BANK FOR INTERNATIONAL SETTLEMENTS

Comments on M. Gordy and B. Howells "Procyclicality in Basel II: Can we treat the disease without killing the patient?"

by

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* The views expressed here are those of the author and do not necessarily reflect those of the BIS.

Introduction

- Paper on important subject by distinguished authors
  - Gordy‘s model is basis for quantitative framework of Basel II
  - procyclicality (P): core interest for BIS research for a long time
- Very nice piece of work
  - blend policy focus with technical excellence
    - Pillars 1 and 3 interaction
  - very stimulating
- Agree with thrust of conclusions
  - degree of P of Basel II hard to gauge …
  - … but merits watching
- Have some reservations about
  - how to assess “excessive”?
  - priorities and shape of research agenda

Structure of remarks

- What do the authors do?
- Focus on three aspects

  - benchmark for measuring P

  - benchmark model of risk

  - benchmark for assessing corrective measures
- Way ahead?

What do the authors do?

- Simulate loan portfolio for banking system

  - focus on change in Economic (EC) (“true” capital) and Regulatory (RC) capital

  where

  - EC = “Standard” point-in-time ratings model

  - RC = Basel II

- Consider 3 smoothing adjustments to:

  - “inputs” : Through-The-Cycle (TTC) ratings

  - “outputs” : Bank-specific partial adjustment (AR)

  - “outputs” : State-specific (macro factor), common across banks

- Assess adjustments based on co-movement with EC

  - the higher the better

Specific conclusions

- Previous studies have overestimated P
- Better to smooth outputs than inputs

  - TTC ratings co-move little with PIT

  - not possible to infer EC from RC

1. The benchmark for measuring P

- Reservation 1: choice of "benchmark" to assess degree of P is not quite adequate
- 3 reasons: does not consider impact of

  1 - default-driven losses on RC

  2 - RC on lending behaviour

  3 - lending behaviour on macroeconomy
- Closes off by fiat the core concern with P (Borio et al 2001, Borio 2003)

  - amplification of cycle ("endogenity of risk")

$\Longrightarrow$ "Hamlet without the Prince"

Explanation

$$\Delta RC = \underbrace{\frac{\partial RC}{\partial E}\,\Delta E}_{(1)} + \underbrace{\left[\frac{\partial RC}{\partial E}\;\frac{\partial E}{\partial RC}\right]\left[\frac{\partial RC}{\partial E}\Delta E\right]}_{(2)}$$

$E = \text{Economy};\ L = \text{Loan portfolio}$

Paper considers (1); excludes (2)

- When RC declines because of (2) conclusions can be perverse

  - partial vs general equilibrium

- Ultimate metric for P should be based on (2)

The benchmark for the experiment (ctd)

- Remedies?

  - 1st best: general equilibrium

  - 2nd best: historical simulation + judgement (eg. Segoviano and Lowe 2002)

  - alternative: fixed portfolio simulation + judgement (Kashyap and Stein 2004)

- But agree that additional P of Basel II is hard to gauge ("Lucas critique")

  - foster better risk management

  - Pillars 2 and 3 can help

2. The model of risk

- Reservation 2: model of risk used may be part of the problem rather than solution
- 2 reasons:

  - too "random walk", no meaningful "cycle" element

    - indicators exploiting conditional mean reversion can help to predict crises (Borio and Lowe 2002, 2003)

  - 1-year horizon for risk quantification is too short
- Corollary

  - standard models can exacerbate P

  - further refinements could add to this (eg. Lowe 2002)

$\Longrightarrow$ need to move from coincident to true leading indicators of risk

3. Evaluation of smoothing devices

- Reservation 3: evaluating smoothing devices based on co-movement of RG with EC is not quite appropriate
- 2 reasons

  - EC may fail to capture risk properly ("risk perceptions gap")

  - response to EC itself may be destabilising ("incentives gap") → externality

$\Rightarrow$ "excessive" P is property of the financial system, not of regulation per se

- Bottom line: if excessive P is an issue, objective of regulation (RG) is to encourage build-up of cushions in good time to run down in bad times

Evaluation of smoothing devices (ctd)

- Remedies

  - derive optimum adjustment from general equilibrium model

    - link to accounting is key (Borio and Lowe 2001, Borio and Tsatsaronis 2004)

  - need to consider practical implementation issues

- TTC ratings should not be ruled out a priori

  - not necessarily as input-smoothing device

  - but as basis for output-smoothing

    - nothing prevents EC to be disclosed too (and it should)

Conclusion

- Very useful addition to the literature
- Some reservations about analysis
- Agree with broad thrust of conclusions but not with specific ones
- Suggested a complementary research strategy

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