Central banks and macroprudential policy. Some reflections from the Spanish experience

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Outline of the presentation

1. Reassessment of central banks’ role and the rise of macroprudential policies
2. The Spanish dynamic provisioning. Description and assessment
3. Implications in the new international setting, European context
The shifting setting for central banks

The model before the crisis

- **goals**
  - Price stability
  - Financial Stability

- **instruments**
  - EMEs

- **MONETARY POLICY**
- **REGULATION & SUPERVISION**
The shifting setting for central banks

The basic changes

Price stability

Financial Stability

MONETARY POLICY

REGULATION & SUPERVISION

goals

indicators

instruments
The shifting setting for central banks

Price stability (medium term)

Financial Stability

Inflation outlook assessment

(ECB 2nd pillar) Monetary and financing indicators

EMEs

RR, e-r, cc

Limits to Kflows

Micro prudential

Regulation & supervisión

MONETARY POLICY

REGULATION & SUPERVISION
Reassessment of the role of central bankers in the fallout from the crisis

- **Asset price bubbles debate as endorsing a hands-off approach**
  - Identification problem
  - Effectiveness, overburdening of monetary policy
  - Preference for moping afterwards
  - Response to dot com bust consolidates this view…
  - ….but backfired: lead to new excesses + great damages

- **The change in perspective. Towards a more proactive stance**
  - Excessive optimism, complacency
  - Risks not well calibrated

- **Lessons**
  - *Need for better regulation and supervision*
  - *Strengthen linkages between financial stability and macro policies,… including monetary policy*
  - *Central banks’ central role*
Reassessment of the role of central bankers in the fallout from the crisis

• ...but monetary policy limits still apply
  • Overburdening, communication challenges
  • Boldness of instruments
  • Risk of jeopardising stability price objective

• Thus, macroprudential policy as a key element of the new approach
Macroprudential policy. Fitting in the new setting

Towards a new setting

- Price stability
- Inflation outlook assessment
- (ECB 2nd pillar) Monetary and financing indicators
- Interest rates

Macroprudential Policy
- Assessment Institutions (ESRB)
- Tools

Financial Stability
- Micro prudential
- Regulation & supervisión

MONETARY POLICY
REGULATION & SUPERVISION
Macroprudential policy. Concept, goals and instruments

• **Overcoming fallacy of composition**
  • If each bank is sound, the system is sound

• **Principles**
  • Preventive nature
  • Provide tools and instruments to minimise impact from crisis

• **Goals**
  • Reinforce resilience >>> loss absorbency capacity
  • Smoothing the financial cycle (countercyclical) >>> mitigating buildup of risks and reducing crisis probability

• **Means**
  • Adapting micro toolbox to system-wide dimension
  • Assessment, monitoring + Instruments
  • ...prominent among them countercyclical elements,…
  • ... including *Spanish dynamic provisioning*. 
The Spanish dynamic provisioning. Motivation

- Evidence of procyclicality of credit, the financial system as a whole...
- ...and of vulnerabilities associated to it:
  - Looser standards
  - Risk taking incentives
  - …exacerbated in periods of low inflation-low interest rates
- Risk in bank portfolios rise during expansions
- Loan loss provision along the lending cycle appears as the appropriate tool.
- Spanish general (dynamic, statistical, countercyclical) provision
  - Enacted in 2000
  - Reference for regulators worldwide
The Spanish dynamic provisioning. Functioning

• Basic features
  • Assess potential losses based on statistical cyclical regularities
  • Development of internal methodologies to estimate impairment
    • Alternatively, BE provides model based estimates (from CIR register) to apply by banks

• The (basic) formula, provision flow
  \[ \text{General provision} = \alpha \Delta \text{Credit} + \left( \beta \text{Credit} - \text{Specific provision} \right) \]
  • Component alpha: inherent losses of increased credit
    • \( \alpha = \text{estimate of } \% \text{ credit loss over the cycle} \)
  • Macroprudential-countercyclical components
    • Component beta \( \ll \beta (x \text{ Credit}) \) reflects the average specific provision over cycle
    • Specific provision \( \ll \text{account for actual detected impairments (NPLs)} \)
    • Difference is procyclical and increasing with the cycle
      • Expansions, low NPLs + Increasing levels of credit = +, increasing =\( \uparrow \) provision stock
      • Downturns, high NPLs + Moderating levels of credit = -, decreasing =\( \downarrow \) provision stock
    • Limit to general provision stock: 125% of \( \alpha \times \text{Credit} = \text{Credit losses over the cycle} \)
The Spanish dynamic provisioning. Facts and results

- Strong procyclicality of credit and countercyclicality of NPLs…

**Chart 1. Credit growth and non-performing loan ratio**

- % y-o-y
- NPL

Source: Banco de España
The Spanish dynamic provisioning. Facts and results

• ...reflects in the evolution of the provision flow
• ...where general provisions display a marked countercyclical behaviour

Chart 2. Loan Loss Provisions (flow) as a percentage of total loans

% Loans

-0.3 -0.2 -0.1 0.0 0.1 0.2 0.3 0.4 0.5 0.6 0.7

Dec-00 Dec-01 Dec-02 Dec-03 Dec-04 Dec-05 Dec-06 Dec-07 Dec-08 Dec-09

Total provisions
Specific provisions
General provisions

Source: Banco de España
The Spanish dynamic provisioning. Facts and results

• Leading to an upward trend in the stock of total provisions
  • The general accumulation/depletion is offset by the specific stock

Chart 3. Breakdown of provision funds (stock) into specific and general

Chart 4. Provision funds (stock) over total loans

Source: Banco de España
The Spanish dynamic provisioning. Facts and results

- The countercyclicalit_y also extends to the profits of the banking system

Chart 5. General loan loss provisions (flow) over net operating income

Source: Banco de España
The Spanish dynamic provisioning. Assessment

- Enable banks to buildup an important buffer against bad times
- Increase the resilience of the individual banks and the whole system
- …but NOT the silver bullet
  - Credit boom was not avoided, only mitigated
  - Sufficient to cope with individual bank losses? NO
  - Timid provision? NO
    - Higher, more stringent parameters feasible?
      - N.B. 15% of net operating income is stringent enough
- Conclusion:
  - Rather buffer (ex-post) than preventing the credit booms
  - Should be in the toolbox, but not enough
Conclusions. Considerations in the new European and international context

- Macroprudential policies should be strengthened
- Spanish example is encouraging but also signals limits
  - Useful, mainly as a buffer, not panacea.
  - Need to be complemented and be consistent with other instruments
    - Other macroprudential tools + Microprudential policies + Macroeconomic management
- Monetary policy limitations still apply
  - How do financial stability concerns ‘inform’ monetary policy?
- Assessment of policies and structures
  - Design, intensity, scope and use
  - Decoupling between assessment and tools. Institutional drive
  - Fitting into the central bank dashboard
- Risks
  - Overburdening of macroprudential policy (to tame financing conditions)
  - Financial segmentation
    - N.B. Targeted to segments where effectiveness is higher (less integrated)
- European dimension emphasises some of these elements
Macroprudential policy. Concept, role and fit in the new setting

- Price stability
- Financial Stability

**Institutions**
- Official interest rates
- Monetary and financing indicators
- Inflation outlook assessment

**Assessment Institutions (ESRB)**

**Tools**

**Macroprudential Policy**

**The European specificity**

**Regulation & supervision**

**MONETARY POLICY**

**REGULATION & SUPERVISION**

**ECB medium term**

**ECB 2nd pillar**

- Financial Stability