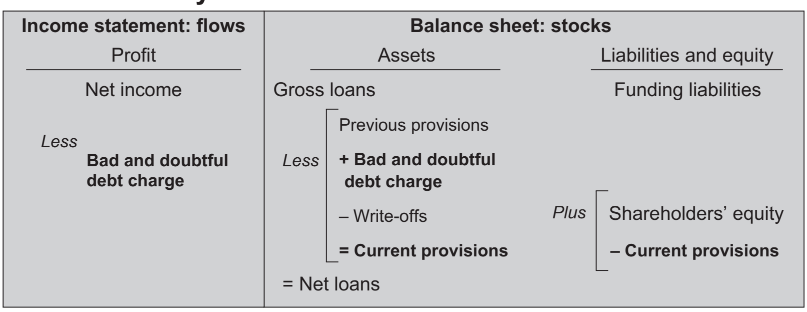
Box A: Banks' Provisioning

Recently, banks around the world have markedly increased the provisions that they hold against losses incurred in their loan portfolios. There are two broad types of provision, both of which have risen since the onset of the financial turmoil. The first is 'individual' provisions that are established when a bank identifies a specific loan as being 'impaired', in that it is unlikely to be repaid in full and the value of collateral is not expected to be enough to cover the outstanding amount. The second type is 'collective' provisions that are held against currently unidentified losses on portfolios of loans with similar risk characteristics, and against a general deterioration in the loan book. These are based on factors such as historical loss experience and prevailing economic conditions.

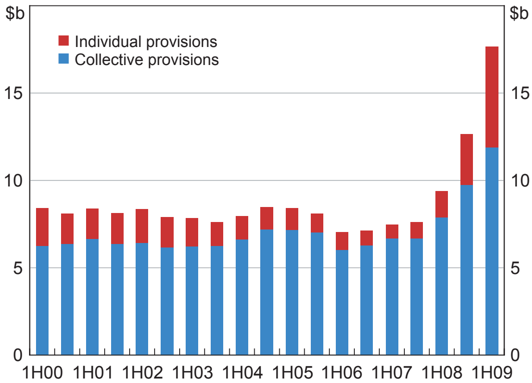
Banks' provisioning affects their profits as well as their balance sheets and capital positions. The impact on profits occurs when a bank changes either type of its provisions. New provisions are raised through a 'charge for bad and doubtful debts', which is recorded as an expense in the income statement and therefore reduces profits (Figure A1). These charges are added to the stock of outstanding provisions that are held on the balance sheet which, in turn, are subtracted from the value of outstanding loans, and from the retained earnings component of shareholders' equity. The stock of provisions is also affected by other factors, such as the value of loans that are 'written off' after the bank deems them to be unrecoverable.

Figure A1
Stylised Bank Financial Statements



While the Australian financial system has performed better than many others throughout the financial turmoil, the domestic banks have still had to increase their provisions, against both their domestic and overseas loan books. For the four major banks, total provisions stood at $17.7 billion as at their latest reporting dates (end March 2009 for three of these banks and end June for the other), compared to $9.4 billion a year earlier (Graph A1). Around half of the increase was in individual provisions, which rose to $5.8 billion as at the latest half year. The available evidence suggests that only around 7 per cent of these relate to residential mortgages,

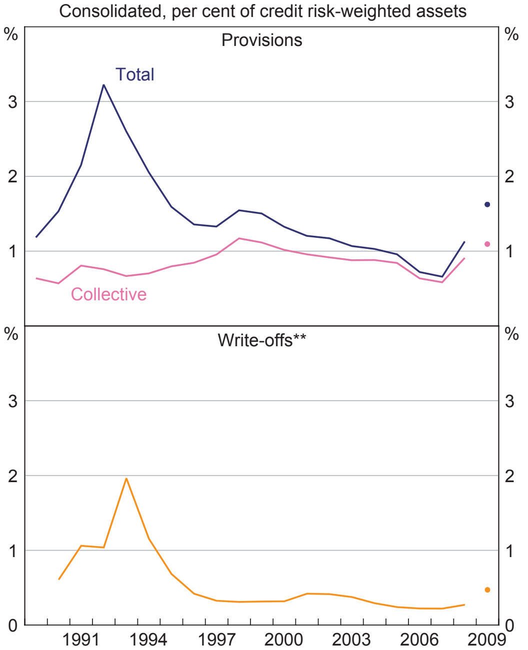
Graph A1
Major Banks' Provisions
Consolidated, as at end of each half year



* First half figures are half year to June for CBA and half year to March for ANZ, NAB and Westpac. Includes St George, and Bankwest from second half of 2008. From 2006 data are on an IFRS basis; prior years are on an AGAAP basis.

Sources: Banks' annual and interim reports

Graph A2
Major Banks' Provisions and Write-offs*
Consolidated, per cent of credit risk-weighted assets



* 2009 observation is calculated based on June 2009 figures for CBA and March 2009 figures for ANZ, NAB and Westpac. Includes St George and Bankwest in 2009.

** Per cent of average credit risk-weighted assets. 2009 write-offs for ANZ, NAB and Westpac are annualised first half to March figures.

Sources: APRA; RBA; banks' annual and interim reports

despite mortgages accounting for about 60 per cent of total (consolidated) lending. The rise in individual provisions against business loans was partly the result of the difficulties experienced by a small number of companies with complicated and/or highly leveraged business models that proved to be unsustainable when financial conditions deteriorated. It has also been due to a recent more-widespread rise in the number of businesses experiencing repayment difficulties as the economy has slowed.

There has been a similar-sized rise in collective provisions over the past year, which the major banks have largely attributed to weaker economic conditions in Australia and abroad. In this environment, the value of some types of collateral has declined and banks have lowered some of the internal credit ratings that they assign to customers, which has resulted in affected loans moving into pools with higher provisioning rates. As at the latest half year, the major banks' outstanding collective provisions stood at $11.9 billion.

These recent developments have seen the ratio of total provisions to credit risk-weighted assets – a measure of provisioning coverage that adjusts for changes in the risk profile of banks' lending – rise to 1.6 per cent, compared to a low of around 0.7 per cent in 2007 (Graph A2). This is, however, still much lower than the ratio of 3.2 per cent recorded in the early 1990s recession when banks experienced a significant fall in the quality of their business loans, especially in the commercial property sector. In contrast to the current cycle in provisioning, almost all of the rise in the early 1990s was due to provisions against individual exposures. The ratio of write-offs to credit risk-weighted assets has also risen much less than in the early 1990s, to around 0.5 per cent compared with 2 per cent in 1993.

The increase in Australian banks' provisioning ratios over the past couple of years follows a prolonged period over which these ratios generally drifted downward. There were several reasons for this, including the strong performance of the Australian economy and the associated low levels of bad debts. It was also partly due to the introduction of Australian equivalents to International Financial Reporting Standards (IFRS) in 2005, which allowed banks to significantly reduce collective – previously termed 'general' – provisions from what they would have been under the previous accounting standards.[1] Under IFRS, provisions may only be set aside if there is objective evidence of an incurred loss on a loan. Although this approach has increased the transparency of financial reports by constraining firms' scope to use provisioning to smooth profits, it has restricted banks' ability to provision for losses that are expected over the life of the loan but not certain to occur. APRA has therefore sought to promote a more prudent and forward-looking approach to regulatory provisioning and introduced a new 'General Reserve for Credit Losses' that covers both expected and incurred losses, as part of the transition to IFRS.[2]

More generally, developments in provisioning ratios over the past decade or so are consistent with the procyclicality inherent in financial systems, especially when short-run changes in economic conditions affect profits or required capital. That is, there is often a tendency for both borrowers and lenders to take an optimistic view of risk during the 'good times', rightly or wrongly, and to quickly change their assessment when conditions turn for the worse.

As mentioned in the *Developments in the Financial System Architecture* chapter, there has been considerable international discussion about ways to dampen this procyclicality and to ensure that banks build up appropriate buffers against losses during the good times when loan portfolios are performing well. One approach, a form of which is already in place in Spain, is 'dynamic provisioning'. This is a rule-based model that requires banks' collective provisions to be increased during periods of below-average loan losses, or run down during periods of above-average loan losses, to ensure overall provisioning remains in line with the long-term average loss experience. Movements in collective provisions would therefore be countercyclical and dampen the tendency for profits to move with the credit cycle. Another proposal, which is currently being considered by the Basel Committee on Banking Supervision, is to base provisioning on 'expected', rather than only incurred, losses. This model would take factors that affect future losses into account and therefore make provisioning more forward looking. These factors could include expectations of future, not just current, economic conditions and developments in lending standards over the credit cycle.

1 *The reduction from the previous accounting standards, Australian Generally Accepted Accounting Principles (AGAAP), is estimated to have been around 20 per cent for the major banks. See Reserve Bank of Australia (2006), Box A: International Financial Reporting Standards,* Financial Stability Review, *September.*

2 *See Byres, W (2009), 'Some Australian Perspectives on Procyclicality', presentation to the 9th Annual International Seminar on Policy Challenges for the Financial Sector, Washington, D.C., 3–5 June.*