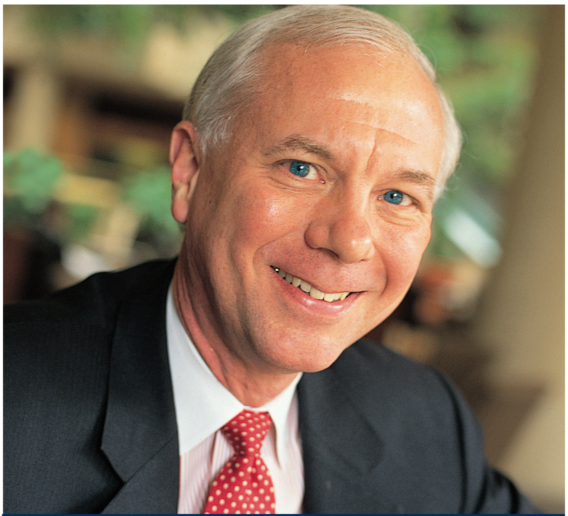
Basel II and pro-cyclicality

The main argument for making regulatory capital requirements more risk-sensitive is to improve allocational efficiency. But this may lead to intensified business cycles if regulators fail to take measures to prevent such an impact. In this first column in a series, David Rowe reviews the rationale for risk-sensitive rules, and how they could magnify business cycles

Allocating credit to those areas promising the highest return relative to the risk is the central economic function of financial markets. This drives dynamic economic efficiency and prevents the massive waste of resources caused by misdirection of society's limited quantity of savings. Obviously such market decisions are never perfect in hindsight. Experience shows, however, that open and competitive financial markets are the best means of maximising such allocational efficiency.

One of the tragedies of the post-colonial era was the government-directed, but massively wrong-headed, allocation of third-world capital into steel mills and other 'prestige' projects that proved to be economically unsupportable. This is also why so much industry in the former Soviet Republics is in shambles. Lacking financial competition for access to scarce resources, the Soviet Union had no reliable basis for making rational decisions among alternative investments. It should have been no surprise that after 1990 these facilities proved woefully incapable of competing effectively in world markets.

The primary reason that risk-sensitive capital rules are desirable is to improve the allocational efficiency of banks' credit-granting decisions. Rules that introduce regulatory distortions into this decision process interfere with such efficiency. The impact of this is cumulatively significant – albeit gradual and often insidiously invisible – damage to economic growth and material well-being.



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The pro-cyclicality argument

The October 2001 issue of *Risk* contains an article entitled 'Pro-cyclicality and the new Basel accord' (page S28). In it CSFB's D Wilson Ervin and Tom WIlde argue that the proposed Basel II capital rules would be significantly pro-cyclical. They construct an example using the S&P credit ratings transition matrix for 1990 applied to a portfolio of all BBB credits at the start of the year. Their analysis shows that, holding all else constant, regulatory capital requirements for credit risk would increase by 20% as a result of that year's average decline in ratings. Furthermore, it is reasonable to assume that banks would not be anxious to raise new capital in a weak economic environment. Consequently, outright asset reduction or shifting the mix towards assets with lower regulatory capital requirements would be the likely means of maintaining compliance with the Accord.

Historical precedent

Such events are not without historical precedent. When Basel I was first introduced in 1988, it imposed immediate pressure on many banks to increase their capital ratios. Part of the resulting response, including that of the bank for which I worked at the time, was to slow the growth in corporate and consumer lending by limiting new loan approvals and shift assets into sovereign securities or obligations of other financial institutions. This introduced a mild credit squeeze in the private non-financial business sector. Fortunately the economy was reasonably robust at the time, and the impact of these credit restrictions was not severe.

The pro-cyclicality argument focuses on the fact that credit deterioration will lead to lower ratings, higher expected default probabilities and increased regulatory capital requirements at precisely those times when the economy is leaving the 'reasonably robust' stage. The fear is that banks will react as they did in 1988 by reallocating assets towards the strongest borrowers with the lowest capital requirements. Restricting lending to weaker credits and to consumers is likely to intensify their financial plight, increase the number of bankruptcies and generally slow the process of restoring confidence and renewed growth.

Other considerations

That said, there are many other factors to consider in this discussion. These include:

- ☐ the behaviour of loss-given default (LGD) over the cycle
- ☐ correlations among probabilities of default (PD) across borrowers
- ☐ correlations among PD and LGD
- ☐ the possibility that capital buffers above the regulatory minimum would cushion the pro-cyclical effect of minimum capital requirements
- ☐ the possibility that improved credit risk modelling will lead to earlier action to restrict credit before the onset of an actual downturn
- ☐ the impact of possible changes in supervisory behaviour under Pillar II of the Basel II proposal, and
- ☐ the role of market discipline on bank behaviour in light of increased disclosure requirements under Pillar III of the Basel II proposal.

To its credit, the BIS has commissioned studies in a number of these areas in the process of deliberating on the new rules. A review of research findings and opinions on these issues will be undertaken in future columns. ■