A Profit-to-Provisioning Approach to Setting the Countercyclical Capital Buffer: The Czech Example

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General approach

Concept

- Observed **provisioning is below** the average through-the-cycle level, while **profits are higher** than average
- Risk premium – portfolio defaults (non-materialized expected loss) = **cyclically overestimated** interest income
- **Financial cycle** is directly reflected **in banks**' balance sheets and profit and loss account

Goal

- **Simple approach** to financial cycle development to inform **CCyB** decisions

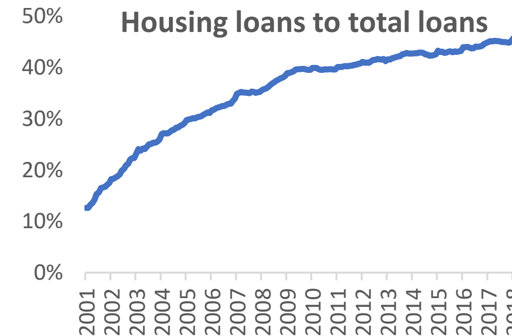
Model

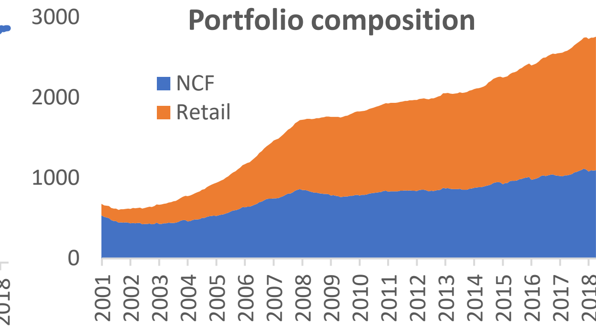
- Three indicators (BPI) combining **interest margins**, **interest profit**, **provisioning** and **leverage**
- **Provisioning** seems to have largest impact on BPIs' dynamics
- Compared to FCI (Plašil et al., 2015) and evaluated by forecasting exercise and regime switching model

Comments and suggestions

Impact of changes of portfolio composition

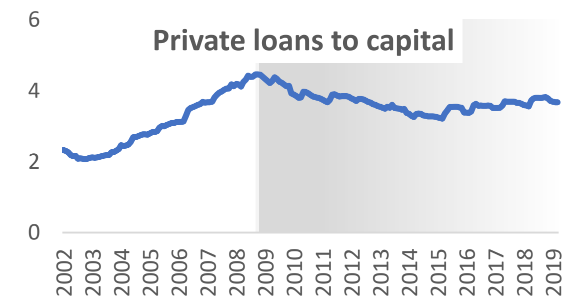
- **Interest margin:** influenced by portfolio composition (housing, consumer, corporate loans, …)
- **Provisioning:** control for share of collateralized loans





Leverage

- **Voluntary capital surplus**: higher voluntary capital should not prevent a decision to increase CCyB
- **Capital level:** can be influenced by other non-cyclical requirements (Pillar 2, CCoB, O-SII, **MREL**…)



Other

- **Structural changes:** income and margins are also driven by competition, market saturation
- **Corporate bonds:** could be part of the cyclical credit cost story (not captured by provisions and margins)
- **Risk cost:** consider including write-offs and sell-offs
- **Non-interest income:** trading income, fees and commissions might be also cyclically overestimated

Open questions

- **Risk cost per unit**
  - **Private loans:** does not account for changing portfolio composition (housing, consumer, corporate)
  - **Risk weighted assets:** can be biased by falling risk weights in IRB banks
- **Interest margin or net interest income**
  - **Interest margin (BPI A):** better proxy for risk premia
  - **Interest income (BPI B):** can increase even in narrowing margins environment (volume effect)
- **Flow vs. Stock**
  - **Interest margin: Flow** is more volatile (Appendix C) but margin on **stock** is not a proxy of risk premia.
  - **Provisioning:** stock of provisions / total loans might be too slow to use it for the release phase
- **Calibration**
  - **Benchmark buffer rate:** If an indicator is good, the Board will push for buffer guide calibration
- **Release phase**
  - Provisioning / RWA seem to be an important indicator for release phase.
    Using provisioning for both **build-up** and **release,** could it be confusing or just the opposite?

What I really like about the paper

Authors: Not only „pure research“ approach, but deeper **understanding of regulation and bank business**

Choice of variables: Good experience with both **interest margins** and **risk costs**

Simple approach: Guided judgement in CCyB requires **intuitive and simple** framework

Data: banking reporting: good **quality**, high **frequency** and little **lag** data

Philosophical set up:

- Some 12 European countries has announced a non-zero CCyB:
  - **Official websites**: Lending, financial market, property market based indicators and/or EW models
  - **Coffee breaks**: Banks are profitable, risk is underestimated, we need to conserve capital
  - **Lukáš and Martin: Let's be honest**: profit and provisioning are strongly cyclical, why not to use it

Message to macropru authorities: "*But let your 'Yes' be 'Yes,' and your 'No,' 'No'.*" (Matthew, 5:37)

Bottom line: We do not always need to wait for **excessive credit growth** to increase CCyB. If banks **underestimate credit risk** and their **profit is cyclically overestimated**, capital buffers should be built.

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