Box 6

PROVISIONING AND EXPECTED LOSS AT EUROPEAN BANKS

Mounting credit losses affected European banks greatly during the financial crisis. In many cases, the corresponding adjustment in loan loss provisions occurred rather precipitously, likely influenced by a combination of market pressure and supervisory action. While for IRB banks the calculation of expected credit loss is tightly regulated in the Basel II Accord and the Capital Requirements Directive, banks retain considerable discretion in determining the amount of loan loss provisions. As a general rule, banks may create specific provisions only when there has been a credit event. This restriction implies that provisions typically lag the deterioration in loan quality and do not consider expected loss that is based on forward-looking default probabilities. This divergence in loss recognition results in a provisioning gap that in the course of the crisis needed to be closed, occasionally with the intervention of the competent authorities.

EU capital regulation prescribes that a provisioning shortfall – the difference between eligible provisions and expected loss for the portion of a bank under the internal ratings-based (IRB) approach – must be deducted fully from regulatory capital. Excess provision amounts, in turn, may be added to Tier 2 capital up to 0.6% of risk-weighted assets (RWA), subject to limitation at supervisory discretion. This so-called *regulatory calculation difference* (RCD) therefore leads to a capital charge even if banks avoid adequate provisioning that would affect profits and thus book capital.

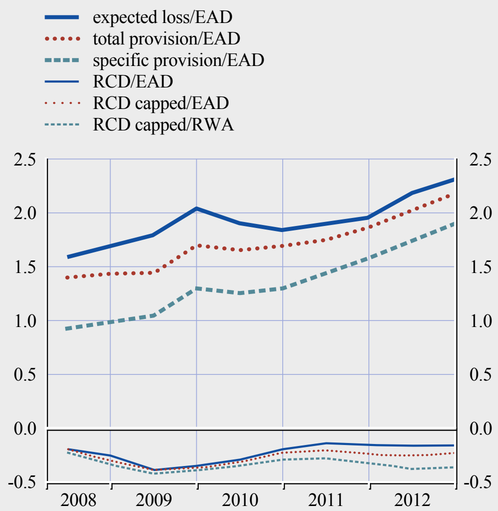
Empirical evidence points to a delay in loan loss recognition in the early phase of the global financial crisis. Data for 110 banks in 16 European countries between December 2008 and June 2013 collected by the EBA-ECB Impact Study Group show that the RCD, expressed as a percentage of total exposure (EAD or exposure at default), became more negative in 2008-09 as provisions were slow to catch up with rising expected loss (see the chart). The difference subsequently narrowed as expected loss stabilised, while provisions kept trending upwards. In some jurisdictions, general provisions accumulated before the crisis were converted into specific provisions, thereby easing the adjustment burden.

These developments were more pronounced at banks in vulnerable countries whose RCD initially exceeded the sample average but then improved markedly, in fact turning positive in 2013, not least due to additional supervisory provisions imposed in some countries under EU-IMF adjustment programmes. Overall, the increase in expected loss was primarily due to a rising share of non-performing loans that required an increase of the probability of default (PD) to 100%, whereas the PDs and thus the expected loss of non-defaulted exposures remained remarkably stable throughout the crisis.

The regulatory impact of the RCD is greater in practice since positive differences are capped and the deduction from regulatory capital needs to be expressed in RWA terms. As a growing number of banks began posting positive RCDs when the crisis abated, the cap of 0.6% of RWA became more binding, which is illustrated in a growing difference between the theoretical RCD (before applying the cap) and the RCD after capping (see the chart). At the same time, the rebalancing of risk assets and deleveraging more generally caused RWA to fall, thereby augmenting the regulatory impact of the RCD that, expressed in RWA, in 2013 was close to the maximum recorded in 2009 (see the chart). Ongoing changes to accounting standards have recognised this issue of the RCD, and their implementation should eventually contribute to correcting it. The International Accounting Standards Board, in 2013, published an exposure draft that introduces for financial instruments an expected credit loss model for the accounting recognition and measurement of credit losses. The reform expressly seeks to address the delayed recognition of credit losses that was identified during the financial crisis as a weakness in existing accounting standards. Under the proposal, recognition of credit losses would no longer be dependent on the bank first identifying a credit loss event. Rather, an estimate of expected losses would always be applied, based on the probability of a credit loss. For performing exposures this would require accounting for 12-month expected credit losses, while for exposures that have significantly deteriorated in terms of credit quality (including doubtful but not yet defaulted loans) lifetime expected credit losses would be recognised in the statement of financial position as a loss allowance or provision.

Expected loss, provisions and regulatory calculation difference

(2008 – 2012; percentages)



Source: European Banking Authority (EBA).

During the transition until IFRS 9 is implemented, the current accounting framework is likely to contribute to continued cyclicality in capital requirements. As past pronounced initial increases in the RCD reflecting a provision shortfall illustrate, some capital-constrained banks may choose to run up the RCD rather than fully recognise rising loan losses by building sufficient provisions as doing so avoids a further deterioration in profits and the capital position visible to stakeholders. However, a rising provisioning gap eventually requires an even stronger adjustment and may have pro-cyclical effects as banks then choose to achieve their capital target in part through optimising risk-weighted assets via rebalancing portfolios to the detriment of certain borrowers. The potential of correlated provisioning to create systemic externalities in the efficient deployment of bank capital would suggest a role for timely supervisory action aimed at avoiding undue delays in provisioning, including by requiring additional general provisions for prudential reasons.