

## CENTRAL BANK CAPITALISATION AND THE INTERNATIONAL ACCOUNTING STANDARDS<sup>1</sup>

### 1

The main function of central banks is to ensure price stability. Controlling inflation requires the monetary authority to have sufficient credibility<sup>2</sup> to warrant the confidence of economic agents, markets and society in general. Only if they have that certainty can economic agents take firmly based decisions consistent with the broad framework of the monetary policy in place and can this in turn be implemented in the most efficient way. For the economic authorities in general, and the monetary authorities in particular<sup>3</sup>, achieving and maintaining credibility is an essential factor, both in theory and in practice (Stella, 2002), for the achievement of their objectives.

One of the factors that most seems to favour this credibility is the independence, or autonomy, of central banks, understood as a mechanism designed to take these institutions out of the political cycle (Hibbs, 1977), since it is considered that with such a status they are in better placed to achieve their basic objective than if they are subject to political vicissitudes, which usually have more to do with the short term than with the medium- and long-term perspective required to achieve and sustain the objective of monetary stability.

Central bank independence has been the subject of numerous analyses addressing both its measurement and its correlation with the achievement of price stability. The indices for measuring independence are generally based on assessing a more or less extensive series of the characteristics that each author considers most important in preserving independence. Although some of the limitations of these indices<sup>4</sup> stem from the lack of consensus on the very definition of independence, or from the differences between nominal independence and actual independence, there does seem to be ample evidence that independence and the level of inflation are inversely correlated and that central bank autonomy is continually being extended<sup>5</sup>.

The factors to be considered in measuring a central bank's independence usually include at least the degree of subordination to the government (institutional independence)<sup>6</sup>; autonomy in the

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<sup>2</sup> Of the varied literature on the subject of credibility, see, for example "Central Bank Credibility: Why do we care? How do we built it?" by Alan S. Blinder (2000) or "Central Bank Strategy, Credibility and Independence: Theory and Evidence" by Cukierman (1992).

<sup>3</sup> The problems deriving from the phenomenon of inconsistency over time in the decisions of the economic authorities have been analysed in depth by the 2004 Nobel Prize winners Kydland and Prescott. Also noteworthy are the studies by Barro-Gordon (1983) and Rogoff (1985).

<sup>4</sup> An extensive list of the analyses conducted on this topic, including the countries and periods considered and the conclusions drawn, can be found in "Central Bank Independence: A European Union Perspective", by Fernández de Lis and Mira Salama (documentation of the I International Seminar on Central Banking held in Madrid in November 2004).

<sup>5</sup> See "Measures of Central Bank Autonomy: Empirical Evidence for OECD, Developing, and Emerging Market Economies" by Arnone, Laurens and Segalotto (IMF, WP/06/228)

<sup>6</sup> For example, composition of governing bodies, how they are elected, duration of mandates, irrevocability of appointments, etc.

exercise of its functions<sup>7</sup> (functional independence) and, finally, its financial capacity or financial strength (financial independence). Although the first two factors have received considerable attention, the third, i.e. financial capacity or strength, has not been studied so extensively, except in regard to the limits on financing extended to the government. Hence matters relating to the level of own funds, the absence of rules for covering possible losses, the actual effectiveness of these rules, the profit distribution regime, the capacity to set aside reserves, the accounting regime for determining annual profit, etc. have been taken into account to a much lesser extent.

## 2

In regard to own funds, there are advocates of the theory that a central bank does not need capital or reserves to achieve the objective of monetary stability and some even hold the view that central banks can carry out this mission perfectly well with a negative capitalisation. The main argument advanced for not needing capital is that if a central bank incurs a loss, it can be restored out of the nation's budget. Indeed, certain central banks have national laws that provide for this, although such cases are not a majority and even when such laws do exist, they are often ineffective<sup>8</sup>.

If the cumulative loss exceeds the capital and reserves, and the automatic recapitalisation mechanism does not exist or is ineffective, the central bank will undoubtedly be able to continue fulfilling its main objective for a time<sup>9</sup>. The problem will then be to determine at what cost and/or how long it can keep doing so, since unquestionably in the long term a negative capitalisation will result in the institution's loss of credibility<sup>10</sup>.

At present there is a broad consensus amongst most experts in these areas on the drawbacks of negative capitalisation<sup>11</sup>, and discussion now centres on what the optimum level of capitalisation is<sup>12</sup>. In this respect, the volume of own funds is related by some authors to the size of the banking sector, by others to the level of money in circulation and by yet others, in what seems a more likely relationship, to the level of risk borne by each central bank in its activity. The exercise here is not to determine the level of capitalisation or even to help decide which factor or factors

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<sup>7</sup> For example, clarity of its statutory objective, explicitness of its formal assignment, exclusiveness in the design and implementation of monetary policy, etc.

<sup>8</sup> Such ineffectiveness may arise for different reasons. The recapitalisation of a bank may not be automatic and be subject to certain requirements which, in one way or another, prevent it from taking place. In other cases a central bank's losses may be covered by giving it long-term public debt at a zero or below-market interest rate, etc.

<sup>9</sup> The examples usually cited to illustrate this are the cases of the Central Bank of the Czech Republic and the Central Bank of Chile, although, in reality, they are exceptions, albeit well-known, to the general rule.

<sup>10</sup> See "Implications and remedies of central bank losses", by Vaez-Radeh (1991) and "Challenges for monetary policy in Japan", by Fukui T (2003).

<sup>11</sup> See John Dalton "Determining Appropriate Levels for Central Bank Capital and Reserves"

<sup>12</sup> See P. Stella, "Do Central Banks Need Capital?" (1997) or K. Sullivan, "X Meeting on accounting aspects of Central Banking (Brazil, 2006)".

should be used to measure it<sup>13</sup>, but rather, simply to define an initial position, which is none other than that of those who advocate that a central bank should not be negatively capitalised.

### 3

The construction of a firm's own funds will depend on fresh contributions by its equity-holders in the case of negative capitalisation<sup>14</sup> and, before then, on the establishment of an adequate level of reserves by annually retaining a portion of profits.

For a firm, whether it be a central bank or not, to become negatively capitalised, it has to accumulate losses that exceed its own funds, which will depend on both the volume of those losses and the level of its own funds available to absorb them. If a central bank is not sufficiently capitalised and, moreover, unable to retain earnings to build up the own funds it needs, it will reach the point of negative capitalisation once sufficiently adverse circumstances arise.

With regard to the retention of earnings as a procedure for increasing own funds, the situation is that, while in some central banks a part of their profits legally has to be allocated to reserves (in a larger or smaller proportion and/or up to certain limits) and in others the percentage to be distributed is agreed annually with the government, there is a very considerable portion of these banks in which the total amount of annual profits must be distributed.

The worst situation facing a central bank is when it lacks the legal provisions requiring its automatic recapitalisation in the event of negative capital and, at the same time, it cannot set up the reserves it needs because its legislation obliges it to distribute all its profit. In this situation, the reaction of many central banks has been to establish their own accounting rules under which they determine their profit taking into account both the special characteristics of their operations and the legislative framework within which they have to carry out their mission. This, in essence, is summarised in the priority application of the accounting principle generally known as that of "prudence".

Having said that, whereas until a few years ago this principle was generally accepted in any accounting code, it has now been superseded by modern accounting principles and, in particular, by the general acceptance of international accounting standards, especially the International Financial Reporting Standards issued by the International Accounting Standards Board.

### 4

The present international accounting standards are being widely disseminated and accepted and central banks are receiving strong encouragement from diverse sectors to apply them. These

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<sup>13</sup> See "Central Bank Financial Independence", by Martínez-Resano (Documento Ocasional no. 0401, Banco de España/2004).

<sup>14</sup> Generally the recapitalisation of a firm is required by corporate law when losses reach a certain percentage of capital, without need for capital to become negative.

standards<sup>15</sup> have relegated the principle of prudence to a secondary role, and give greater importance to immediate economic reality and to fair presentation through the use of market value, establishing that, in certain cases, the differences between cost and market value must be included in profit for the period, even when these results are unrealised because the firm has not sold the related assets. The standards whose application that may pose considerable difficulty for central banks are basically IAS 21 "The Effects of Changes in Foreign Exchange Rates", IAS 39 "Financial Instruments: Recognition and Measurement" and IAS 37 "Provisions, Contingent Liabilities and Contingent Assets"<sup>17</sup>.

As regards the first of them (IAS 21), the difficulty arises because it specifies that unrealised exchange gains and losses arising on valuation of foreign currencies (measured as the change from their average exchange rate per books to their market rate at the end of the period) must be recorded in the income statement for the year. The central banks that do not have the legal power to isolate this effect when they distribute profits will unquestionably have lost their first containment wall for absorbing the losses that result from exchange rate depreciation.

IAS 32 and IAS 39 on financial instruments establish four categories of financial assets: loans and receivables, held-to-maturity investments, available-for-sale financial assets and financial assets held for trading. The first two categories do not have to be adjusted to market price and in the third the difference between cost and market price is not taken to income but to equity accounts. However, in the latter the effect will be the same as that described in the preceding paragraph with regard to the exchange rate. Indeed, the aforementioned standards specify that the price differences between cost and market also have to be credited to the income statement for the period.

It should be emphasized that the problem does not arise from expressing the assets at market prices (which is clearly desirable and enhances transparency)<sup>18</sup> but from crediting the differences (if positive) to the income statement for the period.

As regards provisions for future risks (e.g. those arising from exchange rate or price fluctuations), these accounting standards prevent them from being recorded, considering that they should be covered with reserves to be taken out of annual profits. Thus IAS 37 sets out, inter alia, the criteria for setting up provisions for administrative risks<sup>19</sup>. The basis requirement for setting up these provisions is that the possible losses have to depend on an event that has already taken place. If, along with this accounting prohibition, a central bank does not have the legal power to set up reserves because it has to distribute all its profit, the result will be that this institution

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<sup>15</sup> Although this study focuses on the possible effects of IFRSs on the capitalisation of central banks, there are other factors that may impinge on these institutions to varying degrees. See the paper by the author "Should central banks be subject to International Accounting Standards?" (X Meeting of CEMLA, Rio de Janeiro, 2006).

<sup>17</sup> Noteworthy in this respect are the studies by the Central Bank Budgetary and Accounting Committee of the Centre for Latin American Monetary Studies (Rio de Janeiro, 2006)

<sup>18</sup> The accounting practices used on certain occasions, which consist of holding certain financial assets at cost or even at their lowest historical cost, actually give rise to hidden reserves which of course are hardly compatible with the principle of transparency.

<sup>19</sup> Administrative risks are defined as those arising from events such as commitments to employees, legal proceedings in process and, in general, those not related to financial risks.

will not have any coverage of the risks to which it will unquestionably be exposed and will lack the second containment wall.

In sum, for a central bank that lacks of legal provisions for recapitalisation as needed and that has to distribute all accounting profits, the application of the aforementioned accounting standards may be an unsurmountable obstacle to sustaining an adequate level of capitalisation and/or avoiding negative capitalisation<sup>20</sup>.

## 5

The main conclusions drawn from the foregoing are as follows:

- a) The maintenance of price stability is the primary function of central banks. To achieve this objective, it is fundamental that the credibility of the monetary authority permits the economic, social and market agents and the general public to have confidence that its decisions are taken on a credible and stable basis in the medium and long term. One of the factors that seems to contribute most to such credibility is institutional, functional and financial independence. Effective financial independence basically means that a central bank has to have sufficient own funds to cover its exposure to the financial risks arising from its activity.
- b) Accounting standards have a decisive influence on the profit figure. If these accounting standards do not take into account the effect of legal provisions on the distribution of central banks' profits and on their ability to maintain a certain level of own funds, their financial independence may be seriously jeopardised. The IASs/IFRSs that establish the criteria for determining profit naturally do not take into account how it is distributed and assume that firms are free to decide on their distribution of profit and their level of capitalisation.
- c) The accounting treatment established by certain IASs/IFRSs for crediting unrealised gains to income and the prohibition on recording provisions to cover future risks may cause difficulty for central banks that lack a suitable legal framework. An inappropriate legal framework is one that lacks effective legal provisions for recapitalisation in the event of negative own funds and, at the same time, requires distribution of all book profit (including unrealised gains) and thus does not allow reserves to be set up to cover future risks.
- d) Unless national legislation dictates otherwise, the central banks that lack an adequate legal framework should first endow themselves with legal instruments to avoid the effects of certain IFRSs before implementing these accounting standards and, to this end, they should take the necessary action to ensure that their position is understood by the authorities,

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<sup>20</sup> In view of the various legislative frameworks of the central banks in the euro area and to avoid the drawbacks mentioned earlier, the rule governing the central bank accounting regime (Guideline ECB/2006/16) stipulates that unrealised gains (capital gains recognised at the end of the period) have to be credited to revaluation accounts in the balance sheet instead of being taken to income, thereby diverging from IFRSs on this point.

regulators, auditors and consultants. These decisions, however, should not detract from the necessary transparency that is a requisite for the financial statements of these institutions.