Comments on “Portfolio Effects and Efficiency of Lending under Basel II (Jokivuolle and Vesala)”

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Contributions of the Paper

- A new perspective for thinking about the procyclicality impact of <u>risk-based</u> Basel II vs. <u>flat-rate</u> Basel I
- Result: Risk-based capital regulation may have much <u>smaller</u> procyclicality effect <u>than expected</u>
- Very clearly written, easy to read
- Some comments will follow that may help clarify or enrich the model

Summary of the model

- Project risk level and entrepreneur type
  - **“High-risk”** projects are more sensitive to entrepreneur quality
  - **“Low-risk”** projects are less sensitive
  - High-quality E start “high-risk” projects
  - Medium-quality E start “low-risk” projects
  - Low-quality E become an employee with fixed salary
- Under FR, low risk projects subsidize high risk projects
  - Some of the low-risk guys choose to become employees
  - and thus lower than optimal lending and investment volume
  - Not clear when capital market is also an alternative!
- Under RB: “portfolio effect”
  - reduction of risky projects in the economy / reduce procycliatiy
  - Are risky projects more procyclcical? Not necessarily.
  - High-risk projects are more sensitive to business cycles?

Are “expansionary projects” high risk projects?

- Terminology:
  - Expansionary projects = high risk projects?
  - conservative projects = low risk projects?
- Are they really interchangeable?
  - Lost in translation between the model’s language and the Basel language
- The definition of “expansionary projects” in the paper
  - they are more sensitive to entrepreneur type
- “Expansionary projects” more likely to fail in bad times?
  - If the entrepreneur is the same person and of the same quality through the business cycle…
  - why are “expansionary projects” more likely to fail in bad times?

How to define “high-risk?”

- Statistics language: High-risk projects have greater variance in returns?
- In the model: High risk projects are more sensitive to entrepreneurial types?
- In relation to procyclicality:
  - High risk projects are more sensitive to business cycles?
  - Ie., success rate jointly depends on the realized state of the economy?
  - And high-type entrepreneurs are worse in dealing with negative shocks? Seems counter-intuitive.

An alternative interpretation of the “portfolio effect”

- Composition vs volume – Will the economy become less procyclical?
  - Yes if the bank invest more in low-risk loans under Basel II
  - But how about the composition of bank debt versus market equity in the economy?
- Under FR:
  - The outside option is not only labour market, it can also be capital market!
  - FB leads to more capital market financing
  - More high-risk projects, but bank credit to GDP ratio is lower
- Under RB:
  - High-risk projects decrease, but the fraction of internally-financed projects decrease in the economy as more low-risk entrepreneurs borrow from banks
  - The economy becomes more leveraged

Economic capital vs. regulatory capital

- Capital requirement is binding?
  - Banks always hold more capital than required.
  - Banks do not seem to response to capital regulation in adjusting their capital level (Ashcraft, 2001)
  - Banks may price loans based on risk-adjusted return on capital
  - banks may already think in “economic capital” not in “regulatory capital”
- Flat-Rate leads to over-investment in risky projects?
  - Only true when there is absence of market force in bank’s external financing
- In the model: Loan rate=(R+K)/p
  - What if R is always responding and offsetting the mis-priced K?
  - When K is too low, market charges higher cost accordingly
  - and banks in term price loans based on the market R
  - As a result FR distorts only K, but not R+K
  - Capital regulation strongly matter only when market charge all banks the same cost of capital

Dynamics of Portfolio Effects

- Footnote 11: yes, the dynamics need to be considered
- Can entrepreneurs dynamically choose between investments of different risk profiles?
- The decision process:
  - Entrepreneurs choose a project
  - Economy enters recession
  - borrowing costs go up. Entrepreneurs respond to it?
  - but the entrepreneurs have fixed cost of entry and exit
  - The portfolio is sticky. No portfolio effect….
- Banks facing an **exogenous** change in risk profile
  - Basel II still greatly exacerbates procyclicality

End