“How Has Bank Supervision Performed and How Might It Be Improved?”

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Overview

- Main objective: how to mitigate procyclicality of bank capital requirements.
- Proposal: improved forecasts of bank condition would allow for earlier intervention.
  - Focus here on the “intermediate-term” model
- Implemented through CAMELS rating:
  - Builds on current models (e.g., SCOR) and understanding
  - Uses common, pre-existing vocabulary

Overview

- Authors find that approach generates useful forecasts of banking conditions.
- Adding economic variables in particular is helpful.
  - Supports the argument that economic information is useful in the supervisory process.
- Additional forward looking data would be very useful to the supervisory process.
- The approach could indeed reduce procyclicality -- as well as problems regardless of the cycle.

Implementation

- The paper is essentially proposing a more forward looking CAMELS rating
- Two possible paths to implementation:
  - Explicit: “an alternative to [existing] thresholds for early supervisory intervention”
  - Implicit: “informed discussions about the forecasted CAMELS ratings might well help guide a bank toward a better trajectory”

Implementation

- What might a conversation look like?
  - "You're on our watch list for the following reasons… These are the elements of the model that flagged you."
  - "Unless you change something, next year may be more difficult."
- Potential challenges
  - Bankers will ask many questions about the model
  - How "good" is the forecast?
  - Are the results economically significant?

Risk-Adjusted CAMELS

- Paper introduces "risk-adjusted" camels rating:
  - $ERAC_{t,j} = C_{t+1,j} + r \times S_{1t,j}$
- This is not explicitly done within current CAMELS rating system.
- Questions
  - Does idiosyncratic risk (unrelated to the cycle) matter if procyclicality is the main issue?
  - How to measure S?
- Potential extension
  - Could this approach be used to "stress test" CAMELS ratings?