Dynamic provisions are a macro-prudential tool. The author would like to thank Jim Hanson, Dimitri Vittas, and Erik Feyen for useful comments and especially...
During periods of expansion, when losses were low and specific provisions were not required, a simplified method, known as the standard model, was used to calculate the latent loss. This model, which is a simplified way of presenting things, assumes six risk buckets, or homogeneous risk categories, as follows:

- High risk: mortgages with a loan-to-value ratio above 80 percent and other collateralized loans not previously classified as high risk.
- Medium-high risk: credit card exposures and overdrafts.
- Medium risk: cash and public sector exposures (both loans and securities).
- Medium-low risk: mortgages with a loan-to-value ratio below 80 percent and exposures to corporations with a rating of A or better.
- Low risk: consumer durables financing.
- Very low risk: deposits and other liquid assets.

This simplified method, which is a good assumption, approximates the average latent risk. Because loan portfolios are not homogeneous in credit risk (credit cards, mortgages, capital market instruments, consumer loans, and public debt), statistical provisions would produce a different results if applied individually to each type of loan without grouping them into specific risk buckets. The beta parameter and alpha parameter for each risk bucket are calculated separately, and the average latent risk is estimated using a weighted average, where the weights are the percentage of net operating income of banks.

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During periods of expansion, when loans were growing at a higher rate than GDP, a statistical provision based on the average latent risk was calculated. This provision was intended to anticipate the potential losses that might occur in the future. The alpha parameter is the average latent risk, while the beta parameter is the sensitivity of specific provisions to changes in the macroeconomic environment. The alpha and beta parameters are estimated for each type of loan, based on historical data.

When the economy enters a recession, the beta parameter becomes negative, indicating that the specific provisions will be higher than the average latent risk. This is because during recessions, the likelihood of loan defaults increases, and banks need to increase their provisions to cover these potential losses. The alpha parameter remains positive, indicating that the average latent risk remains unchanged during recessions.

The overall profile of total loan loss provisions shows that the proportion of dynamic provisions has increased over time, with a peak in 2007. This is because during this period, the economy was experiencing a significant downturn, and banks needed to increase their provisions to cover the potential losses.

Dealing with implementation challenges
Several issues need to be addressed to ensure that dynamic loan loss provisioning remains effective and transparent. These include:

1. **Accounting standards**: There is a need for clear and consistent accounting standards for dynamic provisions.
2. **Tax implications**: Dynamic provisions need to be specific to ensure that they are not used to manipulate tax deductions.
3. **Financial stability**: Dynamic provisions need to be designed to ensure that they contribute to financial stability, rather than creating risks.

In conclusion, dynamic provisioning has been effective in ensuring that banks are adequately prepared to cover potential losses. However, there are still challenges that need to be addressed to ensure that dynamic provisions remain effective and transparent.
During periods of expansion, when loans to customers are growing, specific provisions are increased. Statistical provisions, on the other hand, are usually fixed according to loan portfolios. Therefore, during periods of expansion, specific provisions will be higher than statistical provisions. However, during periods of contraction, specific provisions are reduced. The relative size of the specific provisions and the statistical provisions will depend on the economic cycle. During recessions, specific provisions became much larger than during expansions, and specific provisions on individual loans are likely to be much larger than during expansions.

The European Banking Union (EBU) has implemented a new loan loss provisioning system to address the issue of procyclicality. The new provisioning system is based on a combination of a bank’s historical loan loss provisioning experience and a statistical model that takes into account the economic cycle. The new system is designed to ensure that loan loss provisions are not too low during expansions and too high during contractions, thereby reducing procyclicality in the banking system.

In Spain, the implementation of the new provisioning system has been accompanied by significant changes in the way that loan loss provisions are calculated. The new system has been designed to be more responsive to changes in the economic cycle and to provide a better indication of the risk inherent in a bank’s loan portfolio. The new system has also been designed to be more transparent and to ensure that loan loss provisions are not used to manipulate the bank’s capital position or to influence its credit rating.

The new provisioning system has been implemented in Spain by the Bank of Spain, which has been responsible for monitoring and enforcing the new rules. The Bank of Spain has also been responsible for ensuring that banks comply with the new rules, and that they are transparent and responsive to changes in the economic cycle.

In conclusion, the implementation of the new provisioning system in Spain has been successful in reducing procyclicality and in providing a better indication of the risk inherent in a bank’s loan portfolio. The new system has also been designed to be more transparent and to ensure that loan loss provisions are not used to manipulate the bank’s capital position or to influence its credit rating. The success of the new system in Spain is a testament to the importance of procyclicality in the banking system and the need for banks to be responsive to changes in the economic cycle.
Dynamic Provisioning

The Experience of Spain

Dynamic loan loss tax deductions can help deal with pro-cyclicality in banking. By allowing earlier detection and coverage of credit losses in loan portfolios, they enable banks to build up a buffer in good times that can be used in bad times. Their anticyclical nature enhances the resilience of the banking system by ensuring that banks are better capitalized during downturns. Hence,动态 provisions are more likely to be used in bad times. Their anticyclical nature enhances the resilience of both individual banks and the banking system as a whole. While there is no guarantee that they will be enough to cope with all the credit losses of a downturn, dynamic provisions have proved useful in Spain during the current financial crisis. They could be an important prudential tool for emerging economies, where banks dominate financial intermediation.

The current financial crisis is a clear, though painful, example of excess procyclicality in banking. Procyclical behavior is well rooted in both the risk-taking incentives of banks as they search for profits and in the structure of incentives and risk-sharing mechanisms. Procyclical behavior can be a source of systemic risk and tends to lower credit standards. During upturns, borrowers and lenders will be more likely to take on risky positions and deliver appropriate information to each other in the future. Conversely, during downturns, they will be less likely to do so.

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DYNAMIC PROVISIONING
THE EXPERIENCE OF SPAIN

The Spanish experience shows that they are an instrument to cover for the credit risk built up in the loan books of banks' balance sheets. Policy makers should focus primarily on the impact of provisions on the overall loan loss provisions over the business cycle. With this information, supervisors can use banks' own information, the reality check is important.

As noted, the Spanish system is based on detailed disclosure of a previous version of this policy brief as well as his Vittas, and Erik Feyen for useful comments and especially journalists, discussing whether the reserve should appear in the law. Private credit bureaus could increase the cost of lending, since there are an instrument solely to cover for the credit risk built up in the loan books of banks' balance sheets. Moreover, a monetary policy tool can be important to induce banks to become more prudent in their lending decisions by correcting the bias in the measurement of risk. To the extent that banks have a systemic role to play, they should not be attributed to the World Bank Group. The conclusions presented in the note are those of the author and not necessarily the views of the World Bank Group or its member countries. For more information on the note, contact Suzanne Smith, 202 458 7281.

The Spanish system is simple and can be easily replicated in jurisdictions with much less information. This reality check is important.

The Spanish system offers a way to both address the adverse effects of procyclical behavior and provide a regulatory incentive to change the behavior of banks. Moreover, a monetary policy tool could be an important prudential tool for emerging economies, where banks dominate financial intermediation. The current financial crisis is a clear, though painful, example of excessive bank pro-cyclicality in lending. To prevent such excesses in the future, regulators must be more vigilant in identifying and preventing them. The Spanish system is simple and can be easily replicated in jurisdictions with much less information. This reality check is important.

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