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Credit Risk and Financial Stability

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Abstract : In contrast to recent successful developments in macro monetary policies, the modelling, measurement and management of systemic financial stability has remained problematical. Indeed, the focus of most effort has been on improving individual, rather than systemic, bank risk management; the Basel II objective has been to bring regulatory bank capital into line with the (sophisticated) banks' assessment of their own economic capital. Even at the individual bank level there are concerns over appropriate diversification allowances, differing objectives of banks and regulators, the need for a buffer over regulatory minima, and the distinction between expected and unexpected losses (EL and UL). At the systemic level the quite complex and prescriptive content of Basel II raises dangers of 'endogenous risk' and procyclicality. Simulations suggest that this latter could be a serious problem. In an extension to the main analysis we study how liquidity effects interact with banking structure to produce a greater chance of systemic breakdown. We finally consider how the risk of contagion might depend on the degree of asymmetry (tiering) inherent in the structure of the banking system. A number of our results have important implications for public policy, which this paper also draws out.

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