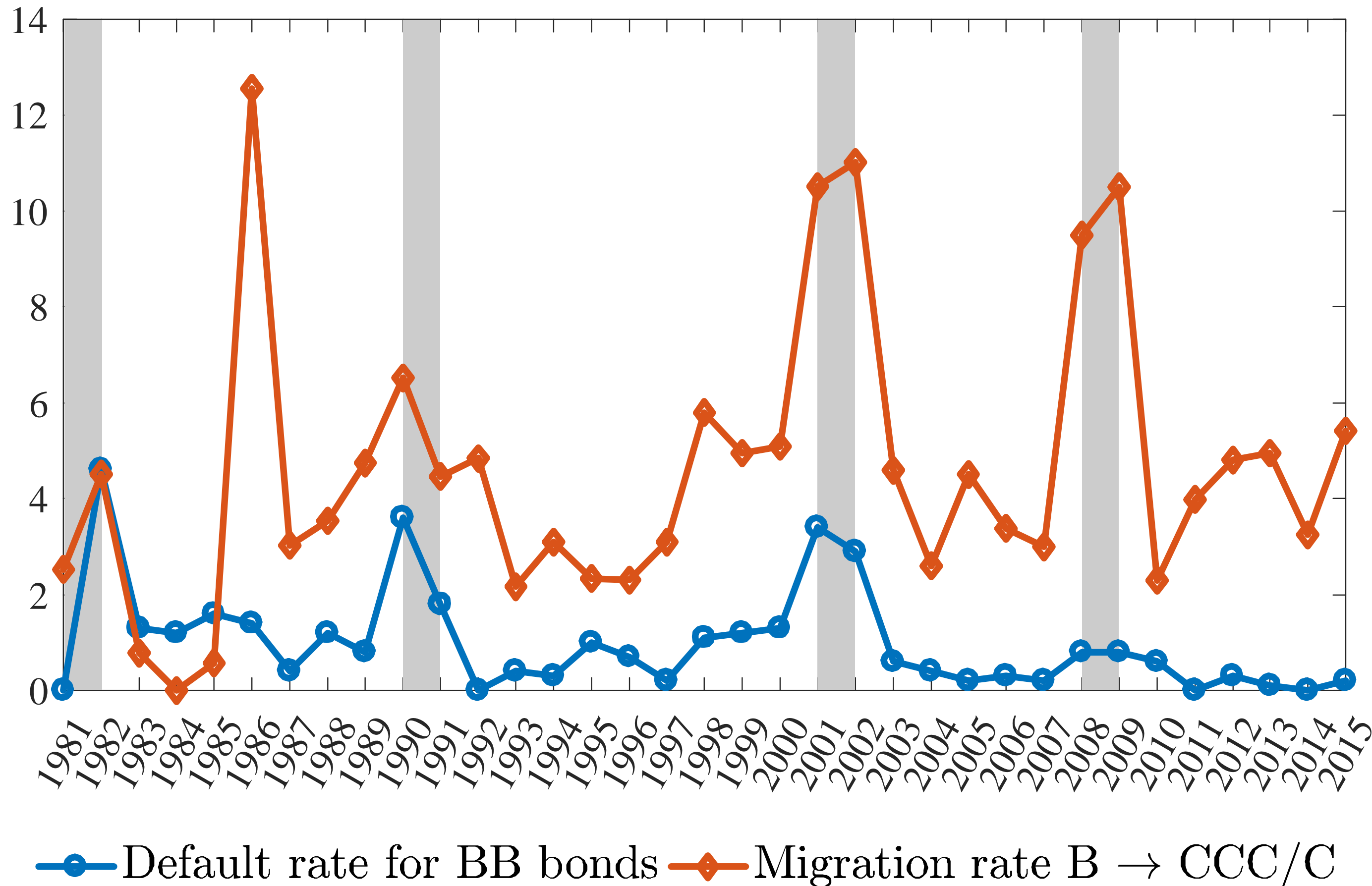
  - Minimal ingredients (3 rating categories, steady loan origination flow, competitive loan pricing, simple debt-equity capital structure) to capture the richness of the new provisions (& surrounding institutional framework) in a compact manner

  - Captures the business cycle as a simple two-state Markov chain (expansions/recessions) affecting credit-risk parameters

- Calibrated for portfolio of corporate loans of European IRB bank

Motivating fact 1: The business cycle affects credit quality

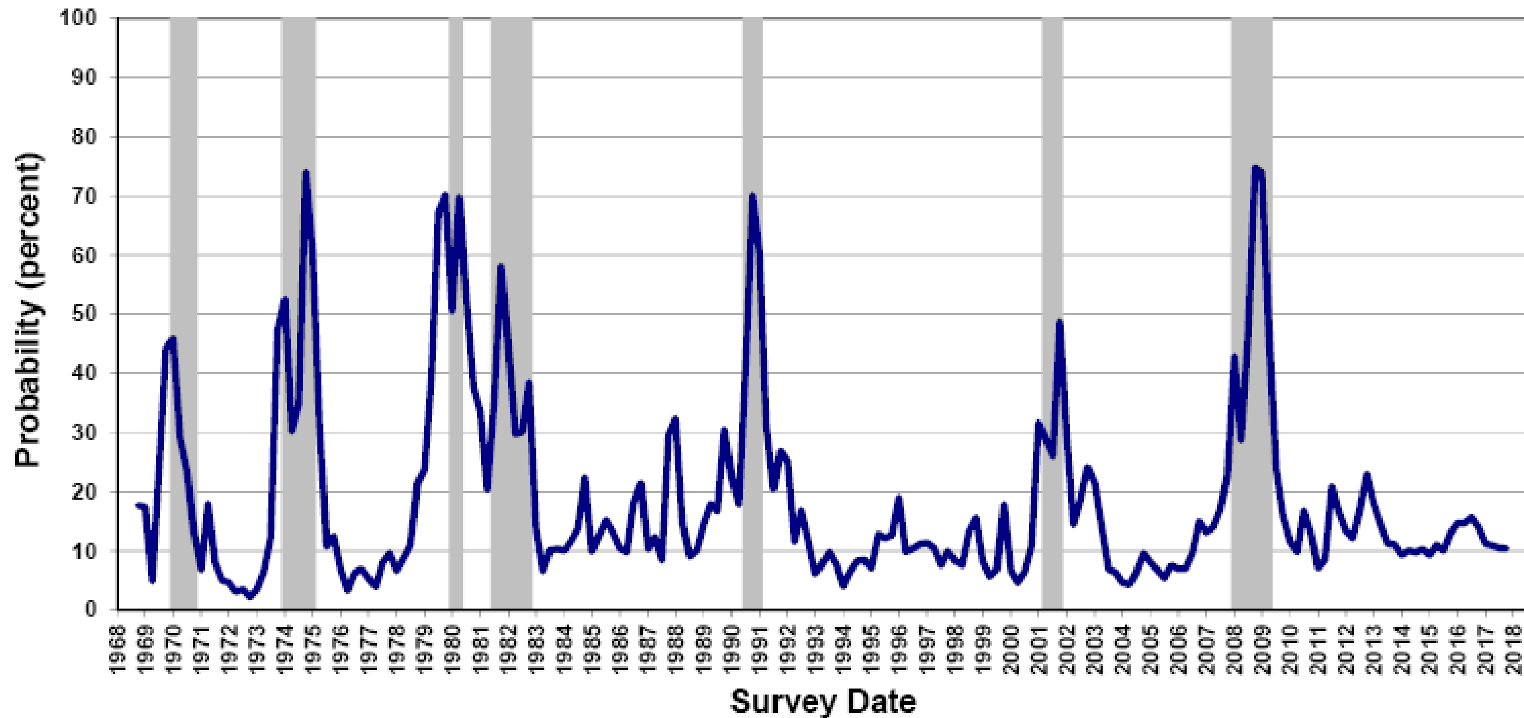
F.B1. Sensitivity of default & migrations to aggregate states



Selected yearly S&P default & downgrading rates. Grey bars identify 2-year periods following the start of NBER recessions

Motivating fact 2: Business cycle shifts are hard to predict

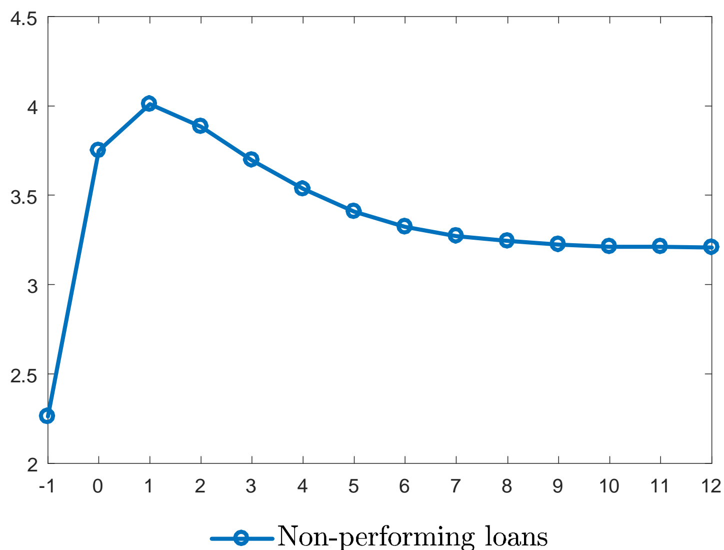
F.B2. The Anxious Index (from Philadelphia Fed)

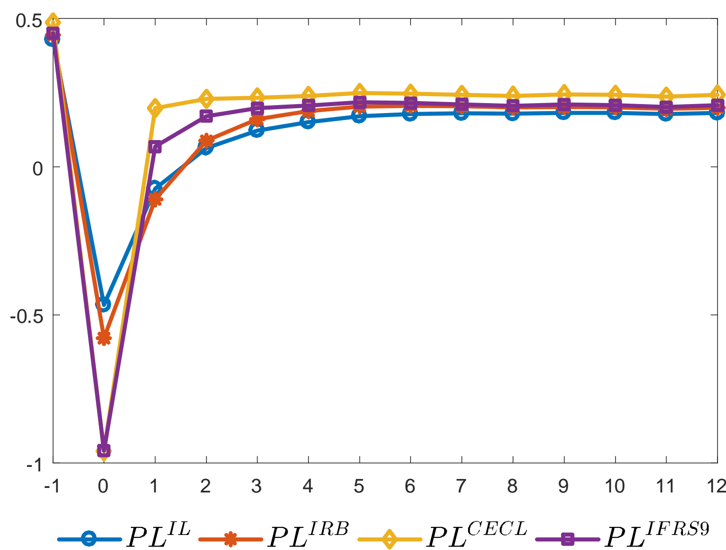


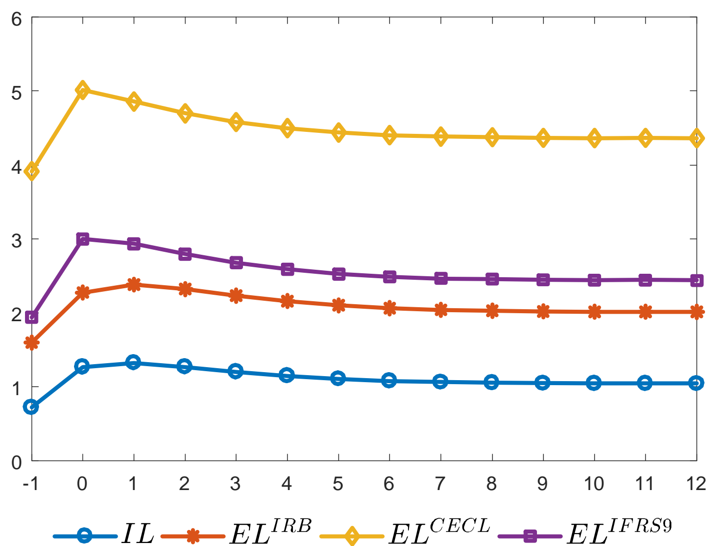
Professional forecasters' median probability of decline in Real GDP in the following quarter. Grey bars identify NBER recessions.

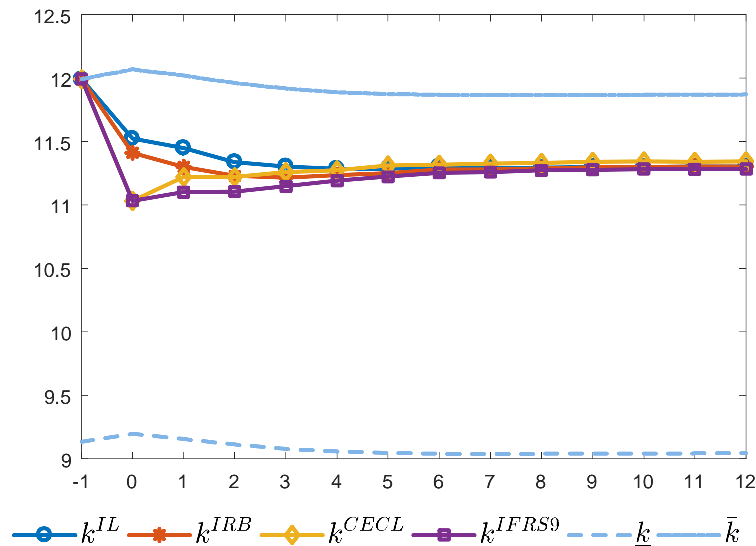
[Consistent with An-Jalles-Loungani (2018) and Breitung-Knüppel (2018). Slightly better with yearly (Isiklar-Lahiri, 2007) & financial (Adrian et al., 2018) data]

Average trajectories after the arrival of a contraction









Abad and Suarez (2018): Summary of findings

- Baseline case (IRB banks):
  - More forward looking provisions imply larger on-impact effects of negative shocks (upfront losses recognition)
  - A typical recession eats up 1/3 of fully loaded CCB (twice as much as under IL)
  - Prob. of needing recapitalization in contractions is several pp higher (IL-IRB-CECL: 13%, IFRS 9: 18%)

- Extensions:
  - Similar impact for SA banks
  - Higher impact when crises are longer / more severe
  - Lower impact if crises are foreseen further in advance

Abad and Suarez (2018): Policy analysis

- Model predicts new provisions will lead banks to recapitalize more frequently

  If bank owners dislike cancelling dividends, consuming regulatory buffers or raising new equity, they may instead cut on loan origination

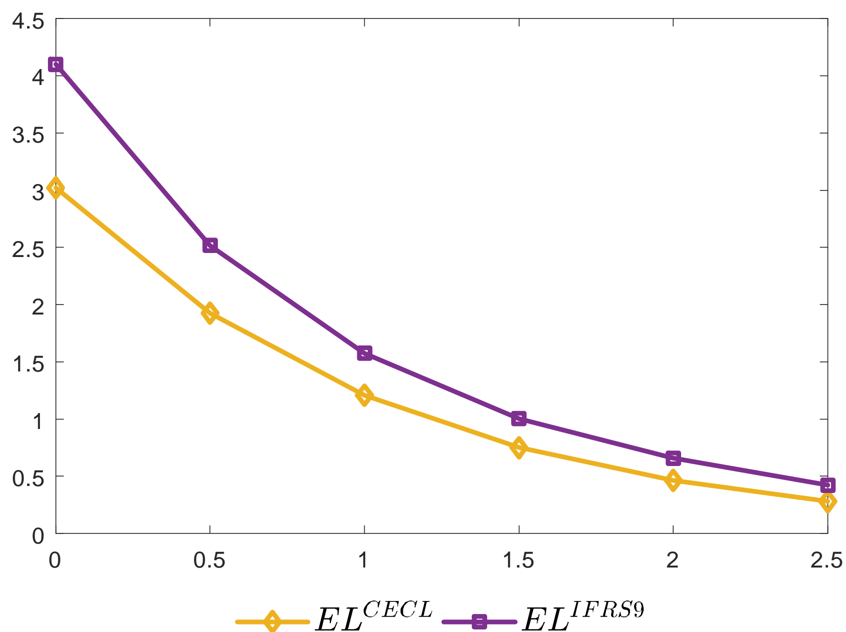
  $\Rightarrow$ We use unconditional recapitalization probability to proxy the pro-cyclical effects & to assess the effectiveness of policies

- Several policies can successfully mitigate the problem:

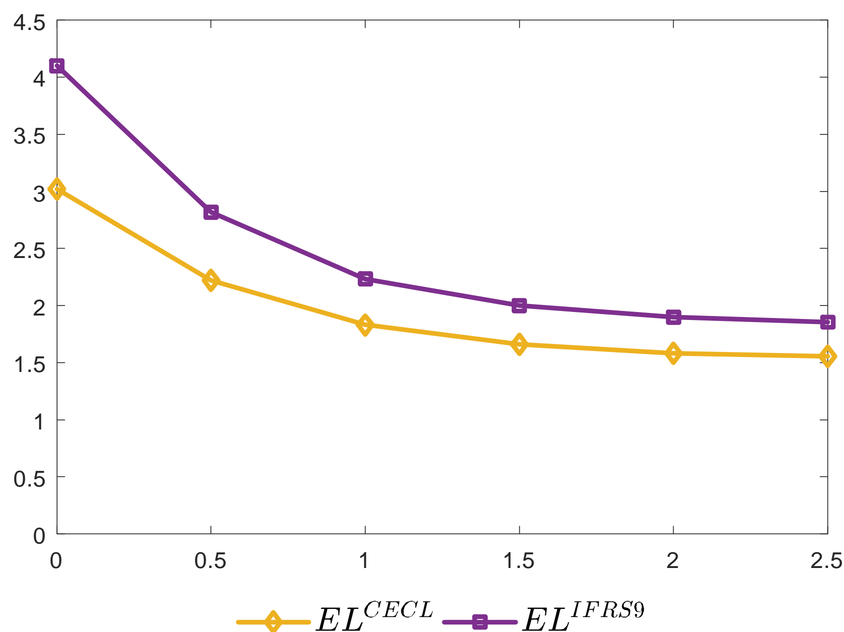
  CCB add-ons (perhaps calibrated using ST results) appear the simplest & most effective tool

F.4. Effects of increasing or activating regulatory buffers

A. CCB add-on



B. CCyB activation



Unconditional probabilities of recapitalization (%) as a function of add-on size or level of activation (in percentage points of RWAs)

[CCyB is activated with 2y implementation lag]

Concluding remarks

- New ECL approaches to provisions introduce a challenging shift of paradigm that scholars & supervisors should not neglect
- There are pros associated with a fuller and more timely recognition of credit losses
- The difficulty to predict the arrival of recessions suggests that the new provisions might suddenly rise right at the beginning of contrationary periods
- Abad and Suarez (2018) estimate significantly higher (but not devastating) rises in provisions at the arrival of an average recession