Discussion: Borrowing Beyond Bounds: How Banks Pass on Regulatory Compliance Costs

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Summary

- Do banks pass on compliance costs to their borrowers?
- Setting: Exploit change in regulation that increases reporting requirements for large credit exposures (LEX)
 - Capital requirements regulation (CRR) reduced LEX reporting threshold for banks in proportion to their Tier 2 capital
 - RDD setting comparing interest rates on new loans with bank exposure just below vs just above the disclosure threshold
- Main findings:
 - After the reform. small banks shift exposures below reporting threshold
 - LEX borrowers have 76bps ↑ interest rates
- Interpretation:
 - Banks pass compliance costs to borrowers

Main assessment

- Interesting research question and topic
- Core Principles for Effective Banking Supervision (on LEX): 'local laws and bank regulations [should] set prudent limits on large exposures to a single borrower" (BCBS; BIS, 2014)
- Important topic!
- Concentration of single-name counterparty risk can have significant real effects (Galaasen, Jamilovic, Juelsrud and Rey, 2021)
- This paper: Unintended consequence of the LEX regulation
- LEX regulations can increase systemic risk (Kosenko and Michaelis, 2022)
- Contributes to literature on real effects / unintended consequences of bank regulation and supervision

Comment 1: Motivation

- Why is compliance costly? ("we remain agnostic about the specific type of reporting cost")
- Banks must identify groups of connected counterparties
- Inflation in institutional operating expenses for logistics
- Fear of reporting largest banks due to more scrutiny in the future
- What changes after the regulation in terms of compliance costs?
- Irrespective of eligible capital, banks already had to keep track of their LEX before the change in regulation ⇒ impact on operational expenses limited
- Most likely related to regulatory scrutiny

Comment 2: Interpretation

- LEX limits:
 - Maximum (binding) limit: 25% eligible capital, with credit risk mitigation
 - Disclosure limit: 10% eligible capital, without credit risk mitigation
- "[There exist] material differences in [...] the scope of application, the value of large exposure limits, methods for calculating exposure values, credit risk mitigation techniques [...] Although a concentration risk adjustment could be made to mitigate these risks, these adjustments are neither harmonised across jurisdictions, nor designed to control traumatic losses from a single counterparty default." (BCBS; BIS 2014)
- Alternative interpretation: Supervisory actions may discipline financial institutions by increasing their awareness of the risks ("nudging" firms to diversify borrowers)
- "Supervisory scrutiny" (Kok et al. 2023, Degryse et al. 2024),...

Disentangling across interpretations

- If operational ("compliance") costs, then interest rate increases should be short-lived (banks incur setup costs for required processes only at the onset)
- If supervisory scrutiny, all new exposures should carry premium
 - Test using a dynamic setting
- If compliance costs, then interest rates should be increased homogeneously for all new exposures above LEX disclosure limit
- If supervisory scrutiny, costs should increase more for firms with larger exposures
 - Slope is negative for firms above the threshold (Figure 6)
 - \bullet ... but driven by exposures very close to threshold ...

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- Possible sources of error:
 - (i) Off-balance sheet exposures (e.g. derivatives)
 - (ii) Exposures of subsidiaries outside of EU (e.g. multinationals operating outside EA?)

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Comment 3: Measurement (cont)

- Important in RDD context as it affects bunching and classification below / above threshold
- Mostly lead to Type II errors (LEX below reported threshold) ⇒ Upward bias
- Could be especially large for big and complex banks
- ... and banks with large Tier 2 ratios; (GSIBs?) ⇒ Discuss whether / how affect results! (e.g. bank heterogenienty)
- Suggestion: Validate LEX measure
 - Subsample of firms with common codes ⇒ Show difference in exposure ratios and correlate with observed characteristics
 - Calculate text similarity of calculated exposures with names disclosed to regulator
 - Calculate number of new disclosures by bank and correlate with new disclosures to regulator

Comment 4: Confusing results

- Figure 2 shows changes in distribution of exposures above and below the regulatory threshold (result in abstract)
- But Figure 5 shows no bunching
- Difference coming from using before vs after vs pooled observations (and potentially different threshold)...
- In Page 7: "In 2019, the original Capital Requirements Regulation was amended and the capital base for both thresholds was reduced to Tier 1 capital"
- Main result (Table 3): Why no significance before CRR? What threshold is being used? My understanding is threshold changes according to the eligible capital (as in Table 1)

Conclusions

- Very interesting paper on important topic
- Important to take a stance on source of compliance costs to relate to literature and motivate further analysis
- Provide validation for measurement of large exposures
- Provide clearer exposition
- Looking forward to reading revised version!