“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:
  \[ \text{ERAC}_{t,j} = C_{t+1,j} + r \times S_{1t,j} \]

• 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?