Discretionary Credit Rating and Bank Stability During a Financial Crisis

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Summary of the paper

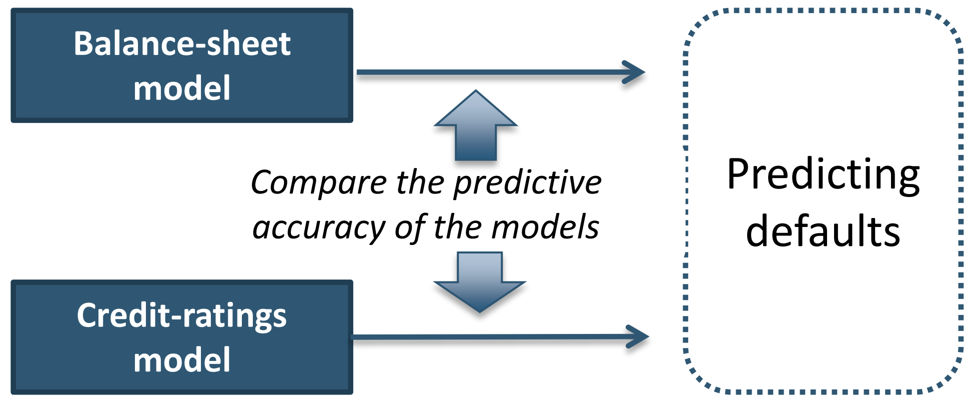
Hypothesis: During financial distress, banks have incentives to undervalue their credit risk assessment in order to strengthen their capital base

Credit rating → Loan-loss provisions → Profit and loss account → Capital

Data:

- 10 Slovenian banks (all but one are SA)
- 2007-2012
- Credit ratings information
- Balance sheet information

Methodology:



Conclusions of the paper:

- During financial stress, banks undervalue their credit risk
- In particular, this is the case for small domestic banks that do not have, otherwise, the possibility to raise capital in adverse economic conditions

Comments

- Credit ratings
  - Scoring? Scoring + expert judgment?
  - Are credit ratings comparable across banks?
  - What is the internal use of the credit ratings? How do they feed into the loan-loss provisions?
- Assumption: Credit ratings model has superior information to balance sheet model
  - Credit ratings model has superior information → its predictive power ↑
  - Credit ratings model has 4 independent variables that aggregate all possible model outcomes into five credit quality categories → its predictive power ↓
- Predicting defaults
  - What about predicting a wider spectrum of risks? Will the predictive power of the two models change?
- Differences between international/ large and small banks
  - Conclusion behind the paper – access to capital and cost of capital
  - Other factors: Integration between accounting and credit risk management for regulatory purposes (more likely in case of international and large banks) → less room for discretion
  - Different (opposite) conclusion in the Huizinga and Laeven (2012) paper

Policy implications

The work presented in this paper could be valuable for the supervisors to make sure that stricter capital requirements are always accompanied by strict monitoring and compliance.

Example presented in the paper: EBA recommendation on 9% Core Tier 1 capital

- The 9% requirement was announced in Q4 2011, to be complied with until June 2012.
- Figure 1 shows a decrease of predictive power until 2010, and a steady increase of predictive power of the credit ratings model since then.
- Reasons for the increase in predictive power:
    - Stricter control and monitoring?
    - Adjustment of the bank models?
    - Better predictive power out of the crisis years?

Suggested improvements and extensions

- Provide more explanations on the credit ratings
- Discuss other possible explanations behind the discrepancy between the predictive capacity of the 2 models during the crisis and what is their weight in this discrepancy:
    - Conclusion behind the paper – incentives for capital requirement relief.
    - Other factors to be considered:
        - Lower ability of bank models to predict defaults during crisis
        - Regulatory forbearance (less strict supervisor)
- Use the models to predict a wider spectrum of risks
- Include other countries in the analysis, as Slovenia seems to be a special case (of course this comes with other issues, such as comparability of credit ratings)

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