Scope and Architecture of Financial Regulation

Discussion of presentations of Avinash Persaud and Silvina Vatnick

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- Tools of macro-prudential regulation : early working signals (IMF and FSB), macro stress-testing, countercyclical buffers, mark-to-funding accounting, etc.
- Micro-prudential regulation also failed by allowing many institutions to escape regulation and banks to engage in arbitrage by using securitization to move loans from balance sheet (where capital is charged) to off-balance sheet entities (where no capital is required).
- The reason why the capital behaved procyclically during the current crisis is due to the fact that banks were obliged to return loans back to their balance sheets, not because of Basel II.

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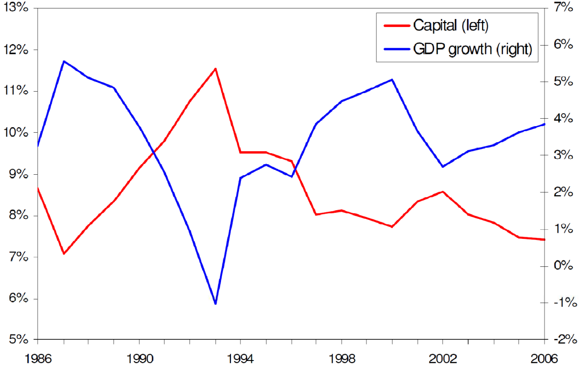
Procyclicality of capital requirements under Basel II

Repullo, Saurina and Trucharte (2009)



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- Authors of Basel II have made attempt to make PDs more neutral by preferring "through the cycle" instead of "point in time" internal ratings. FSA and Committee of European Banking Supervisors proposed to improve methodology.

  ▷ Banks learn more about risk by attempting to model it.

  ▷ Should we trust banks' risk models, when there is a conflict of interests and banks have incentives not to reveal their true risk exposures ?

  ▷ Very little academic research due to confidential data (Jacobson et al. 2006 show large difference in perception of risk by two Swedish banks, which lead to 50 percent difference in LLP between banks).

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- Difficulty in determining the economic cycle.
- Potential candidates for multiplier determinant :

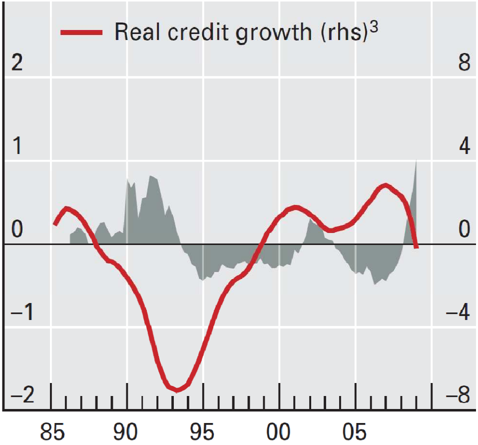
  ▷ Goodhart and Persaud (2009) : Lending growth, asset prices.

  ▷ BIS (2009) : Credit spreads, change in credit, credit/GDP and asset prices.

  ▷ Repullo, Saurina and Trucharte (2009) : GDP growth, credit growth, stock market. Plus autoregressive process for capital requirements or through-the-cycle internal ratings.

BIS analysis (2009)

Write-offs vs. credit growth



Root mean square deviations from the benchmark capital requirement, computed by applying HP filter to actual capital.

	RMSD
TTC ratings	0.45
GDP growth multiplier	0.36
Credit growth multiplier	0.60
Stock market returns multiplier	0.75
Autoregressive adjustment	0.48

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- Rule base approach vs. discretion of supervisors (similar to monetary policy). Supervisors can also be procyclical, not only market participants.
- Local vs global approach ? Spanish banks already use neutral loan loss provisions, which did not stop their growth but allowed them to build buffers to weather the current crisis.

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Other proposals

- Mark-to-funding accounting (Brunnermeier et al., 2009 in Geneva Report) vs FSA proposal to create countercyclical Economic Cycle Reserve.

  ▷ Model based value accounting is similar in spirit to risk based capital requirements.

  ▷ Why not introduce countercyclical buffers for assets valued at market prices ?

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- Remuneration schemes.
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- Contingent capital and capital insurance (Kashyap, Rajan and Stein, 2008).

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Thank you !