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Revisiting Basel risk weights: cross-sectional risk sensitivity and cyclicality

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Abstract We empirically assess the sensitivity of Basel risk weights to bank portfolio risk and the business cycle. With our econometric model, we distinguish between cross-sectional risk sensitivity and longitudinal risk sensitivity (cyclicality) of the regulatory standard. Employing a comprehensive data set covering 200 large banks from 28 countries, we find that actual risk weights are fairly insensitive to the business cycle. There is no evidence that Basel II has significantly increased cyclicality. Furthermore, cross-sectional risk sensitivity of regulatory risk weights to a market measure of bank portfolio risk is low. We further assess the adequacy of the capital standard's risk sensitivity based on a Merton-style model of bank risk and bank default. Judged upon the Basel Committee's self-established goal of maintaining bank default rates below 0.1 %, our results suggest that risk weights and minimum capital requirements are ill-calibrated, even under the stricter Basel III rules.

Keywords Basel II · Risk weights · Banking regulation · Capital requirements · Pro-cyclicality

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