THE NEW BASEL CAPITAL ACCORD WILL MAKE MAJOR CHANGES TO BANKS' REGULATORY CAPITAL REQUIREMENTS, AND WILL HAVE MANY PRACTICAL IMPLICATIONS FOR CORPORATE TREASURERS WHEN BORROWING FUNDS, SAYS **TOLEK PETCH** OF SLAUGHTER & MAY.

CAPITALISING ON BASEL II

All banks are required to hold capital which varies in accordance with their business. Since 1988, when the original Basel Capital Accord was agreed, there has been broad convergence in most countries, with the Basel standards being adopted in over 100 countries.

But despite its past success, the Basel methodology is now considered by many as out-of-date, and no longer capable of accurately capturing the risks involved in bank lending. This has resulted in proposals to replace the 1988 Accord with a new set of rules that reflect the nature and risks of banks' business, and provide incentives for institutions to improve their measurement and control of risk. The final version of the new Accord will be published this month, with the target date for implementation set at 1 January 2007.

The new Accord provides a number of ways of calculating capital with, generally, a trade-off between simpler methodologies, that lead to higher capital charges, and more sophisticated approaches, that are more accurate and result in lower capital requirements.

Provided that they have the data, systems and controls required, banks will be able to choose between the 'standardised approach' (which is an updated version of the 1988 Accord) and a models-based approach based on their own internal assessments of risk (the internal-ratings or IRB approach). The capital charge under IRB will be lower than for the standardised approach, providing an incentive for banks to move to the more sophisticated method.

PRACTICAL IMPLICATIONS FOR BANKS. The capital cost of a loan for a bank will vary with the credit rating of that borrower. For banks that are on the standardised approach, the risk weight for corporate loans will range from 20%, for the highest rated borrowers to 150% for borrowers that are non-investment grade (below BB-). This compares with a risk weighting, under the existing Capital Accord, of 100% for all loans to corporates. The capital cost for loans to high-quality borrowers will thus fall. Conversely, loans to non-investment grade borrowers will become more expensive.

Unrated borrowers will be risk weighted at 100%. Although it may seem strange that unrated borrowers will attract a lower risk weighting than borrowers with a poor credit rating, this reflects the fact that relatively few corporate borrowers in Continental Europe have an external rating.

Banks that apply an internal model to determine their capital requirements, meanwhile, will rely on their own internal assessments of the probability that the borrower will default.

Another major change is that the capital cost of a loan will also no longer be fixed at the time that the loan is originated. Instead, it will vary with the credit rating of the borrower over the life of the loan. For banks on the standardised approach, this will depend on changes in the external credit rating. IRB banks will again apply their own internal assessment. As credit ratings vary during the economic cycle, the capital cost of loans will go up in times of economic downturn, thus possibly increasing the risk of a 'credit crunch' in recessions.

A wider range of collateral will also now be recognised for capital relief, including, for banks that apply internal ratings, commercial and residential real estate. This may encourage banks to use a wider spectrum of collateral.

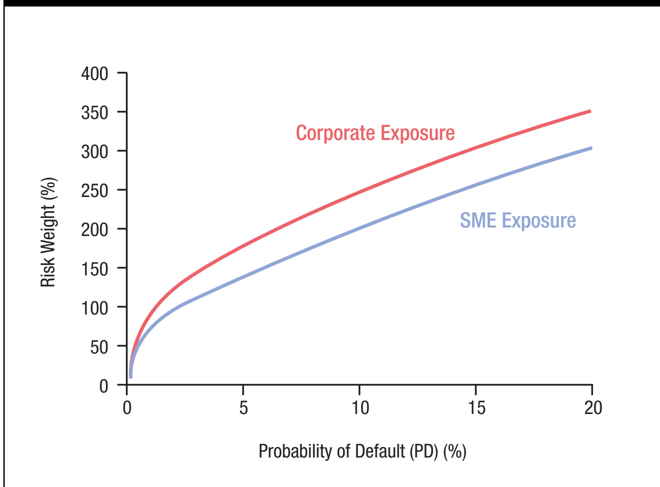
Guarantees (and credit derivatives) will also be granted greater recognition, as will parental guarantees, providing that the parent company is rated A- or above.

Impact of Basel II

The main changes made by the new Basel Capital Accord for banks are:

- the use of external credit ratings under the standardised approach;
- the ability for banks with more advanced systems to apply their own internal models;
- greater recognition of credit risk mitigation techniques (collateral, guarantees, netting);
- a new capital charge for operational risk;
- new requirements for banks involved in securitisations; and
- extensive market disclosure.

Illustrative IRB Risk Weights – Corporate Exposures



The capital cost of certain types of borrowing will rise to reflect the greater level of overall risk. For banks on the standardised approach, this will include private equity and venture capital. For banks on the IRB approach, there will be higher capital charges for designated classes of 'specialised lending.' This includes project finance, object finance (such as the acquisition of a ship or aircraft) and certain commercial real estate.

The capital cost of retail lending will fall. For banks on the standardised approach, the capital cost of retail lending will fall by 25% and the cost of retail mortgages by 20%. It is expected that IRB banks with a significant exposure to retail lending will see even greater reductions.

Finally, the new capital charge for operational risk will have an uneven effect on banks with those that follow the universal banking model, and those with significant investment firms and asset management arms, seeing a substantial increase in their required capital. The reverse applies for retail banks.

IMPACT ON BORROWERS. But just how will these changes impact corporate borrowers? In the fist instance, as the capital cost of a loan will vary from borrower to borrower, this may be reflected in

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loan pricing. Of course, the capital cost is only one of several factors that banks take into account when fixing the margin over the cost of funds, but a direct capital cost could affect pricing. Further, classes of lending that attract higher capital charges (e.g. venture capital, project finance) may also become less attractive. Equally, the significant reductions in the level of capital required for retail lending may result in a shift away from corporate to retail lending. Borrowers – especially those at the lower end of the credit spectrum – may see a shift in the balance between the costs of debt and equity financing.

A further question is whether or not banks will seek to pass on the cost of additional capital charges through an increase in margins. If they do, this is likely to be through a ratings ratchet. Borrowers are likely to resist calculations based on a bank's internal assessment owing to the lack of transparency. This problem would be even greater with a syndicate of lenders, where the capital cost is likely to vary from bank to bank in the syndicate. Borrowers are likely to oppose any attempt to pass on such bank-specific additional costs, or to pay different margins to different banks in a syndicate.

DOCUMENTATION. At present, a wide range of documentation is used in the market and Basel II is unlikely to impact this. Although the New Accord contains a 'reference definition of default' which banks are required to use when determining, for capital purposes, whether a loan is performing, this is not intended to affect banks' legal obligations. Most loan agreements will contain events of default that will be triggered well before the bank is required to treat the loan as defaulted. In other areas, such as guarantees, credit derivatives and securitisation, there will be more significant changes.

An important issue for borrowers currently entering into loan documentation that will still be in place after 2006 is whether Basel II should be addressed. Currently, the 'increased costs' clause in most loan documentation will allow a bank to pass on any additional costs incurred as a result of the introduction of the new Accord. As a general matter, this is reasonable as the bank must account for the current cost of capital when calculating the margin.

However, borrowers may want to see additional costs, resulting from the way in which the bank conducts its own business, eliminated. For example, should a borrower be required to pay an additional margin because a bank has a significant operational risk capital charge due to its asset management business, or a poor historical control of operational risk? If a bank adopts an internal models-based approach the capital charge for non-investment grade loans will be significantly greater than if on the standardised approach. Should the borrower be liable to pay for this additional cost?

Ultimately, in the absence of any consensus, it will come down to a process of negotiation between the parties involved.

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