# Shifting sands

## Executive summary

- The medium-term impact of Basel II is not clear. However treasurers will need to be alert to negative shifts in their funding and transaction costs that are claimed by their banks to derive from Basel II. Treasurers will need to take a view on a range of complications introduced by Basel II.

Technically speaking the provisions of the Basel II agreements have been in a transitional phase across Europe since 1 January 2007. Formally, the accord came into effect for the European Union (EU) and G10 banks on 1 January, 2008 – with the exception of the US where the introduction is delayed until 1 January 2009. (Non-EU G10 countries are Canada, Japan, Switzerland and the US.) In practice it is likely that most banks in advanced economies will have already taken steps to address their internal credit practices and may well have included Basel II in any credit offered to borrowers over the past 6-18 months. Banks in some jurisdictions have been more directly engaged with their regulators – e.g. Germany and France – whereas others, such as the US, have had to debate the impact of Basel II with domestic regulators (where larger banks remain subject to overriding US government capital standards which apply to all US banks).

**VARYING COST OF CAPITAL** Basel I meant that the capital cost attributable to a loan to a borrower was constant over the life of a loan facility and was the same for all banks. After Basel II is implemented the capital cost attributable to a loan to a borrower – and indeed all credit extended by the bank to a customer – will vary over the life of the (loan) facility as assessments of the borrower's creditworthiness change. These assessments may vary from bank to bank, depending on what modelling tool the bank uses. Broadly, banks will choose between more or less sophisticated ratings-based approaches. On a prima facie basis there would appear to be little argument with Basel II. Customers will be treated as independent borrowers albeit within a defined framework, regulators will have better understanding of the market risks (including liquidity risks) and operational risks (i.e systems failures) being run by banks and there will be more effective disclosure by banks to the wider financial markets (see *Box 1*).

### Box 1: More effective disclosure

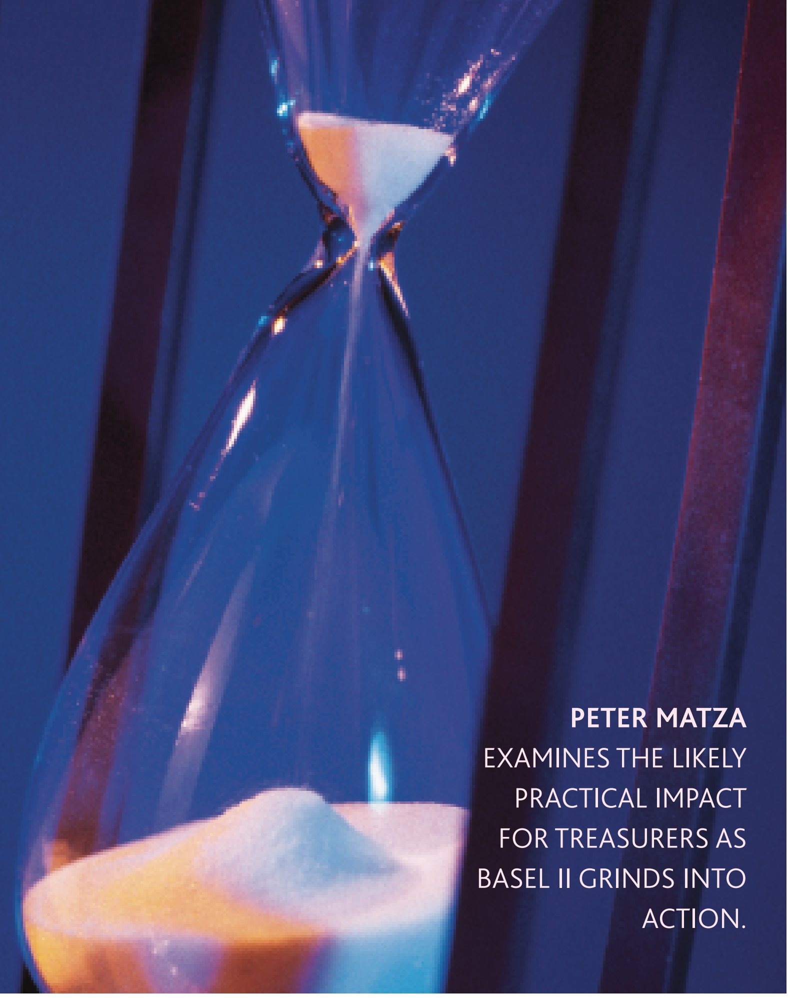
The Basel Committee's own research suggested that borrowers should benefit from material capital savings.

Customers will be treated as independent borrowers albeit within a defined framework. There will be more effective disclosure by banks of their exposure to wider financial market risks (including liquidity risks) and operational risks (such as systems failures).

**MATERIAL CAPITAL SAVINGS** Interestingly, the Basel Committee's own research suggested that at least medium to larger company borrowers should benefit from material capital savings – at least where the more sophisticated internal ratings approach is adopted by the bank. However, whilst all that may be of benefit to a number of market stakeholders (regulators, governments, shareholders perhaps), borrowers and, more especially, (non-financial) corporate treasurers may have other concerns. Treasurers will need to take a view on a range of complications of which the following is not necessarily a complete list.

- Most obviously, those companies without external ratings are at risk of being consolidated into a single "unrated" category irrespective of their particular circumstances;
- During the life of a loan facility companies may be exposed to changes in which method of ratings-style credit assessment a bank uses. There doesn't appear to be any constraint on the bank making a change as and when it likes;
- The borrower may be reliant on the mathematical accuracy of bank modelling techniques or even the bank's ability to fully resource its Basel II credit management;
- Borrowers may be faced with using an existing syndicate of banks which use different credit assessment tools; this may mean that the margins banks are prepared to lend at will differ more significantly than they do at present. Shopping around for loans may be well worth doing;
- The bank may expect considerably more information from borrowers without any obvious return for the borrower;
- Borrowers dealing with local banks in a less sophisticated market may face variable standards of credit analysis and application of even the simplest, external ratings based approach with the added complication of sovereign ceilings.

**GAINING PERSPECTIVE** The ACT has been in contact with a leading international bank to obtain some perspective on Basel II and gain an insight into its approach to credit and risk management. In



**PETER MATZA** EXAMINES THE LIKELY PRACTICAL IMPACT FOR TREASURERS AS BASEL II GRINDS INTO ACTION.

summary its position is as follows.

- Most major [EU/G10] banks have been working on Basel II for several years but there is no consistent approach either between banks, or on the application to borrowers/credit users;
- Major banks will focus on an overall return from their credit provision but there will be opportunities for "loss leaders";
- There may be a squeeze on mid-size banks, caught between those with the scale and resources to manage Basel II and those (mostly local) banks which will use more simplistic credit assessment allied to local knowledge;
- Banks will be expecting much closer dialogue with their leading borrowers. This may raise concerns for treasurers with respect to confidentiality especially in the markets for secondary loans and loan CDS (loan credit default swaps).

**BE CRITICALLY AWARE** The question remains however, what is the likely impact on treasurers? The current suggestion that most major banks are already including Basel II charges in loan margins may well be true but the ACT has not found statements from banks committing to this practice on a continuing basis. The ACT's view is that treasurers should be critically aware of the potential impact of Basel II – not solely in loan margins – and, more specifically, should keep a close watch on other costs that banks claim as arising from its formal introduction. Whilst not exhaustive, the ACT considers the following as particularly relevant.

- Basel II may well create situations where a bank's credit models disadvantage a borrower because of its industry sector, geographic location or sovereign risks (e.g. transfer risks) – i.e. circumstances beyond a particular company's control;
- Uncertainty over how the different credit assessment techniques will impact on securitisation will mean that companies that use this avenue of funding will need to closely liaise with their banks to understand any capital cost impact. Last summer's extreme difficulties in the US and UK mortgage-related asset-backed commercial paper (ABCP) markets may make this position more difficult;
- Companies should carefully review existing and/or proposed loan documentation in relation to the clauses referring to increases in margins and/or costs during the life of a loan. The ACT offers a summary for investment grade borrowers of the impact of Basel II on syndicated loan facilities, and some suggestions for negotiation of the Loan Market Association Documentation provisions[1];
- In circumstances where documentation allows for changes in margins, or where the bank asks for changes without documentary support, treasurers should ensure they are comfortable with the banks' credit assessment. Banks making more than 20% return on capital employed (ROCE) may have to develop better; salesmanship to industrial companies making 10-12% ROCE! It is reasonable, in our view, to expect this transparency to be bilateral!
- Treasurers will need to consider their practice of relationship banking. Banks will increasingly be asking their customers for more income generating business; our position would be that, in return, treasurers are entitled to ask their bankers to explain the returns they make from their relationships. Basel II will see the end of the free/cheap 364 day facilities as credit cost has now been mostly divorced from credit tenor;(see Box 2);
- Lower assessed credits may need to become more selective in their choice of banks – they may be better off remaining unrated and borrowing from banks that use the (less complex) foundation ratings based approach;
- On a practical level, treasurers may well be asked for increased collateral by their banks to address newly assessed, negative credit perceptions. Whether this takes the form of cash deposits or physical security, treasurers must be careful that their business is not overly constrained. More documentary provision may be required – adding cost and complexity to treasury operations.

**MEDIUM-TERM IMPACT UNCLEAR** The medium-term impact of Basel II is not clear. However treasurers will need to be alert to negative shifts in their funding and transaction costs that are claimed by their banks to derive from Basel II. Treasurers should not hesitate to challenge their banks to fully explain such shifts. National treasury associations can play their part by collating and circulating generic examples of bank practice that disadvantage corporate treasurers.

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There will be further discussion on the impact of Basel II at The ACT's Corporate Funding Conference, *Setting a funding strategy in today's environment*, on Wednesday 30 January 2008.

[1] *www.treasurers.org/technical/lmaguide.cfm*

**Box 2:** How banks will manage their positions

Banks will manage their positions in Basel II with a variety of approaches to individual company and industry sector credit assessment.

Corporate treasurers will need to re-think their relationship management process.

Basel II is mostly a regulatory process, not necessarily developed for the benefit of corporate credit users.