By Tarisa Watanagase and Pascal de Lima

Managing Procyclicality in Developing Countries

Procyclicality can be loosely defined as the tendency of financial institutions to amplify trends during a given economic cycle. The management of procyclicality, which is a requirement of global regulatory directives such as Basel III, remains a major challenge — not only for central bankers and academics but also for risk managers and consulting groups, particularly during financial crises.

One staple of procyclicality is that banks tend to contract their lending activity when economic downturns occur, because of their concerns about loan quality and repayment probability. This exacerbates the downturn, as credit-constrained businesses and individuals have to cut back on their real investment activity.

In most emerging countries — including Thailand — managing the procyclicality of the financial system is synonymous with managing the procyclicality of the banking sector. Indeed, in emerging countries (where banks are viewed as engines of economic development that are the lifeblood of the financial system), banking procyclicality is much more important than in developed countries.

While procyclicality is often linked to financial crises, it can also have a significant impact in emerging countries experiencing an economic expansion with a high level of inflation. During such a period, bankers are prone to excessive optimism and may be inclined to justify the feasibility of increasingly higher-risk (or even otherwise "non-bankable") loan proposals, due in part to inflated collateral values and the seemingly unlimited potential of their borrowers. These factors contribute to rapid loan growth and the ensuing swings in loan quality.

Illustration by Ken Orvidas

In contrast, when an economic downturn occurs, bankers optimism turns to pessimism; loan quality problems accumulate; and inadequate reserve levels and provisioning become apparent. At this stage, bankers may significantly tighten lending standards and become reluctant to lend even to creditworthy borrowers — but most of all to borrowers who have in the past already defaulted.

In emerging markets, the most practical way to manage procyclicality is to require explicitly two sets of ratios: (1) a minimum capital ratio; and (2) a minimum targeted capital ratio that is set at a pre-defined level above the regulatory minimum. During good times, all banks may be expected to adhere to the target capital ratio. During economic downturns, on the other hand, bank supervisors may exercise some discretion on how "buffer" capital is needed.

It is also possible to counter procyclical tendencies in the banking sector by increasing the regulatory credit risk-weights assigned to certain high-risk assets/sectors. If bank supervisors see a rapid accumulation of credit concentrations in certain high-risk sectors during boom times, consideration may be given to increase the Basel I risk weights, from 100% to a higher risk-weight function (say, 150 or 200%).

Another rules-based, but less interventionist solution is to provide supervisory prescribed loan-to-value (LTV) guidelines for the property sector, particularly in situations where supervisors are concerned about rapid increases in property values. At the Bank of Thailand, for instance, maximum LTV ratios for the high-end residential real estate market have been in place since December 2003.

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