BANK OF ENGLAND

Speech

Rouge – impair – manque: reflections on accounting standards

Speech given by

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It is a great pleasure to be here with you at Strathclyde Business School. The romance of Strathclyde and its Kingdom of the Rock; its Brythonic – that is, Welsh – speaking civilisation which succumbed to repeated assaults by Picts, Angles, Gaelic Scots and Vikings; all this is resonantly described in Norman Davies's splendid book Vanished Kingdoms. The Picts at the time could be recognised by their tattoos and by what Davies calls their "principled illiteracy". I suspect that at least one of these traditional Pictish markers is no longer to be found at the Business School.

This evening I want to talk about impairments. For the Bank of England's Financial Policy Committee, impairment means credit impairment; the recognition by a bank that a loan it has advanced risks not being repaid. Somehow this potential damage needs to be reflected in the bank's accounts.

The word "impairment" shares a common Latin ancestry with the word "pejorative". It's about stuff getting worse. The unrelated French word "impair" refers to an odd number. Devotees of roulette – a pursuit not actively encouraged by the Bank of England among its staff, although our economists and statisticians adore what they call Monte Carlo simulations – will know that one can place a bet on a red, odd, low number….rouge, impair, manque. That gives me my rather whimsical title – you're in the red, you take a hit, you're short.

Credit impairments matter because they're the number one reason for bank failure. Banks make loans to apparently sound borrowers, then circumstances change. The borrowers are suddenly no longer sound, and the bank may not get all – or in extreme cases any - of its money back. It may or may not have protected itself by taking security over an asset belonging to the borrower, as in a mortgage contract. Or the contract may contain covenants which allow the bank to change the terms of the loan as the borrower's position deteriorates. Many elaborations and subtleties come into play, but the brute underlying position is horribly simple – some of the money will have gone.

Although of the first importance to the banks themselves and to those who supervise them, this phenomenon, as a phenomenon, is little discussed. What more is there to say about it? Well, I mentioned a moment ago that the damage arising from the weakening credit "somehow needs to be reflected in the bank's accounts". The way in which it is reflected is not at all straightforward, and can have serious real world effects.

I have encountered these issues twice in my professional life. The two occasions were more than twenty years apart, and I should confess that in that intervening twenty years I didn't give impairment theory serious consideration, except in the depths of the financial crisis in 2008-9 when like all other sentient observers I was concerned with the overriding question of whether the credit losses washing through the banking system like a tidal wave of filthy water were big enough to sink some large banks (spoiler alert – they were).
The first occasion on which I lay awake thinking about impairments (not just worrying about them, thinking more philosophically) was in 1994. I'd recently become CEO of Barclays, which was recovering from a

near-death experience brought about by very large and unexpected credit losses. Then in the last couple of years the issue has returned to my attention, this time because of a change in the accounting standard for impairment. As a no doubt unintended consequence, the move to the new standard has given the Bank of England an unwelcome headache in the construction of its stress tests. Supervisory headaches can be contagious: the banks may get a bit of a headache too.

What the two episodes have in common is not just that they concern credit losses. They concern the way that credit losses are accounted for. And that is a very murky subject indeed.

Accountancy is a much misunderstood profession. The stereotype of the fussy, meticulous auditor counting matchsticks could not be further from the truth. Or maybe it's just outdated. My grandfather ran a firm of chartered accountants in Lancashire, into which my father reluctantly followed him: not even six years of service in the wartime RAF could absolve my father from joining the family business for the short period of life that remained to him. I imagine him slogging through his exam preparation in the late 1940s, learning about ancient principles derived from Scottish enlightenment thinking such as prudence and matching, neither of which would get him far today. For modern accountants have become theorists on a grand scale, perhaps not realising how perilous the intellectual life can be.

Accounts have always dwelt at the contested frontier where precision, by which here I mean the exact application of a set of rules, meets accuracy, which I take to encompass the concept of the right answer – the truth, if you like, though that's maddeningly hard to define. Pontius Pilate certainly thought so: he may perhaps have had an accountancy training before getting a break as a provincial governor. The business of ascribing a financial value to a variety of very different and valuation-resistant items - unsold goods, half-made machines, rapidly depreciating equipment, trademarks, brands, potential fines or litigation costs, embryonic software in development – and then adding them all up along with things you do know the exact value of (such as the balance of your bank account on December 31st) requires the evolution and application of conventions. Some of these may seem like common sense, but common sense, as so often, can prove itself a treacherous guide.

These conventions are constantly refined and adjusted by accountancy standard-setting bodies, which seem to be responding to three kinds of pressure. The first is genuine change in the business environment – the rapid evolution of digital technology, for instance, or developments in the financial markets such as the huge expansion of derivative contracts: such matters demand a response from the profession, since its existing conventions may simply not be adequate for the new circumstances. The second is the desire, the imperative, even, to gain international agreement on standards. I can remember a time when the consolidated accounts of major companies would consist of the blending of subsidiary accounts which themselves had been drawn up under quite different conventions in different jurisdictions. Sometimes, where it was feasible, some sort of overlay would be provided, sometimes not. It is worth accepting a less-than-ideal convention to gain support for a common approach across countries with different traditions, and

many less-than-ideal conventions do indeed get adopted. The third kind of pressure comes from intellectual fashion within the accounting profession, and this can be of more dubious value.

The important thing to understand is that conventions are just that – conventions - and the choice of one rather than another may be little more than a matter of taste. Sometimes intellectual fashion causes a philosophical trend to be pushed to destruction – witness the 1990s concept, which soon developed into a fad, then a passion, then a mania, for marking everything to market even when the market in question was more or less imaginary. Sometimes it is possible for outsiders to discern lunacy in the sober world of the accountants; witness the mad idea that a company that is in trouble and takes a huge credit downgrade, inflicting losses on those unfortunate enough to hold its bonds, must itself have made, and must therefore recognise, a profit equal to their losses. In this case the profession, perhaps influenced by the laws of thermodynamics, demonstrated an unwillingness, which would certainly have baffled my grandfather, to accept that value might actually have been destroyed. Those of you – from Scotland in particular - who remember 2008 will know that value can indeed vanish.

On the whole, though, the standard-setters seem to me to do a careful and thorough job in conceptually confusing circumstances. For whom do they do it? Auditors have always had in mind a rather nebulous target group, the so-called Users of Accounts. Some rebellious souls may prefer to use accounts, especially as they grow both increasingly arcane and increasingly bulky, to hold back a heavy door or to hurl at the wall in frustration, but the general idea is that a large class of people – those who sell to, buy from, work in, compete with, collect taxes from or own the securities of an enterprise – have a common interest in sets of accounts that correspond to some recognisable version of reality.

What if these Users of Accounts want different things? Managements are generally supposed to want flattering accounts, and there is plenty of evidence in favour of this supposition. Followers of the British banking sector over the last decade have got used to the idea that, alongside volatile and generally weak headline numbers, magical thinking offers a parallel universe of Underlying Profits (in fact they are more overlaying than underlying, but let that pass) which show the businesses were always doing quite respectably, thanks. At last the two measures are beginning to converge. Back in the 1970s the accountants got themselves in a real twist by making a quasi-theological distinction between so-called exceptional and extraordinary items. Exceptional items, although unusual, might be of a recurring nature and therefore went "above the line" and affected pre-tax profits, while their extraordinary cousins, truly non-recurring, in theory at least, were put below the line and more or less buried, though of course they affected shareholders' equity. Managements, I'm ashamed to say, spent a lot of time and energy trying to have positive items classified as exceptional and negative items as extraordinary, and, given the pliability of some auditors, frequently succeeded. Perhaps the most breath-taking coup was carried out by Sir Nigel Broackes of Trafalgar House, who wrote off a huge chunk of restructuring costs as extraordinary losses one year, only to bring back some gains on disposals arising from that same restructuring above the line as exceptional profits the following

year. Users of accounts were well advised to ignore the profit and loss account altogether: they had to look at cash, then at the changes in shareholders' funds, and then at cash again. This remains sound practice.

Banks are uniquely sensitive to accounting considerations. The level of a bank's loss-absorbing capital, a matter of supreme interest to investors and regulators alike, is derived from its accounts. (I say "derived" rather than "lifted" from the accounts because supervisors make a number of adjustments to published figures in arriving at their version of capital. But all else being equal, changes in book capital flow through pound for pound into the supervisory measure). And then price-to-book ratios, comparing the market value of a bank's equity to the book value stated in its published accounts, seem to play a larger role in the analysis of securities issued by banks than those of any other industry. It follows that banks cannot be indifferent to accounting developments that affect them. The truth of the accounts, to use that highly charged word again, may be questioned, but their reality is undeniable.

Let me return to my concerns at Barclays in 1994. My interest then as a user was to change the way we accounted for credit losses, in order to encourage more sensible risk-taking. Two things were perfectly clear. First, we had a highly cyclical business, in which many years with virtually no impairments and thus high profits were followed by a bloodbath – a bloodbath which, though occurring regularly once a decade or so, always seemed to come as a surprise. Secondly, we were paying out in bonuses or dividends during the good years much of the credit spread, the bank's compensation for accepting risk, which ought to have been insulating us against the downturn. When the downturn came, that spread, instead of providing a profit cushion, had evaporated.

In the intellectual climate of the day, at Barclays at least, although it was broadly recognised that riskier loans required higher spreads, there was little or no explicit connection between the two on a case by case basis. Spreads arose in the marketplace – we were price-takers, in other words - and an all-wise credit committee was expected to make a binary determination: would this borrower repay five years from now, or not?

I timidly advanced two views. Notwithstanding the organisation's recent harrowing experience, both were instantly dismissed as heretical. The first was that the credit committee, although composed of people so senior as to be more or less infallible, was bound to make mistakes, and so we needed to price more accurately for the probability of default. This caused consternation among practical bankers. The second was that we needed to recognise that our profits were – on a through-the-cycle basis – overstated in the years when there were few if any impairments. We therefore needed to hold money back – to build capital – in those years to cover the expected loss, rather than raise the dividend excessively. This caused alarm among the auditors. I was accused of seeking to build up secret reserves, a far more dreadful crime, apparently, than merely allowing a bank to fail. Besides, they said, there was no way of accurately calibrating the extent of a potential cyclical adjustment, were such a wicked thing to be allowed (which it wasn't).

Though I might not have expressed it in this way at the time, I was trying to act counter-cyclically. In Basel-speak, a then unknown dialect which has since made astonishing progress among members of the synod of senior supervisors, I was seeking to flex the management buffer. Thanks to the work of a team headed by my admirable colleague Alan Brown, we did manage to calculate the extent by which – given the mix of our loan book and an average length of cycle – profits were boosted in the good years by the absence of impairments. Leaning heavily on Keynes's dictum that it is better to be roughly right than precisely wrong, we were probably correct to within a couple of hundred million pounds per annum either way. I was daring enough to reveal our calculations in my report to shareholders: the numbers were not, of course, permitted to defile the published accounts. But a couple of years later the auditors, with a new partner in charge, demanded to audit this literally off-balance-sheet cyclical adjustment thoroughly, on the grounds that it was clearly influencing the bank's dividend policy and therefore in some strange way, however disreputable it might be, probably mattered. I could not have been happier.

Now counter-cyclical thinking is no longer disreputable. It is respectable, if not yet entirely normative. The FPC is founded on this principle. It is required by statute to set the countercyclical capital buffer for the UK system every quarter, and announced in December that it was raising it by 100 basis points, from 1% of risk-weighted assets to 2%, with the expectation that following consultations by the Prudential Regulation Authority some elements in the minimum capital requirement of the firms would be reduced by a commensurate amount. The intention is modestly to shift the configuration of the capital stack from minimum to buffer, from fixed to flexible, so as to allow the FPC more ammunition to release in a downturn, making a severe credit contraction less likely. This strikes me as hands down one of the most important moves the FPC has made in its now nearly nine years of existence, and I find it curious that commentators have largely ignored it, preferring to concentrate on more topical policy announcements concerning open-ended funds, as well as, to be fair, the general election that had taken place the week before.

The annual stress tests of the banking system are a cornerstone of the committee's countercyclical policy. We subject the banks to a violently negative scenario and see how their capital would hold up under such circumstances over a three-year period. The results are published in reasonable detail, both for the system and for the individual banks. We consider the setting of the CCyB for the whole system in the light of the results, which also influence our colleagues on the Prudential Regulation Committee as they set capital levels for individual banks. As my fellow FPC member Donald Kohn has recently discussed, the stress tests have consequences.

At this point, a few years ago, enter an accounting standard-setter with a new standard to cover the matter of accounting for impairments. Simply put, its effect is to bring forward the impact of credit losses to the point at which trouble first manifests itself. In terms of our stress tests, this means that some losses which would have been spread by a bank over the three years of a downturn will now overwhelmingly occur in the first year: the quantum of overall loss is little affected, but it all hits rather earlier.

In introducing this new standard, the standard setters had some powerful market evidence on their side. It was noticeable in the 2008 crash that the equity prices of the banks had predicted early, and with almost uncanny accuracy, what the eventual losses of those institutions would turn out to be, while impairments in the published accounts came plodding along behind. IFRS 9, for that is the enticing name of the new standard, would have aligned book and market values much better. In so doing it might also have contributed to the general atmosphere of alarm.

It will be interesting to see how it works in practice. Conceptually it differs quite profoundly both from the old standard, which recognised impairments only when they could no longer be denied, and from my last-century attempts to manage the cycle at Barclays, which treated every advance as containing a probability of default from the very start. Personally I feel that it is probably easier to calculate what has clearly happened, or indeed what you might expect on average to happen in the future, than what appears to be just about to happen.

For our counter-cyclical committee – a particular kind of User of Accounts – IFRS 9 did not immediately appear to be helpful. It has the potential to be highly pro-cyclical; if a bank doesn't foresee its losses early enough, or, under pressure from anxious, hair-shirt-wearing auditors, overestimates them in the depth of a crisis, the accounts will not only kick it while it's down, they will break most of its bones in doing so. Since IFRS 9 greatly deepens the trough of losses in the first year of the stress scenario (as it would in a real live stress), a bank's capital base will touch a lower point than it would have done under the old standard. If the bank survives for the next few years, clawing back some capital from its business activities on the way, the score will eventually even up, but the survival of the bank through this troubled period is not a trivial condition.

What was the FPC to do? The earlier timing and greater depth of the trough were serious issues, as here, if the FPC took no action, some major banks which had not breached their regulatory minimum capital requirements in a stress under the old standard might do so under the new one. Given the rigorous way that the FPC uses the results of stress tests, this would require us to raise capital requirements, perhaps sharply. Why on earth should we do that as a result of a more or less arbitrary move – and I mean no disrespect to the auditing profession here – from one accounting convention to another?

Our first reaction was to commit ourselves to acting to avoid unwarranted capital consequences arising from the impact on the stress test of the change in accounting standards. We decided this by a consensus in which I happily joined, and we were keen to make our decision known immediately. The advantage of this swift announcement was that we hoped to avoid nervous uncertainty about the impact on capital; the disadvantage was that we were committing ourselves to finding a solution before we had a clear idea of what that might be. We knew we had some time, as the impact of the standard on regulatory capital was being introduced gradually, with transitional adjustments of which banks could take advantage if they wished; we certainly encouraged them to. And the broad shape of potential solutions was clear - the trouble was that the

shape was uncomfortably ugly. Permanently lowering the hurdles that the banks had to clear in the stress test would do the job, but would be unlikely to enhance confidence in the system. Making adjustments to the banks' accounts for stress test purposes so as effectively to undo the effects of IFRS 9 would do the job too, but it is emphatically not the central bank's business to rewrite accounting standards. In any case, the earlier recognition of losses under IFRS9 was clearly a step in the right direction, and it's not as though we believed that there was anything particularly wonderful about the old standard. It was, after all, just a set of conventions – it happened to be a set of conventions that we were used to working with.

In its December 2019 Financial Stability Report, which covers most things under the macroprudential sun – it's a positive tasting menu of the FPC's preoccupations – we propose, working with our colleagues at the PRA, an outline solution to the IFRS 9 problem which seems to me elegant and sound. It suggests that the new provisions made by a bank in the first year of stress under IFRS 9, but not yet written off because the loans to which they relate are not yet utterly compromised, should be formally recognised as loss-absorbing (which they are) allowing us to adjust the capital requirements set through stress tests accordingly. We have been in the past reluctant to treat provisions as capital, because they relate to individual assets and are not fungible across a bank's book. Not fungible, that is, until or unless a bank is in resolution, which is the state of affairs we most worry about: at that point they would be reliably loss-absorbing. Besides, these new IFRS 9 provisions differ from provisions under the old standard. Our auditors at Barclays in 1994 might have considered them borderline secret reserves (horror), though they may be taken far too late in the cycle to perform the potentially stabilising function of genuine reserves (a shame: that is what makes them pro- rather than counter-cyclical), but under these circumstances we feel we can treat them almost as if they formed part of a bank's capital stack.

If this way forward is accepted – and the Bank has said that it will consult with the industry over the next year or so, running a pilot in the 2020 stress test – there are two further decisions to be taken: highly consequential decisions, which are also very much up for discussion. One concerns the point in time at which IFRS 9 provisions are acknowledged. The obvious answer is - as and when they formally appear in the accounts, but this is likely to be a panicky time, and banks and their investors may not be sure that supervisors will hold their nerve at this point and allow a capital offset, whatever they may have promised earlier. The alternative is to proceed by some form of anticipation derived from a stress-test judgement about the quantum of IFRS9 provisions that a firm may expect to incur, and recognise them early. My first instinct was to regard the calibration of the anticipation or down-payment route as unrealistic, but a moment's reflection reminded me that it would be no more or less so than what I was proposing at Barclays 25 years ago. It has the great advantage of identifying future stressed credit losses at an unstressed point in time, and effectively earmarking a chunk of capital buffer to represent them. While not undermining the new standard, it substantially rectifies its unfortunate tendency to pro-cyclicality.

Unlike my 1990s proposals, it would reallocate capital between different pockets, so to speak, rather than directly resulting in a capital build. It is likely, though, to result in a higher quality of capital since buffers,

which are funded 100% with core equity, will rise at the expense of minimum requirements, where less stringent forms of capital are permitted. But the similarity is that IFRS9 will not allow explicit provisions to be made on a purely statistical expected loss basis (you will recall that secret reserves are taboo). So I suppose some capital would initially move from minimum to buffer; this buffer will become an IFRS9 provision in the stress test – or of course in a real stress – and will then absorb losses as bad credits are written off. There are elements of supervisory ballet about this, but they should not be despised. It is good for supervisors to have explicit conversations with firms in peacetime about what may be expected when economic war breaks out.

The second decision is from which capital pot this new IFRS9-prequel buffer should be carved out. At the moment a bank's minimum capital requirements are matched one-to-one by debt that converts to equity in resolution, to replace the capital that will then have been lost. Do we fund the IFRS9-prequel half and half from minima and bail-in debt, or entirely from minimum requirements? Doing it entirely from minima would require us to alter the one-to-one formula, which would be a shame as it's one of the few really simple design elements remaining to us. It would be a coherent way forward, though, insofar as it would treat new IFRS9 provisions in the stress test as a substitute for the piece of the capital stack that absorbs losses in going concern, which conceptually is what it is. But the option of taking the adjustment entirely in going-concern minima leaves you more highly geared than the half-and-half alternative at the point of crisis, as you'd have relatively more debt compared to equity capital, and more of that equity in buffer form. And that's on top of the 100 basis point flip that is already taking place with the switch from minimum requirements into the countercyclical capital buffer (as a result of our recent review of the UK bank capital framework).

The decision will not be mine to take, since I shall have left the FPC before it comes back to the table. I have no doubt that my colleagues will weigh the options carefully; this set of choices is unusually finely balanced.

I said earlier that impairments mattered because they were the biggest single cause of bank failure. What determines whether and how a bank can recover from the threat of failure is confidence or the lack of it; whether other banks will lend to it, whether shareholders will be prepared to put up new money. The authorities clearly play a determining role in the process of deciding when a firm goes from going-concern to gone-concern, and what means of resuscitation, if any, can be brought to bear. One of the crucial parts of their assessment is concerned with whether a bank has breached its minimum requirements. Reducing minimum requirements thus has two contradictory effects. Clearly, the lower they are, the less likely a firm is to breach them, and so the less likely it is to fall accidentally into resolution. But if they are set too low, the risk is that the market will lose confidence in the soundness of the system. At this point minimum requirements are no longer under the control of the supervisors: the financial markets – providers of short- and long-term debt as well as equity – take charge, and set their own minimum.

We don't know where the market minimum is, and I trust we are wise enough not to want to find out. We believe it's a long way below the minimum requirements currently set by supervisors. But we also know that in a panic the market minimum rises, because in a panic markets act pro-cyclically, maybe even more pro-cyclically than the accountancy profession.

I have tried in this speech to give a flavour of what the FPC's work is like, attempting along the way to make some relatively arcane subject matter accessible, though I may not have succeeded in making it interesting. There is a danger that those who work with technical minutiae grow – after an initial period of repelled bemusement – rather too fond of it all, and end up wallowing in the fascinating complexities that are thrown up. I don't believe the FPC does this – not yet, anyway. We try not to be distracted from the task of addressing the big risks to financial stability.

The counter-cyclical methodology that informs so many parts of the committee's policy work has immense potential value, if only because it's such an unusual way of proceeding – it runs counter, in so many ways, to human nature. Done well, it holds the promise of significantly reducing both the amplitude of future crises and the economic damage they might do. The stress tests that I've discussed today loom large in our work. As I've said, they have real-life consequences, but at bottom they are a kind of game – a deadly serious game, but a game. The FPC will demonstrate its value not in stress tests, but in the testing circumstances of a real stress. At that point the illusion of control will be shattered: beyond the fastidious refinements of the various liabilities which make up an individual firm's capital, that firm will either turn out to have enough equity or it won't. The job of the Bank of England is to make sure it has enough – not way too much, for we believe excess bank capital has public as well as private costs - but clearly enough. The rest is noise – not silence, as at the end of Hamlet – noise. Thank you so much for listening to me.