Credit Risk Measurement in Financial Institutions: Going Beyond Regulatory Compliance

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Abstract

Capital adequacy is an important factor considered by financial institutions when they formulate their lending policy and balance sheet growth strategy. The majority of financial institutions employ the Standardised Approach for calculating their credit risk capital requirements as they cannot meet the stringent criteria stipulated in Basel II (and Basel III) and qualify for the more advanced approaches. The Standardised Approach lacks the necessary risk sensitivity and the resulting regulatory capital requirements serve as a very crude proxy of the actual credit risk taken. Strategic decision making based on this approach, often provides institutions with a perverse incentive for pursuing (a) collateral-driven lending policies rather than focusing on obligor financial standing and repayment ability; (b) balance sheet short-term growth strategies where excess liquidity takes the form of high-yield government bond investments. This paper presents two simplified credit risk models that are not data demanding and, by addressing the very weaknesses of the Standardised Approach, more informative in measuring the possible future loss impact of credit risky business or investment decisions. It provides a comparative analysis of the presented models with empirical results suggesting that financial institutions would need to do more than simply maintaining compliance with the minimum regulatory capital requirements.

Keywords: Capital allocation, Capital requirements regulations, Credit risk measurement, Eurozone banking crisis, Value-at-Risk (VaR).

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