

# The Pro-cyclical Effects of Bank Capital Regulation?

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# Overview

- Basic model under Basel II implies
  - higher capital ratios in recessions
  - pro-cyclical credit (constrained in recessions)
- Authors' extensions/modifications
  - to avoid pro-cyclical credit
- My own views on evolution of credit risk
  - regular (amplified) cycles versus *super cycles*

# Assumptions

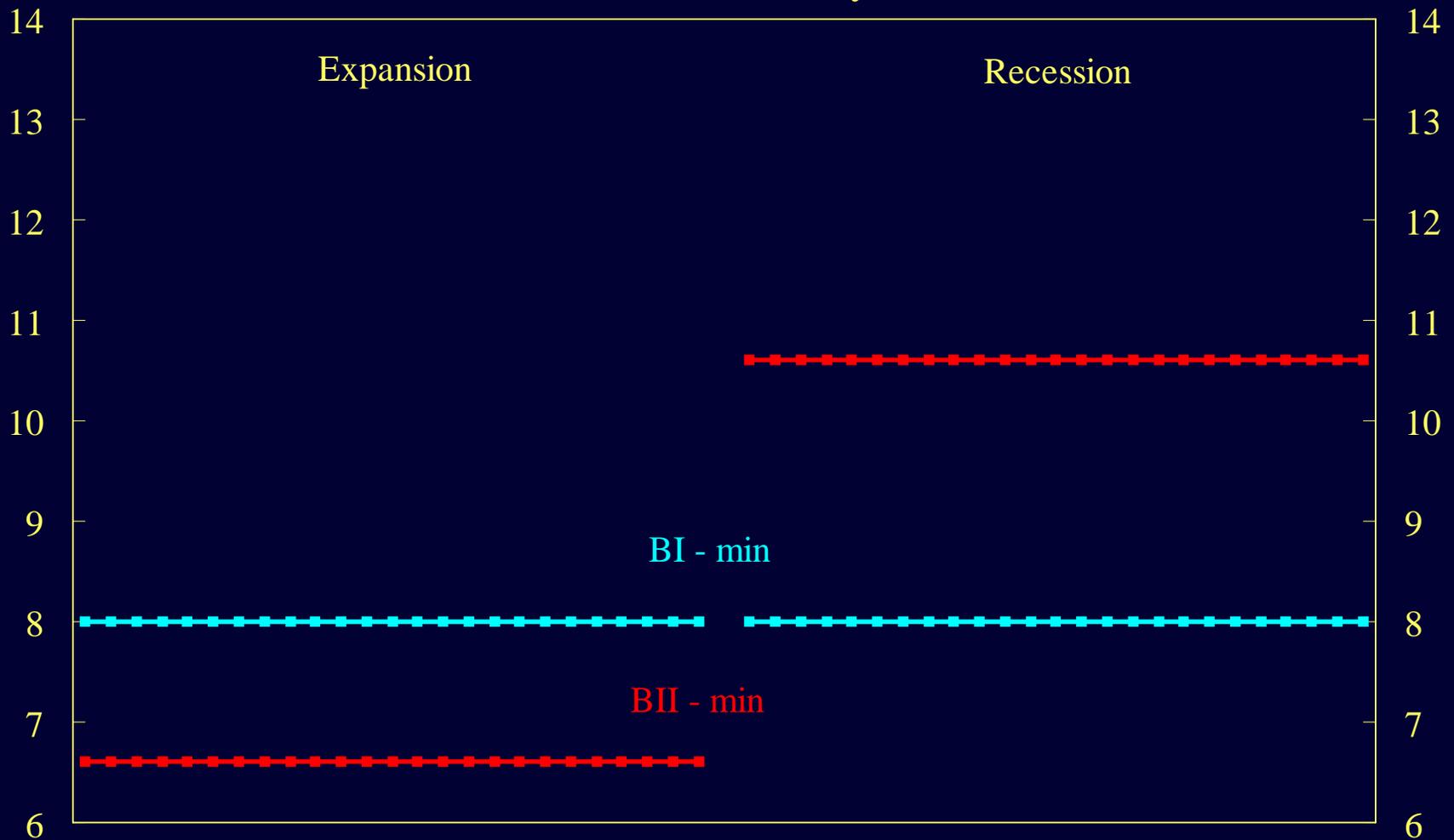
- Overlapping generations banks/firms
  - live for two years
  - *two states: expansions or recessions*
  - probability of default on loans higher in recessions
- Market failures (in the second year)
  - *banks cannot raise more equity*
  - borrowers cannot go to another bank

# Mechanisms

- Basel II has minimum capital requirements that change with the cycle, according to *one minimum level* of bank solvency
- Banks 'self insure' with capital buffers above the minimum requirements

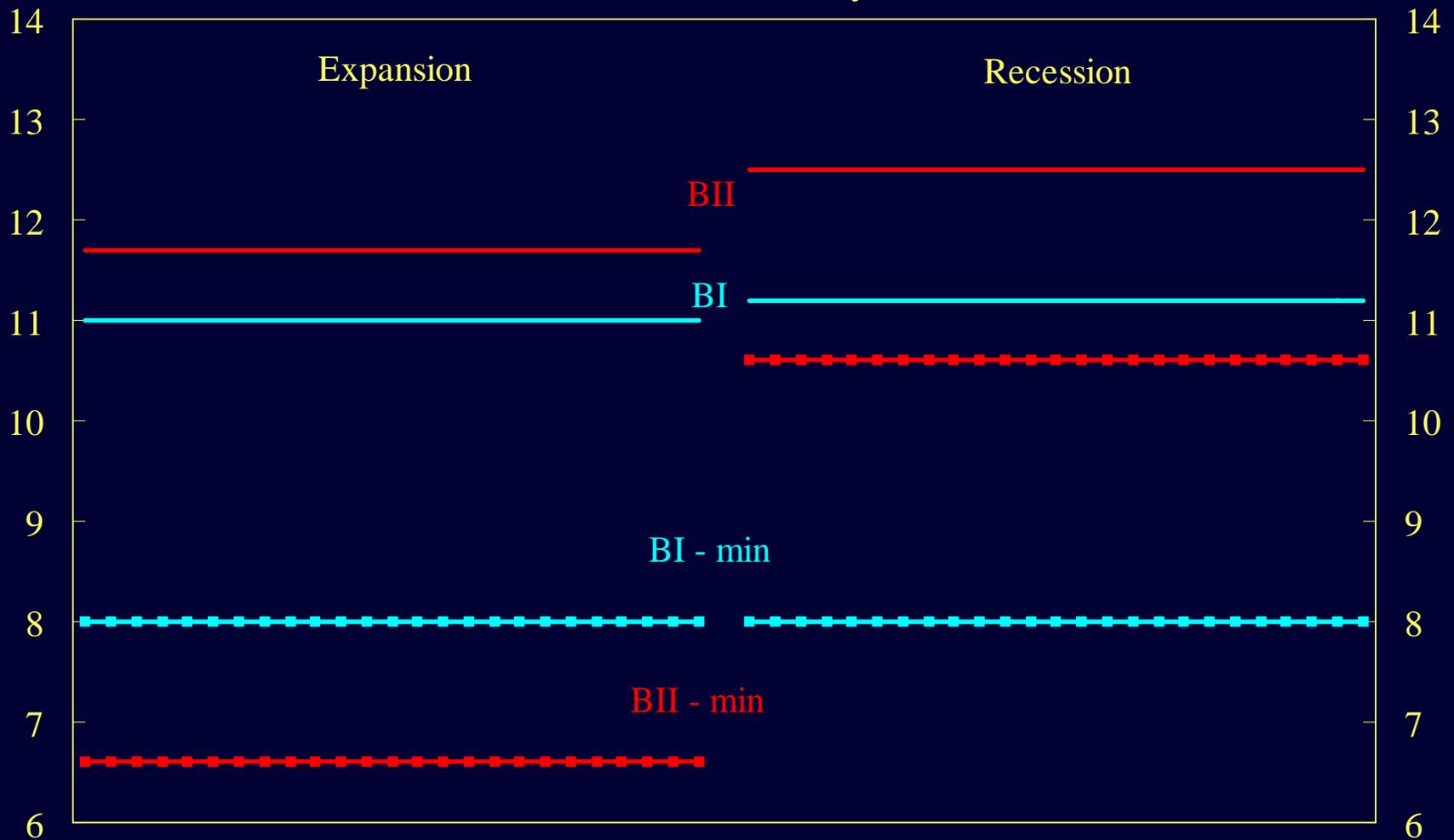
# Minimum capital requirements

(Table 4, medium volatility scenario)



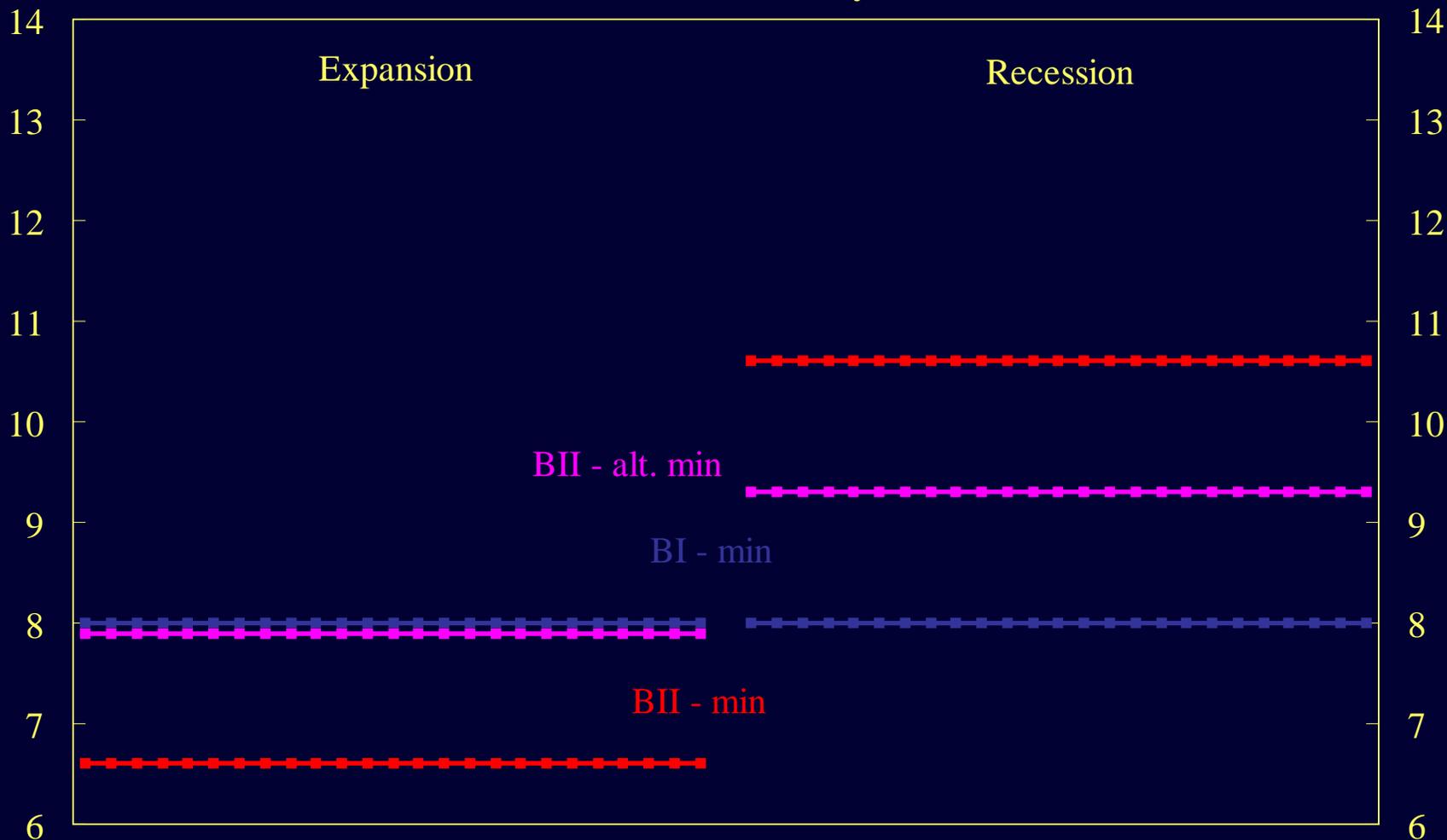
# Actual Capital Ratios and Buffers – First-year Banks

(Table 4, medium volatility scenario)



# Extension: Alternative Confidence Levels to Correct for Credit Pro-cyclicality

(Table 7, medium volatility scenario)



# Relevant Australian Experience?

## Depression episodes

1890s – financial catastrophe/banking crisis

1930s – some financial distress

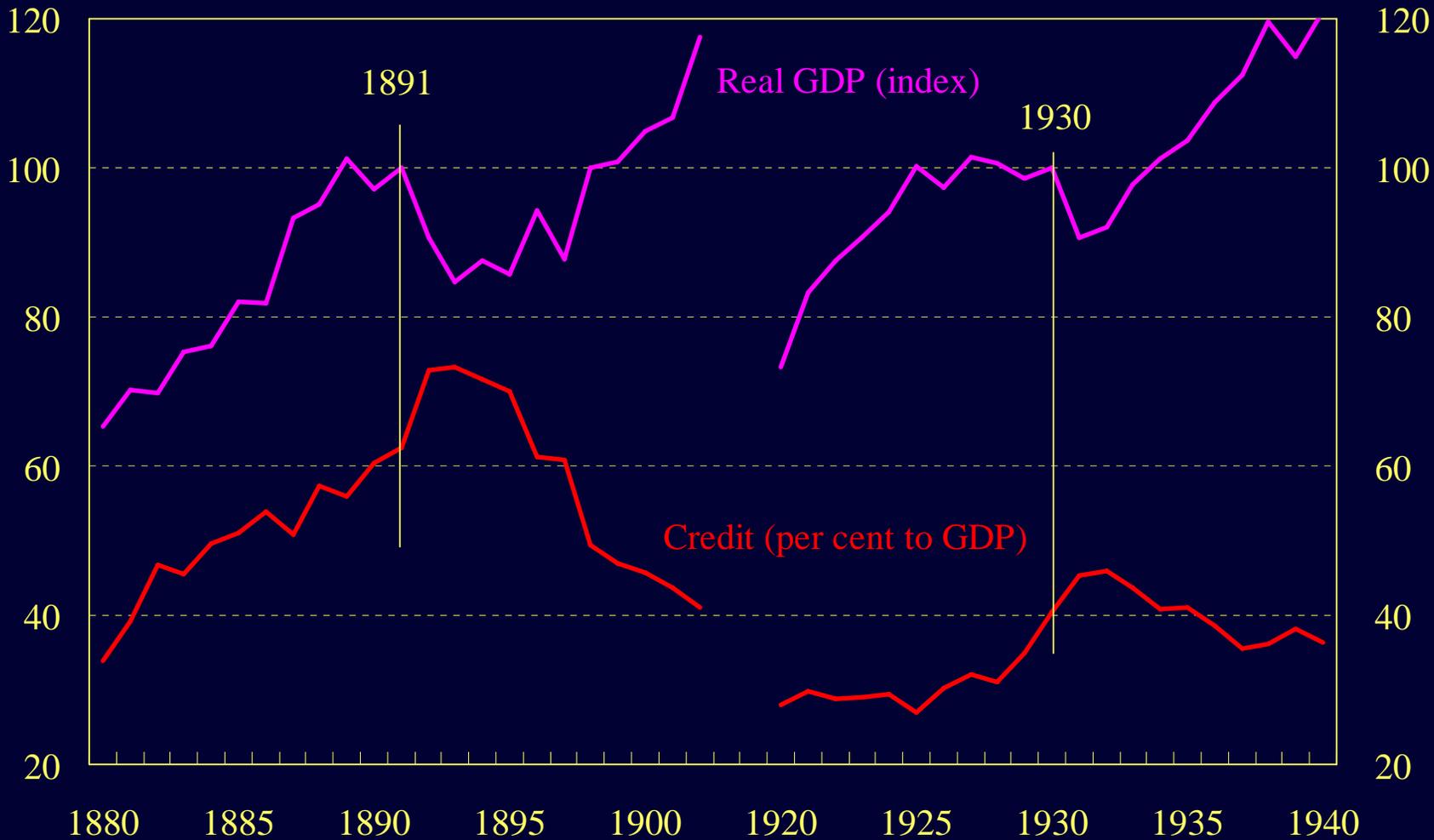
## A key difference?

Capital ratios – pro- versus counter-cyclical

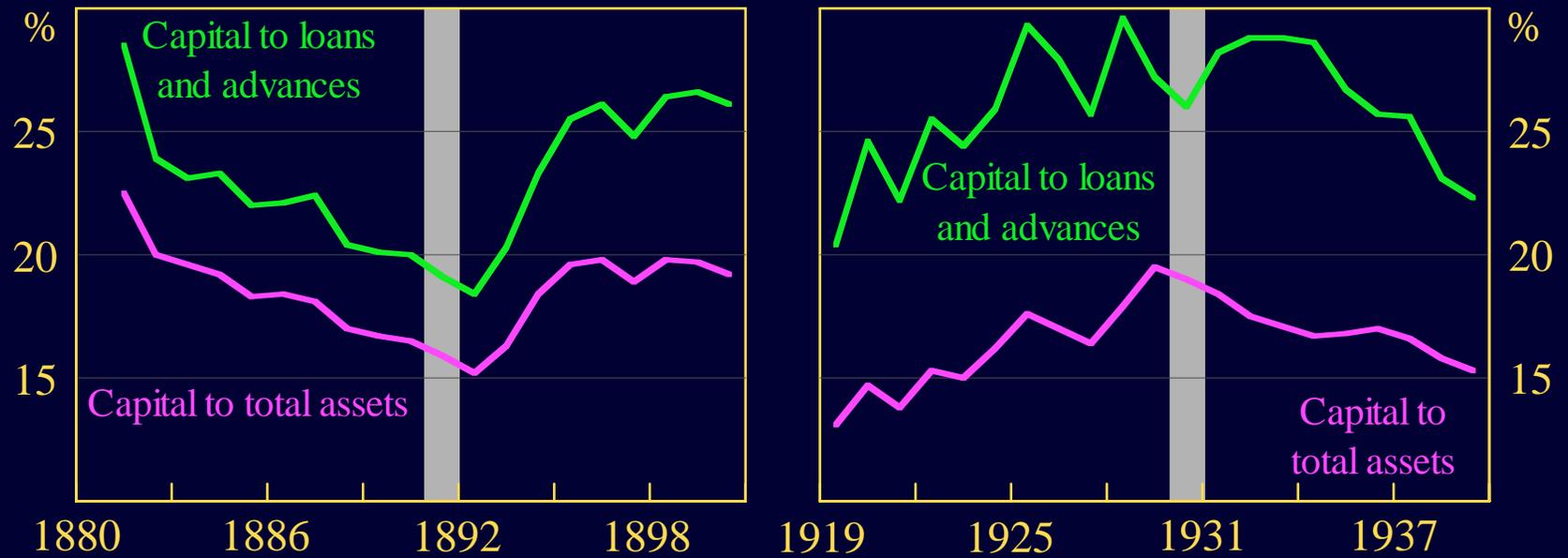
Kent (2009), ‘Two Depressions, One Banking Collapse: Lessons from Australia’ –  
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D’Arcy and Kent (2001), ‘Cyclical Prudence – Credit Cycles in Australia’, in BIS  
Papers No 1.

# Australia's Two Depression Experiences



## Capital Ratios



[www.rba.gov.au](http://www.rba.gov.au)

