BASEL II: THE NEW ACCORD

CHRISTOPHER KARAOLIS OF TAVAR EXPLAINS HOW THE NEW ACCORD WILL EFFECT CREDIT RISK ASSESSMENT AND THE IMPACT IT WILL HAVE ON THE WAY WE DO BUSINESS.

We all know it is coming, but how will this simple formula affect the banks' perception of corporate credit risk and, in turn, how should companies view banks? In this article, we will examine and assess some of the possible impacts the Basel II Accord (the new Accord) will have on the way companies undertake business with banks. We will also look at a number of the proposed changes to credit risk management in the areas of risk weighting, capital adequacy and credit risk mitigation (CRM).

THE ACCORD FRAMEWORK. Under the July 1988 Capital Accord (the Accord) banks are required to adopt the approach of applying a consistent risk weighting factor of 100% for all corporate credits – a 'one size fits all' approach. This approach does not take into consideration any differentiation between the various risk classes. Further shortcomings are that it does not consider maturity sensitivity; it only allows limited relief in terms of offsetting collateral for capital weighting purposes and generally does not reflect the underlying economical capital requirements.

The Basel Committee for Banking Supervision recognises and accepts that the current risk weightings for the allocation of capital does not fully reflect the underlying levels of risk being undertaken by the banks. The Basel Committee is now encouraging banks to more accurately reflect the capital requirements as well as actively manage the credit risks contained within their portfolios. This concern has been heightened during the economic downturn, as it has led to some banks extending credit to lower rated companies in search of greater returns, which under normal market conditions they may not have previously undertaken.

Having recognised the limitations of the Accord's adoption of a 'one- size-fits-all' approach, the Basel Committee has proposed the adoption of a more risk-sensitive and balanced portfolio framework for the calculation of capital risk weighting and risk management. It is also intended to bring the current regulatory capital requirement more in line with the economical capital allocation approach adopted by banks.

Under the new Accord, banks will be able to choose from two broad methodologies for calculating their capital risk weighting.

Capital requirement

(K) = LGD x N [(1 - R)^-0.5 x G (PD) + (R / (1 - R))^0.5 x G (0.999)] x (1 - 1.5 x b(PD))^ -1 x (1 + (M - 2.5) x b (PD))

TABLE 1

RATING AND RISK WEIGHTING.

Credit Rate	AAA to AA-	A+ to A-	BBB+ to BB-	Below BB-	Not Rated
Risk Weight	20%	50%	100%	150%	100%

These two methods are categorised as:

- the standardised approach; and
- the internal rating based (IRB) approach, which is further subdivided into: the foundation method; and the advance method.

Under the standardised approach, risk weights for companies needs to be referenced to an externally assigned rating obtained from a credit assessment institution, such as a credit rating agency, and then allocated a credit risk weighting on the following basis (see *Table 1*).

Under the IRB approach, banks will be allowed to use their own internal estimates to determine the borrower's creditworthiness to assess the credit risk. This approach adopts a detailed analytical framework based on a number of factors to calculate risk weightings using either the foundation or advance methodologies. The more commonly used factors are probability of default (PD), exposure at default (EAD), loss given default (LGD) and for maturity (M). Banks adopting the IRB foundation method will be allowed to estimate the PD for each borrower and the supervisors will then supply the other inputs.

Whereas banks which adopt the IRB advance methodology will themselves supply all the necessary data inputs, the IRB advanced methodology will only be permitted to be used by banks which can clearly demonstrate to supervisors that they have a sufficiently developed internal capital allocation process.

One of the regulator's key goals under the new Accord is to ensure that a bank's overall regulatory capital requirements should not greatly change one way or another. However, the regulators are keen to encourage banks to adopt the IRB approach, moving away from the standardised methodology, as it is felt that this will provide banks with the ability to actually reduce their risk-based capital requirements.

Figure 1 summarises the various risk weightings by comparing the current Accord with those of the proposed standardised and IRB methodologies for a hypothetical corporate having a LGD of 25%.

COST OF DOING BUSINESS. One of the key factors used by banks to determine the pricing of a product or a transaction is to assess how much capital it requires.

While the new Accord is likely to help banks reduce their capital requirements for the higher rated companies, it is conceivable that we may not see a reduction in the actual pricing of transactions to the corporate. Some banks may claim that this is already a highly competitive market and that any reduction in the price of doing business may be minimal or has already been factored in.

Alternatively, banks may argue that they have been getting better at using pricing models to ensure a risk-based return. When the return for a given name is below the levels suggested by the secondary bond or credit derivatives market, additional capital friendly collateral business, such as foreign exchange and derivatives and the like, is demanded to enhance the return to the level suggested in the secondary market. In summary, pricing is driven by the need for a risk-based return on capital which is broadly consistent with that available in the secondary market.

As Chris Vermont, Head of Project and Structured Finance at ANZ Investment Bank, recently stated: "Basel II will affect some banks' corporate lending more than others. Those driven by systems based on economic capital are likely to see only minor changes. Those that have not yet graduated from using regulatory capital as the main driver are in for a shock."

For the lesser-rated company the picture will not be the same and they may well see an increase in the cost of transactions in order to account for the increased capital requirement.

Companies rated in the region of BBB+ to BB- may see no effect on pricing, whereas those rated better or worse could see some impact on their cost of doing business.

DIFFERENT BREEDS OF BANKS. It is generally felt by the Basel Committee that under the new Accord capital requirements will increase for those banks that hold high risk assets. Whereas, in comparison with those with low risk assets, a balanced portfolio and effective risk management controls and systems will see a decrease in their capital requirements.

One of the side effects of this will be the development of different breeds of banks. Those that have the capability and resources to develop their own capital allocation process qualifying for adopting the IRB approach, and those which have limited resources and have to adopt the standard approach. The result of this being reflected in their ability, or inability, to competitively price transactions on a level playing field.

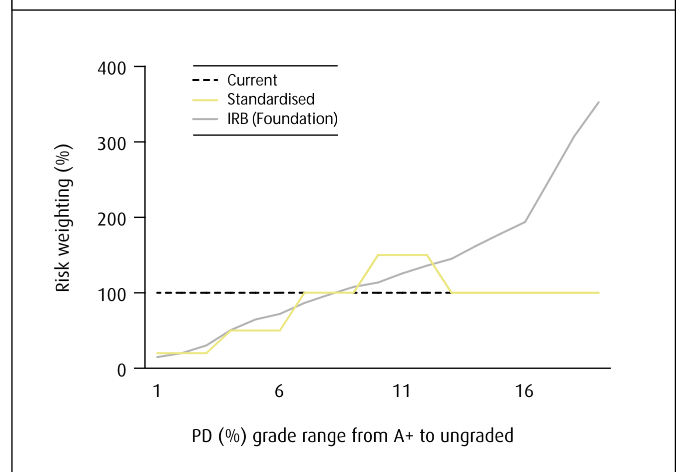
Another scenario may well be that larger banks that operate the IRB approach will be forced to reduce their exposure to the lower rated corporates during the bottom of an economic cycle because of the heightened level of capital required. This would not necessarily be the case for banks adopting the standard approach.

As an alternative, banks may choose to specialise in extending credit to specific areas in which they feel they have the expertise, experience, historical data and so on to meet the demands of the new Accord and the supervisors.

This could well necessitate a degree of housekeeping of the banks books and removal of certain types of credit which would no longer be considered core to their business.

REGULATORY ARBITRAGE. With the introduction of the different methodologies for calculating credit risk it could be argued that there are arbitrage opportunities available to the company, or at least the ability to shop around. If we take the example of a company rated BB-, or even unrated under the standardised approach, the risk weighting applied to the bank would be 150% or 100%, whereas, under the IRB approach, in extreme cases it can be as high as 625%. This could provide an incentive to the lower rated companies to move between banks, in an attempt to find

FIGURE 1
COMPARISON OF CORPORATE RISK WEIGHTINGS.



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institutions that are using the standard approach and therefore provide finer pricing.

CREDIT RISK MITIGATION. CRM is another area in which the new Accord has been enhanced. Under the terms of the Accord, only a limited number of products falling within a strict band of criteria can

be used to reduce the risk weight of the underlying credit exposure. The new Accord now takes into account a much wider effect of risk mitigation through the use of guarantees, credit derivatives, netting agreements and collateral, including cash, bonds rated above a minimum level, certain equities and gold.

Well, that's the good news anyway. The bad news is that the recognition of the wider range of CRM techniques are subject to meeting minimum legal requirements and the banks' ability to demonstrate a robust risk management process. In essence, the enhanced effects of adopting CRM techniques will have minimal impact for banks which operate under the standardised and IRB foundation methodologies. Whereas those adopting the IRB advance method will expect to see some regulatory capital relief being gained as a result of the introduction of the new Accord CRM rules.

CURRENT TIMETABLE. The current time frame for the implementation of the new Accord is 2006. Part of the rationale for the lengthy implementation is to allow sufficient time for banks to build a database and profile of their clients and portfolios. This data will then be used to feed various models that will allow banks to measure not only the regulatory capital required but also to indicate the level of economic capital. In turn, this will drive banks to enhance their risk management capabilities, using both on-balance sheet and off-balance sheet techniques and products, to adopt new approaches to lending, as well as enhancing risk mitigation techniques.

OPPORTUNITIES FOR TREASURERS. It is generally accepted that the biggest failing of the original Accord approach to 'one size fits all' was its lack of flexibility and sophistication to more accurately measure the quality of the credit risk.

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While the new Accord goes a long way in rectifying these shortfalls, as can be seen, it also introduces a new range of anomalies, not currently present in the original Accord.

It is suggested that treasurers should now use the new Accord changes as a negotiation tool and as an opportunity to align their business with the banks that best fit their activities. Maybe they should even consider adopting a similar approach to looking at how they view their own clients.

Finally, Brian Ford of BV Risk Advisors Ltd, sums the situation up. He said: "Corporate treasurers need to mimic this new approach to credit risk, not just to become a better judge of their bankers but also of their trade customers. 'You are whom you deal with' applies to anybody who wants to avoid the falling dominoes effect of an Enron or Worldcom situation."

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