No choice but to wait and see

Executive summary

- The banking industry has faced unprecedented change in the last few years with increased consumer action, new technology and an ever competitive marketplace. This, coupled with the relentless pace of regulatory and accounting changes in the UK, has left the sector exhausted. Basel II is one such change which has involved a major investment on the part of those institutions required to adopt it. The impact will be felt far wider as credit models used to assess the creditworthiness of obligors have been developed for the corporate and retail sectors alike. This article seeks to establish what those impacts might be.

Arguably, the foundations of the regulation of banking capital can be traced back to the US savings and loan crisis of the 1980s when more than 1,000 institutions failed. The costs of the crisis have been put at $150bn, of which $125bn is estimated to have been funded by the US government.

Depositor confidence is vital if banks are to do their job of financing economic activity. A cushion of capital, which serves to soak up losses that arise in the normal course of business, protects the depositor and passes the cost of insurance into the financial markets. In view of the cost of capital, however, market forces alone may not be sufficient to ensure adequate capitalisation, so to a degree banking regulation serves to attempt to bridge the gap between market demand and the need for depositor protection.

BASEL II: 2007 TO WHEN? The original Basel accord[1] in 1988 was the first time that banking capital became a regulated activity. The main criticism of the first accord was that it paid little attention to the true economic risk of a financial exposure. For example, the amount of capital that a bank was required to hold for any £100m loan to a corporate would be £8m, irrespective of the credit rating of the company concerned. Clearly, this had implications among the banking community for key performance indicators such as return on equity.

Not only did the new Basel accord[2] seek to address capital 'arbitrage' opportunities such as this, but it also sought to recognise that a) banks faced risks other than credit risk and market risk, and b) that risk management techniques had become increasingly sophisticated over the previous decade and a half. Such progress warranted recognition in the amount of regulatory capital banks should hold.

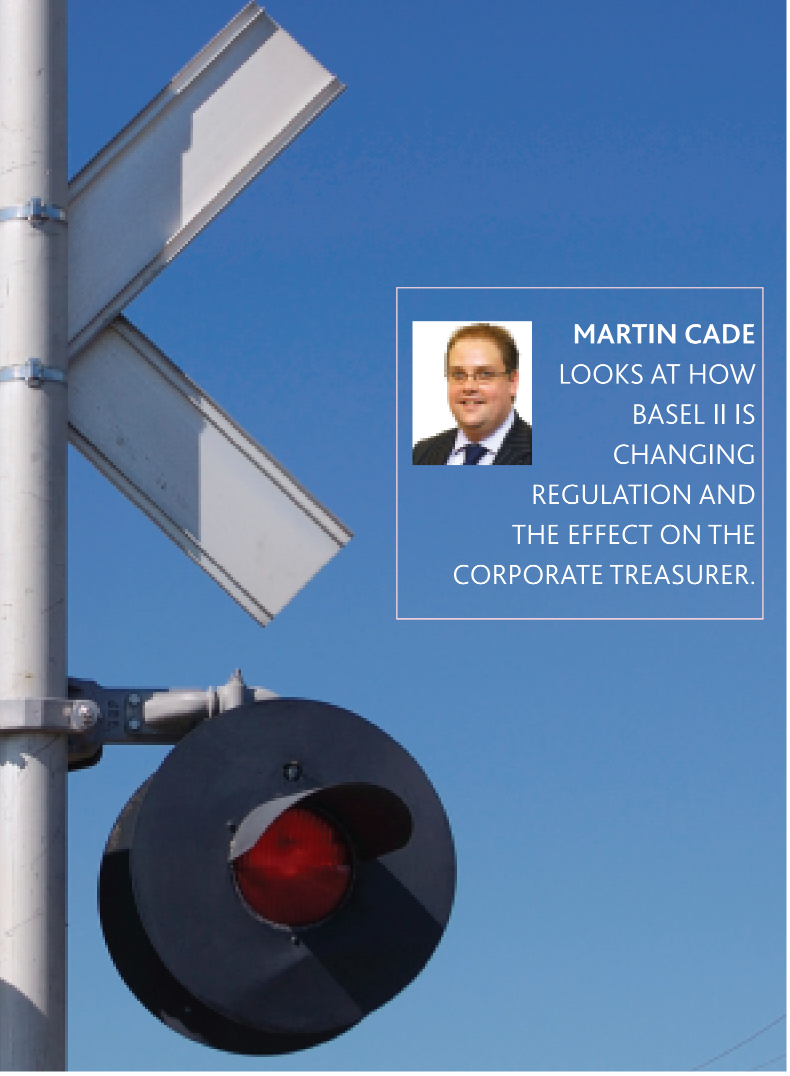
Basel II now forms part of EU law in the shape of the Capital Requirements Directive and has been passed into UK law in the form of the Financial Services Authority's (FSA) handbook, the General Prudential Sourcebook (GENPRU) and the Prudential sourcebook for Banks, Building Societies and Investment Firms (BIPRU).

Affectionately termed the three pillars, the broader approach that has been adopted for capital adequacy requirements and the key issues with which banks have to grapple with in respect of lending decisions include:

- The ability of financial firms to use their own credit models to calculate expected credit loss on an exposure and hence the capital requirement to cover unexpected losses. In order to do this, a firm must submit an internal ratings-based waiver application. The FSA is empowered to reject these applications if the models do not meet minimum standards;
- The recognition of operational loss as a risk class in its own right;
- The responsibility of firms to identify and, if necessary, calculate a capital requirement for any other risks that it faces via the internal capital adequacy assessment process under Pillar 2; and
- The requirement to disclose information about risk management practices and capital adequacy under Pillar 3.

THE IMPACT OF BASEL II ON BANKS In 2006 the FSA issued its consultation paper, *CP06/3: Strengthening Capital Standards*, part of which included a study on the impact of the Capital Requirements Directive. It was estimated that Basel II would give rise to a 15% (or £23.8bn) reduction in the UK in the regulatory capital requirement, which would translate to an estimated 3bp reduction in the weighted average cost of capital (WACC) and the overall cost of compliance across the industry.

However, a major assumption behind the FSA's study was that



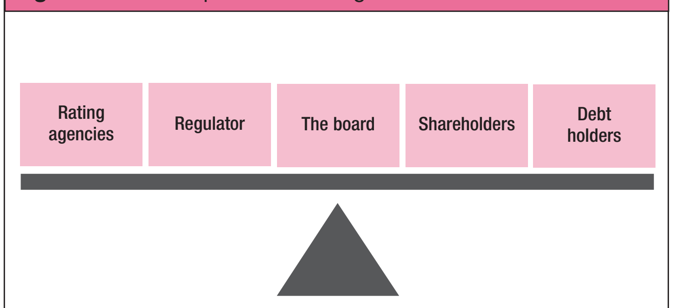
MARTIN CADE LOOKS AT HOW BASEL II IS CHANGING REGULATION AND THE EFFECT ON THE CORPORATE TREASURER.

DURING THE PERIOD TO 2010, TREASURERS SHOULD NOT EXPECT TO SEE SUBSTANTIAL REDUCTIONS IN LOAN PRICING CAUSED SOLELY BY BASEL II.

"firms will change actual capital held in response to changes in regulatory capital requirements on a one-for-one basis". Given the influence that other stakeholders have in how much capital is held by banks (see *Figure 1*) and the raft of supplementary regulation that the banking industry currently faces, it is arguable that such an assumption will not reflect reality and that compliance savings in one area will be countered by an additional compliance cost in another.

THE IMPACT OF BASEL II ON THE CORPORATE TREASURER The picture painted above is not a good one for the average corporate treasury seeking to reduce borrowing costs. During the period to 2010, while capital floors are in force regarding the permissible reductions in capital levels, treasurers should not expect to see substantial reductions in loan pricing caused solely by Basel II. Indeed, it is more likely that for a relatively worse credit risk, increases in loan pricing will start to be felt more quickly, particularly in the corporate sector. As a result one would expect to see more novel and innovative forms of financing, such as securitisation, becoming more popular as corporates seek to reassess the risk carried on their balance sheet against the need for ongoing funding.

Figure 1: The capital balancing act



One expectation is that the sophistication of pricing models used for some years by the providers of finance will continue to grow as a result of these regulatory changes by using internal estimates of probability of default, loss given default, and exposure at default. Such models for those non-market maker players will serve to provide underwriters with better information on which to base a lending/pricing decision.

Ultimately, however, the market will decide on the right price for a loan and the changes that Basel II will bring about might perhaps be less tangible. Lenders may, for example, use loan pricing increasingly as a carrot to win ancillary business and develop more comprehensive relationships with their customers. Equally, cash-rich corporates may begin to see improving returns on their deposits as a result of these changes.

If nothing else, loan pricing is set to become more transparent as a result of one of the Pillar 3[3] requirements as firms are obliged, if requested, to provide an explanation (in writing when asked) of their rating decisions to SMEs and other corporates. Administrative costs of the explanation have to be at an appropriate rate to the size of the loan.

HAS IT BEEN WORTH IT? The problem for our financial institutions is that the integration of Basel II into their businesses came at the same time as various other regulatory initiatives – the Market in Financial Instruments Directive (MiFID) and Treating Customers Fairly Directive to name but two. But few would deny that Basel II has made banks focus on risk management, understand the risks that they face and measure the risks in financial terms.

For the corporate treasurer the answer is wait and see. Few internal ratings-based waiver applications have been approved unconditionally so far, and the existence of capital floors may mean no immediate changes other than potentially for those lower-rated organisations that give rise to a higher regulatory capital requirement under the new rules. For stronger credits, it is likely that some will derive some benefit over the course of time. The extent to which this is the case perhaps depends less on the impact of Basel II itself and more on the combined effect of wider regulatory change across the sector.

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Footnotes

1 *International Convergence of Capital Measurement and Capital Standards, Basle Committee on Banking Supervision, July 1988*

2 *International Convergence of Capital Measurement and Capital Standards, A Revised Framework, Basel Committee on Banking Supervision, June 2004*

3 *See BIPRU 11.3.4 R*