

Procyclicality and the new Basel Accord – banks' choice of loan rating system

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Received: October 25, 2003; revised version: April 27, 2004

Summary. The Basel Committee on Banking Supervision is proposing to introduce, in 2006, new risk-based requirements for internationally active (and other significant) banks. These will replace the relatively risk-invariant requirements in the current Accord. The new requirements for the largest bank will be based on bank ratings of the probability of default of the borrowers. There is evidence that the choice of loan ratings which are conditional on the point in the economic cycle could lead to sharp increases in capital requirements in recessions. This makes the question of which rating schemes banks will use very important. The paper uses a general equilibrium model of the financial system to explore whether banks would choose to use a countercyclical, procyclical or neutral rating scheme. The results indicate that banks would not choose a stable rating approach, which has important policy implications for the design of the Accord. It makes it important that banks are given incentives to adopt more stable rating schemes. This consideration has been reflected in the Committee's latest proposals, in October 2002.

Keywords and Phrases: Basel Accord, Bank rating, Endogenous default, Procyclicality, Risk weights.