

How to make banks reveal their risk: the case of Basel II

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Overview – the model

- Bank can invest resources into project or earn private benefits
- Return on project is private information, to be observed by supervisor only through inspection
- Supervisor can observe capital level – if too low, can decide to inspect
- Supervisor can make type I and type II mistake
- Supervisor can order recapitalization, downsizing or closure

Overview - results

- Risk-based capital requirements only possible if there is sufficient supervisory quality
- High capital costs reduce incentives for mis-reporting if supervisor uses recap and downsizing as disciplinary tools, but not for closure
- Recapitalization preferable over downsizing, but
 - Macroeconomic circumstances
 - Downsizing with asset specificity
- Optimal supervisory scheme depends on cost of capital
 - High cost of capital – recapitalization
 - Intermediate cost – closure
 - Low cost – insensitive capital requirements
- Optimal strategy: combination of recap and fine

What I like about the paper

- Very timely!
- Models interactions between bank and supervisor
- Flexible enough to introduce additional frictions, supervisory measures etc.
- Provides testable results
 - What strategy do supervisors choose across countries and over time?
 - Which supervisory strategy has worked best across countries and over time in terms of stability, welfare etc.?

What do results tell us about anti-cyclical capital requirements?

- Cross-sectional analysis, one-time game
- Arguments behind anti-cyclical capital requirements:
 - Cumulative effect – cushion built in good times for bad times
 - Dynamic effect – boom and bust, macroeconomic cycles

Introducing market discipline and other agents

- Reinterpreting gamma – quality of market signals
- Relaxing assumption of complete deposit insurance – make depositors a stakeholder
- Additional agency problem – bank-borrower?
- What about credit rating agencies?

The supervisor – incentives and tools

- Supervisor welfare maximizing – is this a reasonable assumption?
 - Definition of welfare – additional costs from private benefits beyond loss of project?
 - Supervisor maximizing survival chance of bank (so negative utility from closure or downsizing)
- Political constraints:
 - Penalty too low
 - What about limited monitoring capacity (γ)
 - What about high monitoring costs (low capacity or high complexity)?
- Incentives of owners of financial safety net – tax payers
- Alternative to closure: sell whole bank to other owners, lower social costs than under closure

Conclusions

- Very nice theoretical insights into interaction between bank and supervisor
- Can we make this dynamic – repeated game – moral hazard, expectations, macroeconomic influences etc.
- Features that make it more real world-like