

Discussion of:
**Bank Capital Redux: Solvency, Liquidity,
and Crisis**

by Ò. Jordà, B. Richer, M. Schularick, A. Taylor

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Basel III in the Context of the Macro-Prudential Approach
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Disclaimer! The views presented here are those of the author and do NOT necessarily reflect the views of the Central Bank of Chile

Motivation and research questions

- ▶ Motivations
 - ▶ Basel III recommendations on leverage ratios
 - ▶ The role of liquidity risk and non-core deposits (as stressed by the GFC)
 - ▶ The construction of an extraordinary historical data-set of banks' assets and liabilities for a group of advanced economies since 1870s.
- ▶ Research questions
 - ▶ What matter for crises prevention?
 - ▶ Take systemic banking crises as defined by Leaven & Valencia (2012)
 - ▶ Focus on the predictive power of (unweighted) capital ratios, liquidity ratios, non-core deposits, and credit-to-GDP growth.
 - ▶ Do capital requirements matter for recovery after crisis?
 - ▶ Take a country entering a recession after a crisis.
 - ▶ Do countries that are highly capitalized recover faster? (use GDP and credit growth as a metrics).

Approach

- ▶ Data
 - ▶ Annual banks' liabilities (tier 1 capital, sight and term deposits, non-core liabilities).
 - ▶ 17 advanced countries.
 - ▶ Exceptional effort to build-up a unique dataset (see <http://www.macrohistory.net/data/>).
- ▶ Logit estimations
 - ▶ **A lot of interesting features.** Different sample periods (full vs post WWII), lagged RHS variables, country FE, clustered S.E., and AUC to measure predictive power. Heterogeneity in the case of Italy.
 - ▶ But, **misses some surprising elements.** No time FE or macro-controls (e.g. MP, a measure of risk!). A measure of "excess capital" or of a "well capitalized" system. No variables that can capture contagion, although **crises appeared to be synchronized.**
- ▶ For the crisis recovery use local projection techniques (Jordá, 2005).

Main findings and conclusions

- ▶ Data shows interesting trend for capital ratios (downward) and non-core liabilities (upward).
- ▶ Higher **capital ratios can not be associated with lower probability of financial crises.**
 - ▶ If any, the relationship is positive, although usually not statistically significant.
 - ▶ According to the authors, "**capital ratios are raised in response to higher risk-taking**".
 - ▶ Results are robust to several specifications.
- ▶ **Liquidity risk measures matter for crises prevention.**
- ▶ Higher capital ratios can lower the costs of a financial crisis.
 - ▶ **Highly capitalized economies recover faster from a crisis.**

Comments #1: Are leverage ratios aim to prevent crisis?

- ▶ Instead, focus on the stability of lending.
 - ▶ Consider a country i coming out of a business cycle expansion and entering a recession ... **when there was a credit boom in a window +/- 2 years.**
 - ▶ Do economies that are highly capitalized **face an smoother contraction (boom with no bust)** than those that are less capitalized?
- ▶ If still want to look for crises prevention \Rightarrow **look for heterogeneities and non-linearities**
 - ▶ Bank level data ... not at the aggregate level!
 - ▶ Raising capital **when capital is very low** reduces the probability of crisis by more (Dagher et al 2016).

Comments #2: Capital ratios can reduce international spillovers

- ▶ As stated by the traditional **bank-lending channel**.
- ▶ Reducing international spillovers may be particularly important for EMEs
 - ▶ As (more recently) crises are coming from abroad...
 - ▶ ... and financial cycles are synchronize across countries (GFSR, 2018).
 - ▶ Capital ratios can **mitigate international shocks that are being transmitted through cross-border funding**.
 - ▶ Preliminary finding at the Central Bank of Chile show precisely that (Jara & Cabezas, 2018, Gómez et al, 2019).
- ▶ Again, the focus is on the **stability of domestic lending**.

Final Remarks

- ▶ Raising capital is as much about **measuring risk properly**, as it is about capital itself.
- ▶ This paper add to the literature **an historical perspective** on the role of credit-to-GDP growth rates and liquidity risk measures as crises predictor. And studies the **role of capital ratios during the recovery of a crisis**. It does so from the analysis of a **novel dataset**.
- ▶ (Unweighted) capital can help to **stabilize lending** more than can prevent financial crises \Rightarrow look at the **role of capital during the contraction phase of the business cycle**.
- ▶ As for EMEs, the emphasis should be on **the role of capital in reducing spillovers**.

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