BANK FOR INTERNATIONAL SETTLEMENTS

Discussion on "The impact of the strengthened Basel III banking regulation on lending spreads: comparisons across countries & business models"

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The views expressed are those of the discussant and not necessarily those of the BIS.

Outline

- Summary of the paper
- General comments
- Specific comments

Summary of the paper

- Goal: Measure the impact of strengthened bank capital and liquidity requirements on the average loan rate
- Approach (capital)
  - Risk-based capital requirement ↑ => equity ↑ and long-term debt ↓ => lending spread ↑ to maintain the same ROE
  - Major factors affecting the size of lending spread changes, which are also different across business models, are
    - the ratio of RWA to total asset,
    - the cost of long-term debt,
    - the ratio of loans to total asset.

Summary of the paper (Cont'd)

- Approach (NSFR)
  - (Step 1) Extend maturity of wholesale debt => ASF ↑, NSFR ↑ and debt financing cost ↑ => lending spread ↑ to maintain the same ROE
  - (Step 2) Government bonds ↑ and high-yielding securities ↓ => RSF ↓, NSFR ↑ and interest income ↓ => lending spread ↑ to maintain the same ROE
  - Major factors affecting the size of lending spread change
    - cost difference between long-term and short-term debt,
    - yield difference between government bonds and high-yielding securities,
    - NSFR factor (for both ASF and RSF calculation),
    - the ratio of loans to total asset.

Summary of the paper (Cont'd)

- Main results
  - To keep ROE constant after 1%p increase in capital ratio, lending spreads of commercial banks, savings banks, cooperative banks, and mortgage banks should increase by 9.1bp, 6.3bp, 4.7bp, and 0.1bp, respectively.
    - Required lending spreads are smaller during 2008-2010 than during 2005-2007.
  - To keep ROE constant after increasing NSFR from 0.88 to 1, lending spreads of commercial banks should increase by 20.03bp.

General comments

- How reasonable is it to assume that banks maintain the same level of ROE under Basel III as they had during 2003-7?
  - High level of ROE is achieved by leverage, regulatory arbitrage, maturity mismatches, profits from not-capital-intensive businesses and/or cost cutting.
  - Under Basel III, how easy is it to take advantage of these?
  - Endogenous choice of business model by banks under Basel III may not support the high level of ROE any more.
- Microprudential QIS vs macroprudential perspective
  - Systemic view, second-round effects
  - business cycles and financial variables

General comments (Cont'd)

- Conflict between shareholder value and financial stability?
  - Tensions may arise in the short run, but they disappear in the long run in the sense of sustainable returns (Caruana 2012).
  - King (2010) and this paper assume the cost of long-term wholesale funding is deposit rate + 200bp.
    - Thus, no benefit to shareholders from funding cost reduction due to higher capital and liquidity ratios.
    - In the long-run, lower funding costs due to higher capital and liquidity ratios benefit shareholders.
  - Better capitalised banks are less inclined to make excessively risky investments that benefit shareholders at the expense of debtholders or government (Admati et al 2011).

Comment 1: what happens after loan rates increase?

- After loan rates increase, more risky loans are extended.
  - Then, average risk weight increases and so does RWA. An increase in RWA requires additional increase in equity.
  - If the size of total loans decreases due to higher loan rates, the average loan rate should increase further.
  - More generally, banks may want to endogenously adjust their asset and liability structure, instead of loan rates.
    - Banks reduced their RWA (eg by replacing assets with high risk weights with assets with low risk weights) during the recent crisis.

Comment 2: structural break due to introduction of Basel II and government bailout

- Sample period covers 2005-2010
  - Basel II was introduced in different years across countries: Basel I, Basel II (or Basel II.5)?
  - What was the impact of recapitalisation of banks by governments in 2008 and 2009?
  - Would it be enough to divide the sample into 2005-2007 and 2008-2010 for all countries?

Comment 3: Role of policies

- How important are cross-country differences in monetary policy and macroprudential policies when we consider the impact of Basel III introduction?
- Monetary policy
  - Policy rates directly affect deposit rates and indirectly affect loan rates.
  - Reserve requirements control credit supply
- Macroprudential policy other than Basel III
  - Maximum loan-to-value ratio and debt-service-to-income ratio curb housing credit booms
  - Dynamic provisioning affects profits.

References

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