

# Industry Practices in Credit Risk Modeling and Internal Capital Allocations: Implications for a Models-Based Regulatory Capital Standard

## Summary of Presentation

*David Jones and John Mingo*

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### I. WHY SHOULD REGULATORS BE INTERESTED IN CREDIT RISK MODELS?

Bank supervisors have long recognized two types of shortcomings in the Basle Accord's risk-based capital (RBC) framework. First, the regulatory measures of "capital" may not represent a bank's true capacity to absorb unexpected losses. Deficiencies in reported loan loss reserves, for example, could mask deteriorations in banks' economic net worth. Second, the denominator of the RBC ratios, total risk-weighted assets, may not be an accurate measure of total risk. The regulatory risk weights do not reflect certain risks, such as interest rate and operating risks. More importantly, they ignore critical differences in credit risk among financial instruments (for example, all commercial credits incur a 100 percent risk weight), as well as differences across banks in hedging, portfolio diversification, and the quality of risk management systems.

These anomalies have created opportunities for "regulatory capital arbitrage" that are rendering the formal

RBC ratios increasingly less meaningful for the largest, most sophisticated banks. Through securitization and other financial innovations, many large banks have lowered their RBC requirements substantially without reducing materially their overall credit risk exposures. More recently, the September 1997 Market Risk Amendment to the Basle Accord has created additional arbitrage opportunities by affording certain credit risk positions much lower RBC requirements when held in the trading account rather than in the banking book.

Given the prevalence of regulatory capital arbitrage and the unrelenting pace of financial innovation, the current Basle Accord may soon become overwhelmed. At least for the largest, most sophisticated banks, it seems clear that regulators need to begin developing the next generation of capital standards now—before the current framework is completely outmoded. "Internal models" approaches to prudential regulation are presently the only long-term solution on the horizon.

The basic problem is that securitization and other forms of capital arbitrage allow banks to achieve *effective* capital requirements well below the nominal 8 percent Basle standard. This may not be a concern—indeed, it may be desirable from a resource allocation perspective—when,

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# Risk Based Capital Regulatory And Industry Approaches To Capital And Risk

**Michal Rosen-Zvi**



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