

**The Research Centre of the Faculty of Economics**

cordially invites you to a research seminar  
on Wednesday, 3<sup>rd</sup> December 2014 at 12 p.m. in room P-109 at the  
**Faculty of Economics, University of Ljubljana**

Author: **Igor Masten, PhD, Associate Professor, Faculty of Economics,  
University of Ljubljana and Bank of Slovenia**

Coauthor: **Arjana Brezigar-Masten, Faculty of Mathematics, Natural  
Sciences and Information Technology, University of Primorska**

Coauthor: **Matjaž Volk, Bank of Slovenia**

will present the article:

**"Discretionary Credit Rating and Bank Stability During a  
Financial Crisis"**

“In this paper we study the incentives for discretionary credit risk assessment under current banking regulation. We use the Slovenian data on credit ratings assigned by banks to their clients and study their reliability as predictors of corporate default to test whether banks in financial distress systematically underestimate credit risk. Our results show that predictive accuracy of credit ratings deteriorated during the Great recession both in absolute terms and relative to the benchmark econometric model that uses only public available data. Moreover, we show that predictive accuracy was lowest for domestically owned banks and, within this group, for small banks. We argue that these banks had the largest incentives to under-value risk because their portfolios were more exposed to non-performing loans and had limited possibilities to raise additional capital. Given that credit ratings are closely related to the rates of loan-loss provisions, our analysis indicates that under-estimation of credit risk served to inflate banks' books. These findings can also rationalise the results of the comprehensive review of the Slovenian banking system in 2013, which revealed significant capital shortfalls on average, but also significant differences in capital shortfalls across groups of banks with different incentives to underestimate risk. A number of robustness checks confirm the validity of our conclusions. Our findings provide a plausible explanation of similar findings of the comprehensive review in the Euro area prior to the launch of the Single Supervisory Mechanism in late 2014.”

You can register for the free seminar by phone (01) 58-92-490, or via e-mail:  
[research.seminars@ef.uni-lj.si](mailto:research.seminars@ef.uni-lj.si) by Tuesday, 2<sup>nd</sup> December 2014.

**We look forward to seeing you!**