Financial Accounting Standards Board

401 Merritt 7, PO Box 5116, Norwalk, CT 06856, USA
Tel: +1 203 847 0700
Fax: +1 203 849 9714
Website: www.fasb.org

International Accounting Standards Board

30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410
Fax: +44 (0)20 7246 6411
Website: www.iasb.org

INFORMATION FOR OBSERVERS

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Subject: **Spanish Provisions under IFRS (Agenda paper 7C)**

SPANISH PROVISIONS UNDER IFRS

- This note clarifies the concept of the Spanish provisioning system and its integration within the accounting regime.
- **Provisioning under IFRS**
  - Under IAS 39 loan loss provisions are determined based on an **incurred loss model**, supported by **objective evidence of impairment** (either due to a single loss event or to **a group of events**). This includes observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group. IAS 39 states that loan loss provisions cannot reflect losses based on expected future events.
  - The current regime, nevertheless, allows for two broad aspects of provisions for financial assets carried at amortised cost (loans in particular):
    - There is an individual assessment for assets that are individually significant and another assessment for those that are not individually significant.
    - Of the two groups mentioned above, those assets with no objective evidence of individual impairment are grouped with assets with similar credit risk characteristics and collectively assessed for impairment ("**collective assessment for impairment**").
  - The Application Guidance for IAS 39 clarifies some characteristics of that assessment:
    - All credit grades (and not just the lower quality ones) should be analysed for impairment.
    - For the collective assessment, the assets are grouped on the basis of similar credit characteristics. **Historical loss rates** may be used, as well as formula-based or **statistical methods**.
  - The Basis for conclusions accepts provisioning matrixes in certain cases and sets out what is acceptable and what is not acceptable (inter alia, the expected loss approach).
- **The Spanish provisioning model**

- The Spanish provisioning model, the so called generic, dynamic or **statistical provisioning** model, refers to the "**collective assessment for impairment**". The term dynamic is used frequently, but this should not be seen as indicating an extensive system, that facilitates earnings management by banks. On the contrary, the Spanish system does not allow for earnings management by banks, since it is a **rule-based system**. Probably, the term "statistical provision" rather than "dynamic provision" should be used since it fits better with the nature of the provision.
- In principle, the regulation states that entities must develop internal methodologies to estimate impairment in the loan portfolio based on the "inherent losses": that is, losses that may already have been identified as relating to a specific transaction (giving rise to the appropriate specific provision), or losses which have already been incurred but which cannot be assigned to a specific transaction (once again the "collective assessment for impairment").
- For entities which do not have their own model, Banco de España has developed a model based on its experience and information on the Spanish banking sector, to cover inherent losses in loans classified as performing for credit activity only in Spain (it would make no sense to apply the Spanish parameters to loans made abroad by the Spanish banks).
- The Spanish model uses the historical credit loss information stemming from Spanish Central Credit Register (CCR), housed at the Banco de España. This CCR contains information from 1968 onwards, and comparable information covering a full economic cycle (i.e. since the late 80s). Without the CCR the Spanish model would not have been put in place.
- Before the crisis, the Banco de España was working with the industry in the development of a framework for internal provisioning models. That work has been postponed in the context of the financial crisis.
- Thus, the Spanish model uses historical loss data information for different asset classes, albeit in a simplified way (a kind of standardized model).
- It uses a **statistical model**, presented in an operational way using statistical and risk management terminology, and it is not focused on using accounting terms.

- It is **not an expected loss model**: it does not use the statistical information to forecast future losses. On the contrary, it is a **backward looking model**: it uses historical information to set out provisioning levels at the balance sheet date.
- The key assumption is the cyclical position, as reflected by the betas. This affects the transition from the collective assessment to the individually impaired assets and specific provisions. In the model used it is assumed that **during good times** it takes **longer** for provisions to transit **from the collective assessment to the specific provisions** (to provisions for individual assets that are impaired). And **during bad times** the individually impaired assets are easily identified and the **transition** period from the collective assessment to the specific provision is **shorter**. We believe that, although **IAS 39** does not specifically address this issue, it **does not rule out this assumption**.
- The Spanish system allows for an earlier detection of credit losses building up in the banks' loan portfolio.
    - It is a **transparent** system (rules based, formula based), that
    - **gives investors supplementary information** (i.e. the collective assessment is disclosed as a separate item, and this additional information is not difficult to interpret), that is both
    - **comparable across banks** and predictable (in the sense that it does **not allow for earnings management by banks**).
    - Since it is designed to be consistent with the accumulation of credit risk and credit losses, it also signals the build up of credit risk and **credit losses** in the banks (acting as an **early warning system to financial statement users**) and
    - By **building up provisions early** as credit losses accumulate in bank loan portfolios, in the process it helps avoid delayed credit loss recognition by banks.
- From a macroeconomic viewpoint, it limits the excess procyclicality of provisioning rules and helps banks to weather recessionary periods. Having said that, total provisions in the Spanish model continue to be highly procyclical, as one should expect.

- When looking at the Spanish system economists usually apply some of the following terms: it helps building buffers, it is consistent with a prudential view, it is a prudent estimate of provisions, etc. Without denying the validity of some of these points, it must be nevertheless clarified that all these are a **consequence of a proper assessment of the credit risk and credit losses building up in the loan portfolio** (of a proper "**collective assessment for impairment**"), which is the sole objective of the Spanish statistical provisioning system.
- Another issue that is frequently highlighted is the countercyclical behavior of the Spanish statistical provision (not of total provisions in Spain, which are still highly procyclical). These are the result of the view that **during good times** it takes **longer** for provisions to transit **from the collective assessment to the specific provisions** (to provisions for individual assets that are impaired). And **during bad times** the individually impaired assets are easily identified and the **transition** period from the collective assessment to the specific provision is **shorter**. In the formula-based approach, we use a term (**the betas**) that represents the average specific provisions over the last cycle, to reflect that view on the migration from collective assessment to individually impaired assets. But this is just an **operational way to do it**.
- Finally, the great distance between the Spanish statistical provision and the "collective assessment for impairment" in other countries is also widely commented. But this distance is the result of, on the one hand, the very low levels of this collective assessment for impairment in other countries (stemming from a misinterpretation that gives rise to an extremely narrow interpretation of what IAS 39 really allows in the area of provisioning) and, on the other hand, the high growth rate of Spanish banks´ balance sheet (reflecting both a buoyant demand for loans and an absence of off-balance sheet financing vehicles such as SIVs). In normal times, and with a consistent application of the "collective assessment for impairment" under IAS 39, the distance should narrow significantly and almost to a non material level.

- **The impact of the Spanish provision on Spanish banks.**
  - Before entering into the details of the Spanish provisioning system, it is important to understand that it is based on extensive research assessing the

losses in Spanish banks' loan portfolios. It is also important to understand the macroeconomic context in which Spanish banks have operated the last ten years. There has been:

- significant credit growth, due to a permanent decline in both nominal and real interest rates; and a
- catch-up process (at the outset of EMU the banking system in Spain was relatively small compared to GDP).

- The mechanism of the statistical provision in Spain is straightforward:
  - Banks provision the credit growth according to a parameter α which is the average estimate of credit loss. The alfa parameter corresponds to the "collective assessment for impairment" in a year neutral from a cyclical perspective.
  - The parameter α varies across homogeneous groups of loans (i.e. it is different for mortgages, 0.6%, than for credit cards, 2.5%) according to our historical information on credit losses. That information covers more than a full business cycle and allows for separate parameters depending on different levels of credit risk. Altogether, there are six different homogeneous loan portfolios each one with a different α that picks up a distinct level of credit risk and credit losses.
  - Credit risk or incurred losses not yet identified in a specific loan translate into specific loan losses at a different speed depending on the business cycle. The speed is quite high in downturns and may be quite low in long periods of expansion. Therefore, the α parameter is supplemented by a β parameter. This β parameter is calibrated as the historical average specific provision of each group of homogenous loans. By comparing the β parameter with the current level of specific provisions, the bank can assess the speed at which incurred losses not yet identified in a specific asset evolve into specific losses identified for individual assets. In good times the distance is large, so that the provision is positive. In bad times, the distance is almost non-existent and the β component of the general provision is negative.

- It is important to mention that α and β parameters are based on the historical experienced stemming from the Spanish Central Credit register.
- Along a business cycle the β component cancels out, that is, the positive amount in the periods where the transition from incurred-non-individually-identified losses to already-identified-specific-losses is slow (i.e. a positive β component) cancels out with those periods where the opposite is true.
- The Spanish statistical provision also includes a cap and a floor in the amount of the statistical fund build up. In order to avoid excess provisioning in good times (i.e. in order to avoid the creation of excess reserves that smooth the P&L account), there is a cap on the amount of the general provisions that can be built up in a banks' balance sheets. On the other hand, the statistical fund cannot be fully depleted because the collective assessment for impairment should always be positive.

- The statistical provisions have been applied in Spain since mid-2000 although there was a change at the end of 2004, when IFRS came into effect.
- The impact on the P&L of Spanish banks has been significant: the statistical provisions, on average, amounted to around 10% of the net operating income of the banks. However, that very high level is due to the extraordinarily high growth rate of credit in Spain (i.e. a strong build up of credit risk and credit losses in the loan portfolio), together with abnormally low levels of non-performing loans and specific provisions during this period (which did not reflect the accumulation of credit risk and losses taking place).
- From the perspective of the balance sheet, the results are more balanced. At the end of 2007, the accumulated statistical fund was around 1.3% of total assets of the Spanish banks. It is clear that in a less prolonged expansion, with a lower growth in credit and with higher levels of problem loans, the buildup of statistical loan loss provisions would have been more moderate and its impact in the P&L significantly smaller.

DYNAMIC PROVISIONS IN SPAIN

Dynamic provisions-Summary

- **Set aside in mid-2000; modified in 2004 because of IFRS**
- **Mechanism very simple: increase LLP in good times (to cover the increase in credit risk/losses), use them in bad times, when credit risk/losses appears ex post**
- **Based on extensive research and statistics on loss experience for bank loan portfolios in Spain**
- **Transparent mechanism**
- **Countercyclical mechanism that increases the resilience of banks along the business/lending cycle**
- **In a sense, dynamic provisions are transparent valuation reserves, a way to improve IFRS**

Rationale for countercyclical provisions

- **Banking supervisors know that banks' lending mistakes are more prevalent during upturns**
  - Borrowers and lenders are overconfident about investment projects
  - Banks' over optimism implies lower lending standards
- **During recessions, banks suddenly turn very conservative and tighten lending standards**
- **Lending cycle with impact on the real economy**
- **Too much competition makes things worse**
- **Monetary policy (i.e. long periods of low interest rates) increases bank risk taking**

Rationale for countercyclical provisions

- **There is ample evidence of looser credit standards during expansions**
- **Banking supervisors' concerns are well rooted both in theoretical and empirical grounds**
- **We need a prudential tool to cope with the potential problems due to too rapid credit growth**

- **One answer is countercyclical loan loss provisions**
- **Need to make IFRS more flexible regarding countercyclical provisioning, while keeping them transparent**

- **Alternatively or complementarily, apply countercyclical capital requirements (Pillar 2 in Basel II is one place to do it)**

Rationale for countercyclical provisions

1) To acknowledge the inherent or latent loss as a cost

- *better risk management and prudent accounting*

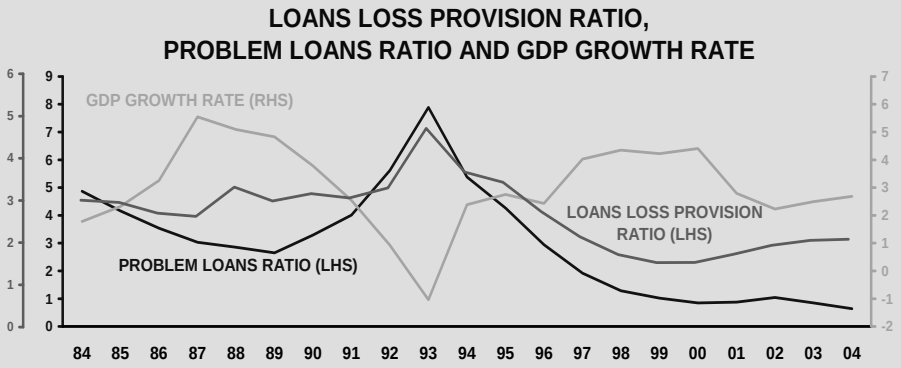
2) To counterbalance the excessive procyclical behavior of the existing LLP

3) To recognize that the transition from collective assessment for impairment to specific provisions in much longer in good times that in bad times

4) To correct the excessive cyclical bias in profits:

- *Low (high) LLP in the upturn (downturn) may overstate (understate) profits*
- *Bank profitability could be distorted:*
  - overvaluation of dividends, erosion of capital
  - wrong information delivered to investors

Loan loss provision ratio, problem loans ratio and GDP growth rate



The Spanish dynamic provision

The Spanish dynamic provision is based on the cyclical position of the economy:

- In good times, when problem loans and specific provisions are low, the dynamic provision increases
- In bad times, when problem loans and specific provisions are high, the dynamic provision liberates funds from the previously built reserve

In boom periods the dynamic provision is positive, negative during recessions

The underlying idea is quite simple:

- In good times banks increase embedded credit risk/losses, thus, a higher loan loss provision is required to account for that increase in risk/losses

Mechanism

Currently, we have specific provisions and general provisions
General provisions are set aside according to:

$$dot.gen_t = \alpha \Delta C_t + (\beta - \frac{dot.espe_t}{C_t})C_t$$

C_t is the stock of loans and ΔCt its variation
α covers the inherent loss
β is the average specific provisions for a long period of time
The first component of the general provision is the normal one: increase in provisions when loans are granted.
The second one is the dynamic provision:

- **it increases in good times because the current specific provision is low compared with the average specific provision across the cycle (β)**
- **it is negative in bad times when current specific provisions are higher than the average of the cycle specific provision**

Mechanism

The former formula is a simplified way of presenting things

In fact, α and β are assigned according to the six risk buckets or six homogeneous risk categories

The parameter vectors are:

(0%; 0.6%; 1.5%; 1.8%; 2%; 2.5%) for α

(0%; 0.11%; 0.44%; 0.65%; 1.1% y 1.64%) for β

Six homogeneous groups:

1. zero risk (cash, public sector debt)
2. home mortgages with LTV below 80%, corporates with rating A or above
3. loans with real gauarantees and home mortgages with LTV above 80%
4. rest of loans, including corporates and SMEs
5. consumer durables financing
6. credit cards and overdrafts

Mechanism

The formula of the new general provision is:

$$dot.gen_t = \sum_{i=1}^{6} \alpha_i \Delta C_{it} + \sum_{i=1}^{6} \left(\beta_i - \frac{dot.espe_{it}}{C_{it}} \right) C_{it} = \sum_{i=1}^{6} \alpha_i \Delta C_{it} + \left(\sum_{i=1}^{6} \beta_i C_{it} - dot.espe_t \right)$$

Note that there is no need to know which is the exact position in the cycle. That is endogenously provided by current specific provisions that, by definition are closely tied to non-performing loans that are a variable closely linked to the lending and the business cycle (see the figure in slide 6)

It is easy to look backwards and stablish the length of the last lending cycle and, therefore, the average of the cycle specific provision (the β). They can be set even by trial and error if you are flexible enough at the beginning to adjust the β's

Mechanism

The general fund is bounded upward and downward

The maximum is relatively low: around 1.5% of total loans

avoid a continuous increase in loan loss reserves

The minimum amount is also low: around 0.1% of total loans

you need to have a coverage of collective losses not yet individually identified

The general provision is set aside until the bank reaches the maximum

In downturns, when the general provision is negative, the general fund can be depleted until its minimum level

A simulation exercise

Initial expansionary phase (first 2 years)

Slowdown (from year 3 on)

Recession (around year 7)

Economic growth resumes again (from year 8 onwards)

Traditional provisioning system:

specific plus general

procyclical, dominated by specific provisions

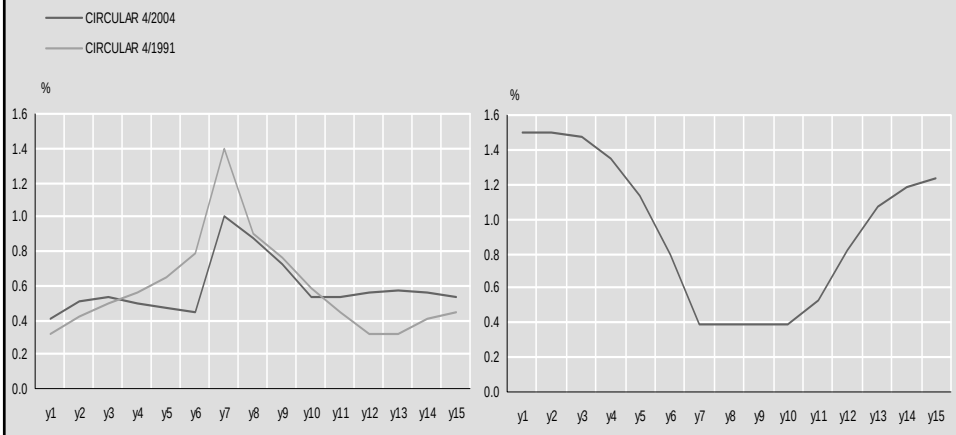
New provisioning system:

Specific plus new general (i.e. including dynamic component)

Still procyclical, but much less as the general fund is used during the slowdown

Depending on the choice of α and β the new provisioning system can be more or less procyclical. For a set of parameters is even possible to have flat provisions along the whole cycle.

Provisions (left) and new general fund (right) as % of total loans



Provisions are less procyclical when there is a dynamic provision (blue line)
The general fund is bounded here between 1.5 and 0.4 but boundaries can be changed

Transparency

Banks are required to disclose yearly the amount of the dynamic provision, apart from the specific provision

Thus, users of accounting statements can "undo" the impact of the dynamic provision on the P&L

Transparency and prudential regulation complement each other

Policy action

- IFRS need to be a little bit more flexible to allow for dynamic provisions
- In fact, dynamic provisions are a way to improve IFRS
- Some standards setters see no alternative to fair value….
- …but the current crisis has shown that fair value needs to be improved
- Dynamic provisions are in line with proper credit risk measurement and management and with prudent accounting that enhances financial stability
- On top of that dynamic provisions can be fully transparent and fully disclosed by banks
- Thus, with some flexibility from IASB, we can have a countercyclical macroprudential tool that enhances the stability of the financial system, bank by bank, country by country and globally

Policy action

- Dynamic provisions are, in fact, the way to compute the credit loss aspect of the fair value of a loan portfolio
- Dynamic provisions are one tool to cope with procyclicality
- We will need more than one tool to deal with procyclicality, a threat to financial stability
  - Intuitively, car safety is enhanced by safety belts + ABS brakes and airbags, that is, several instruments together reinforce the safety; do you want to take out any of them of your car?
- Therefore, we need dynamic provisions and countercyclical capital requirements (Pillar 2) as two of the main tools to deal with procyclicality
- IFRS allow bank managers to choose different options with different impact in the P&L. Make dynamic provisions one of those options while keeping it fully transparent