

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

$$a_t = \exp(a \cdot w_1 X_{t-1} + w_2 X_{t-2} + \dots + w_k X_{t-k}) - a^2/2$$

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.