A Profit-to-Provisioning Approach to Setting the Countercyclical Capital Buffer: The Czech Example
Lukáš Pfeifer and Martin Hodula, CNB

Discussed by Štefan Rychtárik, NBS
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.