Discussant to M. Gordy and B. Howells by C. Goodhart

**Charge offs**: Exclude or Include

**Authors**: Exclude, because

(a) Already in present regime, so no additionality

(b) Misleading to include “without also imputing accumulated interest income net of dividend payments”.

**Comment**: Would (b) be possible?
**Portfolio Management**: Active or Passive

N.B. Unless replacement occurs, portfolio shrinks continuously, so how replaced?

**Choices:**
(a) Passive, same as existing non-defaulted loan book
(b) Fixed Distribution
(c) Anti-cyclical, i.e. tightens in recessions
(d) BZ weighted (2 a / 2 c)

Authors prefer c or d, based on BZ, Kashyap/Stein, Berger and Udell evidence.

**Comment:**
(1) It matters a lot, see Figure 2 and Table 2.
(2) Where do you find all these higher quality borrowers in a recession?
(3) What happens to interest rate spreads?
First General Comment: Basel II too focussed on Capital, not enough concern with:-

(1) margins and profitability, UL/EL

(2) liquidity
**Loss Given Default (LGD)**

Authors use fixed value, but claim it “may overstate the procyclicality of capital under the Advanced IRB”.

**Comment**: All the reading I have done (Altman, Acharya (LBS)) strongly suggests the reverse, though key factor may be industry, not economy. Specific capital. Adjustment for ‘stress value’ now.

**Maturity**

Authors: Declines in recessions

**Comment**: Agreed

**Binding**

Authors: Some time variation in buffers above the minimum required

**Comment**: Agreed
Second General Comment

Authors somewhat sceptical of pro-cyclicality, largely via reinvestment assumptions, p. 25. I would be less sceptical:-

(1) reinvestment
(2) LGDs
(3) No interactions modelled. All on the basis of simulating the single bank. Contagion via interbank, asset prices, macro-economy
Purpose of simulation is to compare three methods of further smoothing pro-cyclicality, beyond steps already taken.

(a) Smoothing input : TTC ratings

(b) Flatten risk curves further

(c) Smoothe output
Smoothing Inputs: TTC

Authors against: Distorts comparative information inter-temporally, although not cross-sectionally at a point in time.

Comment: Agreed. Also

(1) How do you define position in cycle. Deviation from trend?

(2) Contrary to move to market, or fair value accounting approach more generally. IAS

(3) Banks will not do it. Treacy/Carey.
Smoothing Curves further

Authors against: Relatively little dampening effect for small changes. If much more flattened then back to Basel I.

Comment: Agreed: Also Basel II has already done quite a lot of this. Presumably tried to find optimum.
Smoothing Outputs

Authors: Two versions

(1) AR
\[ C_{it} = C_{it-1} + a(C_{it} - C_{it-1}) \]

Authors’ preference

Comment: Surely some moral hazard. Rewards worst bank. Why not average overall all banks if data allow?
(2) Based on Fundamentals

\[ a_t = \exp(a \cdot w_i X_{t-1} + w_2 X_{t-2} + \ldots + w_k X_{t-k}) - \frac{a^2}{2} \]

Authors note as cumbersome to run.

Comment:

X would presumably be main factor (for each type of loan?), e.g. GDP, property prices for residential mortgages, etc.
X then is trended. Need to estimate deviation from trend.
My own preference is to base coefficients on \( X_t - X_{t-n} \), since this is less ambiguous, but how large should n be?
Anyhow my belief is that this general approach is the way to go. Insurance companies and housing mortgages in UK.
Final Comment

Excellent, thought-provoking paper, though I do not agree with all the authors’ prior beliefs.