Are Banks' Internal Risk Parameters Consistent? Evidence from Syndicated Loans

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This study examines consistency in the estimates of probability of default (PD) and loss given default (LGD) that nine large U.S. banks assign to syndicated loans for regulatory capital purposes. Using internal bank data on loans that had PDs and LGDs assigned by more than one bank, we find substantial dispersion in these parameters. Banks differ substantially in PDs, but only a few set PDs systematically higher or lower than the median bank. However, many banks differ from the median bank systematically in LGDs, and these differences affect their Basel II minimum regulatory capital significantly. The differences in LGDs imply that, for an identical loan portfolio, the bank that sets the highest LGDs would have Basel II minimum regulatory capital twice as large as the bank that sets the lowest LGDs. We argue that these differences in risk parameters across banks can be at least partially explained by bank behavior that complies with the Basel rules. We also find a negative relation between banks' LGDs and their shares in loan syndicates, suggesting that differences in risk parameters have implications beyond bank capital.

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