Discussion of

Drivers of supervisory capital add-ons

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Contribution

- Drivers of capital add ons on banking supervision
- Data set: banks under supervision of the SSM 2014-2020
- Internal model inspections: 267 (over 1180) have induced the supervisor to impose higher RWA until a non-compliance/deficiency in an internal model is remediated
- Asssessment report: severity from F1 to F4
- IRB models for calculating the credit risk RWA
- Analysis of determinants of capital add-ons (standardized by total assets) depending on the outcome of inspections controlling for banks’ riskiness, size, profitability, business model
- Reverse causality is evaluated

Main results

1. The number of deficiencies in a model is unimportant, but rather their severity matters, when calculating the counterfactual RWA impact of supervisory capital add-ons
2. Subset of non-compliances with the Capital Requirements Regulation are the material drivers of model risk
3. Inspections after TRIM led to more severe limitations (SSM allows to address come leniency on the national level)
4. Early warnings: severity of limitations is associated with non-compliances with regard to (i) the initial application to use an IRB Approach, (ii) the overall use of models, (iii) requirements for its estimation, and (iv) requirements for own estimates of the Loss Given Default (LGD)

Comments

- The interpretation as model risk is not fully convincing. The distinction between number (noise) and severity (signal) is not so straightforward. Relevance of severity and not of the number may have other intepretations referring to the supervisor's approach
- Statistical significance (F4 # and CRR prevalent) is not strong in several regressions (5%)
- Better capitalized banks appear to receive larger limitations; riskier banks appear to receive smaller limitations (!) these results do not agree with the literature e.g. Mariathasan and Merrouche (2014)
- Early warning implications: not so surprising (vague from the presentation of the paper)
- Strong limitations after TRIM don't necessarily imply that leniency on the national level was resolved. It may be for other reasons (e.g. Supervisors is learning to do their job)

Wrap up

1. Nice paper, there are very few papers dealing with supervisory data

2. It is difficult to obtain strong restults. Results of the paper are robust

3. I am not convinced by its focus on model risk which is extremely difficult to define and to address:

‘‘what constitutes a “bad” model: Is it either a model with numerous deficiencies, or rather a model with limited numbers of but substantially big concerns? Our analysis shows that the number of issues identified in a model is – statistically speaking – not a significant driver of the counterfactual penalty that the supervisor has to impose in order to maintain a level playing field. Instead the severity of the associated findings drive the limitation.’’