FINANSSIVALVONTA
FINANSINSPEKTIONEN
FINANCIAL SUPERVISORY AUTHORITY

Di Iasio & Quagliariello: Incentives through the cycle: microfounded macroprudential capital regulation

Comments by Jukka Vesala

Band of Finland, SUERF and CEPR Conference on Risk Management,

22 September 2011

Motivation

- **Highly topical subject: Macro-prudential policies and tools are being contemplated and implemented**
- **Crockett and Borio / Lowe (early 2000's):**
  - ➢ Exclusive focus on the stability of individual institutions fails to pay sufficient attention to the stability of the financial system as a whole
- **De Larosière (2009) and Turner (2009) reports:**
  - ➢ Systemic stability aspects were not well understood or managed, which contributed to the severity of the financial crisis
- **FSF 2009:**
  - ➢ Need to build-up a capital buffer above the regulatory minimum during a boom; use the buffer to absorb higher losses in stressful environments

Main premises of the paper

- **Objective of capital regulation is to ensure <u>proper risk management incentives</u> (monitoring effort) for banks (Dewatripont & Tirole)**
- **Increasing asset prices distort banks' monitoring incentives:**
  - A strong and credible point given the experiences from the financial crisis!
    - Authors could work further on the foundations of this argument
    - Bad incentives possible aggravated by certain remuneration policies
- **Micro-prudential capital regulation is pro-cyclical: Minimum capital requirement decreases in good times and increases in bad times**
  - Consistent with Basel II risk-based capital regulation
  - In expansionary phases, incentive distortion is underway generating future financial instability
  - However, assumes "point-on-time" risk measures in the calculation of capital requirements

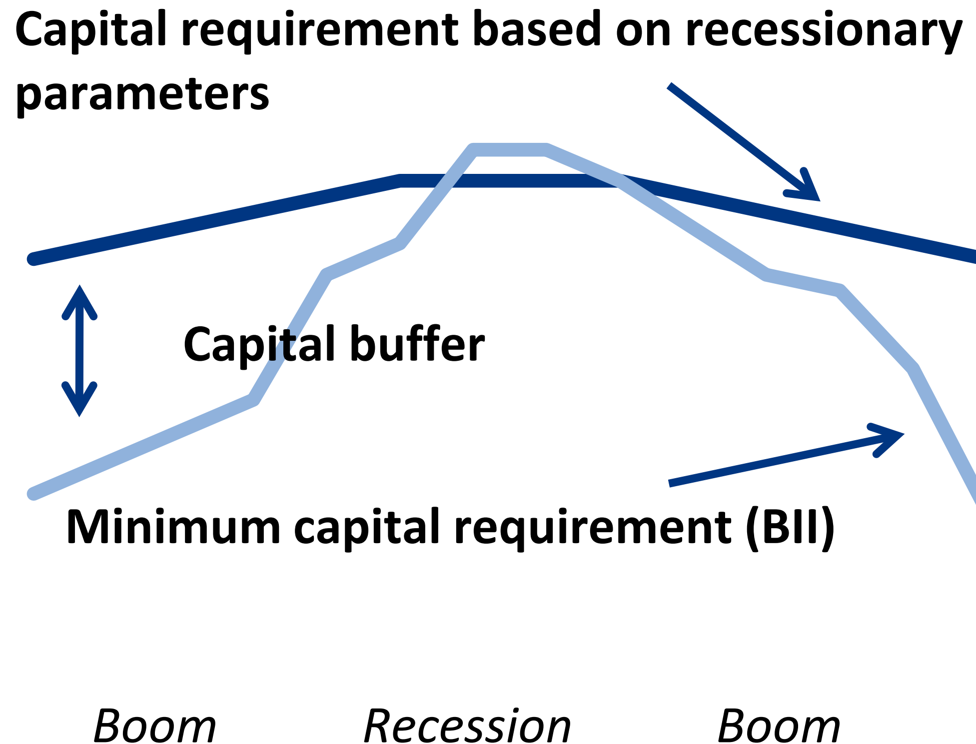
Main results of the paper

- **Macro-prudential intervention is beneficial: A capital buffer requirement during the expansion phase preserves incentive compatibility**
  - Strong theoretical foundation for counter-cyclical capital buffers!
- **Wide objectives for macro-prudential policy:**
  - Provide reserves to draw from in bad times, but also:
    - Correct banks' risk management incentives in boom periods
    - Smooth cyclical fluctuations in asset prices: macro-prudential intervention dampens equilibrium asset prices (equation 8)
- **Realignment of incentives requires a large additional buffer requirement**
  - The required buffer is increasing in asset values and decreasing with banks' ease of funding (intuition for the latter?)
  - Macro-economic costs due to reductions in credit supply?
- **The paper is a very good addition to the literature!**

Discussion (1)

- **Benefits of “through-the-cycle” risk parameters should be more widely recognized**
  - Would (some of) the incentive problems disappear with “TTC” risk measurement and capital charges and/or applying more stringent “stressed” risk parameter values?
  - Originally promoted by the Basel Committee, but not at the moment on top of the regulatory agenda
- **Counter-cyclical capital buffer might also be determined by using banks’ internal models:**
  - Required buffer = Difference between the capital charge using parameters estimated for recession periods (PD, LGD) and the minimum capital requirement under Basel II
  - Greater data requirements, but no public intervention required on the size / build-up / release of the buffer
  - Captures bank-specificities in loan portfolio composition
  - However, modeling failures and heterogeneity (or even bad incentives) still pose major problems

Counter-cyclical capital buffer based on internal models



Discussion (2)

- **Counter-cyclical capital buffer in Basel III is based on public intervention and national discretion**
  - Allows for active macro-prudential intervention to set up an additional buffer requirement of up to 2.5% of CET1 Own Funds
- **Lessons for implementation from Di Iasio & Quagliariello:**
  - The buffer needs to be timely activated (no major implementation delays)
  - The required counter-cyclical buffer may be large: Need flexibility to exceed the Basel 2.5% level
  - The triggers to activate the buffer should include asset price levels / growth (thorny measurement issues!)
- **Home-host issues very important in implementing macro-prudential tools:**
  - Full and mandatory reciprocity required for the regulation to be effective
  - European-level coordination important (ESRB, EBA)

EU implementation of macro-prudential tools

- **Commission proposals in CRD4/CRR1:**
  - Counter-cyclical capital buffer as in Basel III
  - Pillar 2 capital requirements should be used for macro-prudential purposes
  - Standardized model risk-weights for mortgages could be tightened at the national level
  - Commission would have powers to tighten prudential requirements at the EU level
- **Comments:**
  - Powers needed to intervene with wide-ranging prudential measures also at the national level beyond the counter-cyclical capital requirement (e.g. to set LTVs)
    - Need controls at the EU-level to preserve "level-playing-field"
  - The use of Pillar 2 is promising, but has to be legally clarified
  - Possibility to intervene in risk-weights should be extended to IRBA-banks
  - Major issue to tackle is the heterogeneity of RWAs based on internal models; This needs to be addressed by the EBA