Is 8% for all seasons?

Considering the potential pro-cyclical impact of Basel II and the limited effectiveness of countervailing influences, David Rowe concludes that making the 8% ratio of capital-to-risk-adjusted-assets a discretionary policy variable should be part of the new capital Accord

In recent months, this column has considered how introducing greater risk sensitivity into the Basel capital Accord could accentuate the business cycle. Michael Gordy, senior economist at the US Federal Reserve Board, has argued that, in practice, required capital will be smoothed over the business cycle, since the consequences of not doing so are simply too severe. He sensibly maintains that the issue is how to do this with the least damage to the alignment of regulatory and economic capital and to the integrity of banks' internal credit rating processes. He emphasises that, for all its shortcomings, Basel II is the first modern and standardised metric of credit portfolio risk. If done properly, it has signal value across time and across institutions that is important to preserve. He argues that there are three ways to address the cyclicality issue.

The first is to smooth the inputs by, for example, demanding through-the-cycle estimates of parameters to make them less cyclical. This breaks the link between the rating system and a bank's actual current risk. It is rather like saying the seasonally adjusted temperature in Minnesota in both January and July is zero degrees Celsius. It may be true, but it doesn't provide much information on what to wear when you go outside. Such a rating scheme ignores valuable current information and makes the results virtually useless for many pricing decisions. It also undermines the basis for back-testing by clouding the issue of exactly what actual realisations are the appropriate historical benchmarks.

The second is to smooth the capital calculation model by, for example, reducing the derivative of the risk weight as a function of the probability of default. This approach preserves the signal value of point-in-time parameter estimates, but reduces the effectiveness of the resulting capital requirement as a current measure of a bank's capital adequacy.

The third is to adjust the regulatory minimum capital ratio over the cycle. Gordy suggests five possible ways of accomplishing this.

☐ *Fix regulatory capital charges at the inception of a loan.* (To such a regime, Gordy suggests adding the requirement to disclose the minimum regulatory capital based on

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current ratings.) While preserving risk sensitivity on new loans, this approach opens many opportunities for regulatory arbitrage. It creates asymmetric incentives to refinance after an upgrade but not a downgrade. If the original capital charge was transferable upon sale of a loan, this would distort pricing in the secondary market. If it was not transferable, it would discourage economically desirable risk diversification when one or both parties stood to lose a favourable regulatory capital treatment.

☐ *Smooth capital requirements at the instrument level.* In effect, this approach would set the capital requirement for an instrument based on a declining weighted average of current and past ratings. While more responsive to current conditions than the previous method, it also creates both capital arbitrage opportunities and distortions in the risk transfer market. This approach also implies an increase in the complexity of the calculation and in auditing it effectively.

☐ *Smooth capital requirements at the portfolio level.* This approach estimates a required capital ratio implied by current parameter estimates, but the actual required capital ratio would be a declining time-weighted average of these estimates. Disclosure of both current and smoothed requirements could be mandated. This approach also preserves relative risk on current loans and accommodates bank-specific cyclical influences. Being simple to implement, it creates no additional burden in auditing the calculation. Conversely, it could cause anomalies with large shifts in the balance sheet and would be slow to boost required capital in the face of a deteriorating credit culture.

☐ *Counter-cyclical indexing.* This would allow the 8% ratio applied to risk-adjusted assets to vary based on a bank-specific cyclical variable. This preserves risk sensitivity, avoids introducing capital arbitrage opportunities and preserves the consistency of risk-weighted assets over time. On the other hand, an appropriate index might be hard to define for many large banks, and such indexes might need to be revised for many banks in light of specific experience.

☐ *Discretionary rule.* Realistically, national regulators will not seriously aggravate a domestic economic contraction to defend a mechanical bank capital rule. Gordy argues, and I agree, that it is better to make this explicit. Supervisors could demand gradual increases in minimum capital ratios during expansions and allow for a measured pace of reductions during recessions, all of which would have to be made public and justified based on cyclical conditions. It is highly unlikely that this would lead to a competitive devaluation of standards in an increasingly risk-sensitive world. It would also preserve the signal value of consistently published risk-weighted assets across banks and over time. In effect, supervisors would mandate a gradual build-up of capital buffers during good times and release them during periods of economic stress. This could be a very powerful monetary policy tool. If used prudently during recessions, particularly if this followed a period of gradual increases in the capital ratio, it is unlikely that markets would be spooked into losing confidence in the banking sector. In addition, with increased disclosure mandated under Pillar III, investors would already be aware of the capital condition of banks, both individually and collectively, in any case.

If the pricing and market-signalling value of a consistent and reasonably sophisticated credit risk assessment regime are to be preserved, banking regulators should step up to the challenge of discretionary counter-cyclical adjustments to the minimum required capital ratio. ■