# Into the unknown

As treasurers continue to try to get to grips with issues such as Sarbanes-Oxley and international financial reporting standards, another regulatory shift is on the cards and it is just around the corner. Basel II, the new accord, is due to be implemented in the UK from January 2007 and treasurers need to start assessing its likely impact.

The original Basel accord, established in 1988, has long been considered outdated and in need of a serious overhaul. Talks began in the late 1990s and early 2000s to devise a sophisticated accord, which involves better risk management and takes into account a wider range of issues. Rules were finalised for Basel II in 2004 and preparations for implementation have been under way since then.

Finalising the details of the new international regulations has been a long drawn-out process, which has been understandably difficult to follow for those not intimately concerned with all the adjustments. Naturally, it has not been at the forefront of treasurers' minds nor their top priority, but the ACT's Technical Officer Martin O'Donovan argues that although no one is certain of what the full impact of the new accord will be until 2007, treasurers should be turning their focus to how their company and department may be affected.

O'Donovan says: "For a while now everyone has found Basel II coming up in conversation and in headlines and has thought it is too early to be thinking about it and understanding it. Actually the time has come now."

Although the new rules are not currently in force, loan agreements signed recently and during the rest of 2006 will certainly be affected by the new rules.

O'Donovan says: "Current deal pricing should reflect the effects of Basel II since future drawings under a deal being signed now will come under the new regime. For example, bearing in mind the new rules, a treasurer may want to build into a loan something that deals with credit rating changes and how this affects the margin."

**THE FUNDAMENTALS** So what exactly is Basel II and why should treasurers be paying more attention to it?

The new accord is designed to deal with some pitfalls of the original agreement. Basel I was set up to deal with capital adequacy issues, attempting to ensure that banks retained enough capital to guard against unexpected losses. The original accord was criticised for not being sufficiently risk-sensitive. For example, it adopts the same risk weighting for lending to any corporate, irrespective of rating.

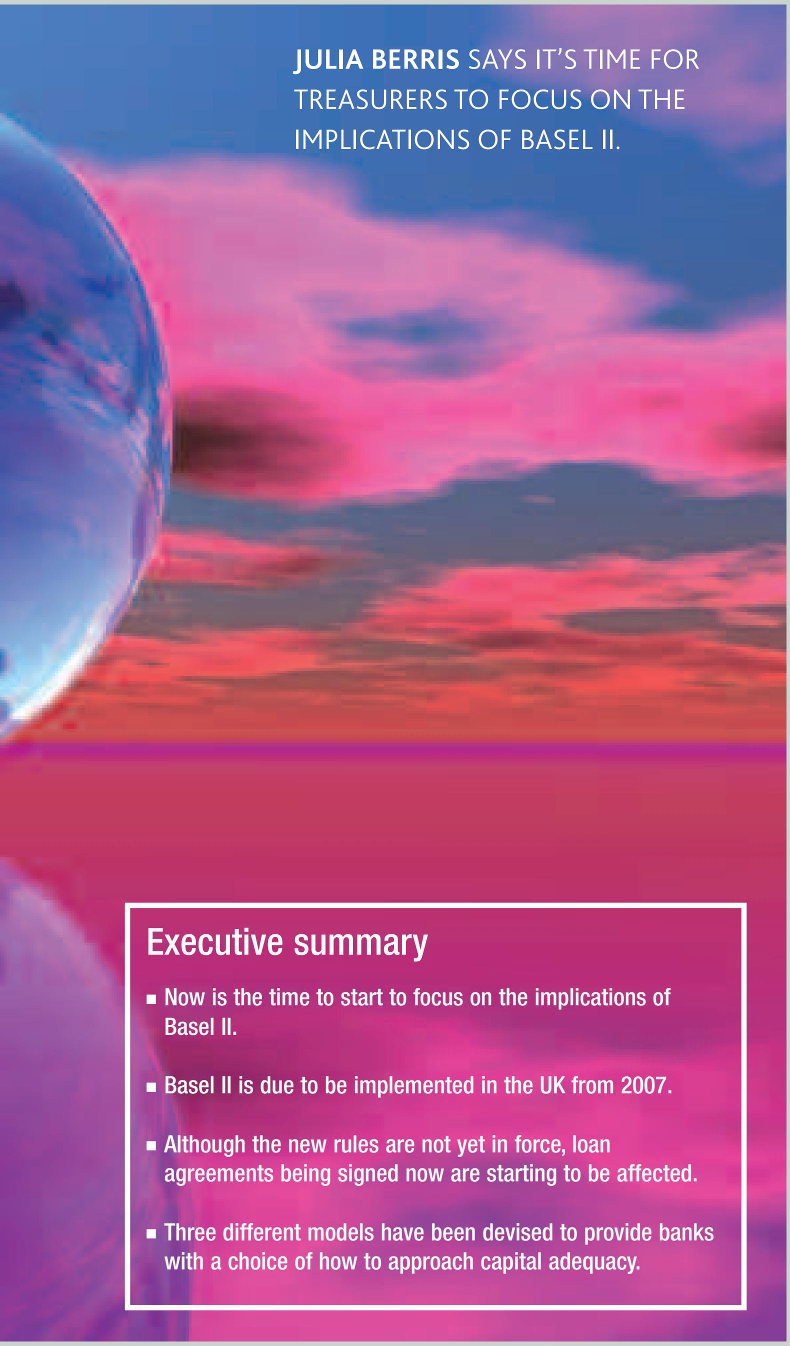
The Basel Committee also wanted to include and keep separate operational risk from credit risk while attempting to deal with regulatory arbitrage which the old accord could not minimise as it was.

**DIFFERENT RISK WEIGHTING STRUCTURE** The new rules have a different risk weighting structure, which is designed to be more sophisticated and match up capital with risk.

Three different models have been devised to provide banks with a choice of how to approach the issue of capital adequacy: the standardised approach, the foundation internal ratings-based approach and the advanced internal ratings-based approach. If the more advanced model is adopted and more sophisticated methods used, then more information will be needed for inclusion in the calculation by the bank.

Under the standardised model, the risk weighting for corporates varies from 20% to 150%, depending on the rating (see *Table 1*). Undrawn 364-day facilities which were zero-weighted become 20% across all ratings.

One of the internal ratings-based models can be adopted by banks with a strong method of calculating risk internally. Banks will then adopt many sophisticated methods to be able to do this.



**JULIA BERRIS** SAYS IT'S TIME FOR TREASURERS TO FOCUS ON THE IMPLICATIONS OF BASEL II.

"YOU SHOULD BE LOOKING AT THE LOAN AGREEMENTS YOU CURRENTLY HAVE. DO THEY LEAVE ROOM FOR THE BANKS TO LOAD YOU WITH COSTS AFTER THE NEW RULES ARE IMPLEMENTED? IF THEY DO, YOU EITHER WANT TO START NEGOTIATING TO CHANGE THE CLAUSE OR TEAR UP THE WHOLE THING AND START AGAIN."

## Executive summary

- Now is the time to start to focus on the implications of Basel II.
- Basel II is due to be implemented in the UK from 2007.
- Although the new rules are not yet in force, loan agreements being signed now are starting to be affected.
- Three different models have been devised to provide banks with a choice of how to approach capital adequacy.

Instead of tarring every company with the same brush and putting every borrower in the same risk basket, the new rules give more due consideration to credit rating.

It sounds fair enough, but what problems could this present to corporate treasury? Fluctuation of credit rating will change the cost of a loan, which will no longer be fixed, so the margin will change as a company's rating changes. Banks may well introduce margin ratchets so that borrowing costs increase if a company's rating falls. From a risk management perspective this is not good news. Failing companies will have to pay extra interest, thus compounding their problems.

**MORE ACCURATE VALUATIONS** It could be argued that this is just a part of adopting a more suitable model that is fairer across the board. Analysts have commented that forcing banks to disclose publicly more information about their risk profiles and processes will help investors and ratings agencies to price shares and debt more accurately and be more open about the risk of bank default. Investors and agencies will therefore encourage banks to improve their risk management processes.

Another important new element to the accord is the inclusion of operational risk. After implementation, banks will be required to employ an executive responsible for operational risk who will not be part of the audit function and not restricted by any conflict of interest between business and operational risk.

Banks will have to set aside capital for operational risk, ensuring that it is a key part of bank processes – something that the original accord did not address.

Once each bank selects a risk-weighting model and those using an internal ratings-based model establish exactly how they will calculate risk, borrowers may find their relationships with banks are altered.

**INTO A DIFFERENT CATEGORY** O'Donovan says: "If you as a borrower can get yourself into a basket with a lower risk weighting, you will pay less margin. It could get very interesting. For example, if I as a borrower go to one bank and the bank's particular model calculates that I am a fantastic risk while another bank's model produces something totally different, I am in a strong position in terms of choice. The borrower may find a difference in costs between banks and it may be worth shopping around a bit to find the best deal."

**CHANGING BANK RELATIONSHIPS** Typically, many corporate treasurers feel they benefit from developing a strong relationship with a bank. After implementation of Basel II this attitude may not be so prevalent. If considering more banks instead of sticking to the old favourites leads to a lower cost of borrowing, branching out could be a good option.

**Table 1.** Higher Risk Weighting Assessment

| | | | | | |
|---|---|---|---|---|---|
| **Credit assessment** | AAA to AA- | A+ to A- | BBB+ to BB- | Below BB- | Unrated |
| **Risk weights** | 20% | 50% | 100% | 150% | 100% |

## BASEL II RISK MEASUREMENT MODELS

**Standardised Approach** Banks using this approach will use ratings agencies for the measurement of credit risk. This is a relatively simple update to the original accord and does not require complicated and more sophisticated models.

**IRB Approaches** Banks will be able to develop their own internal systems to calculate risk. The adoption of either foundation or advanced internal ratings-based (IRB) methods will depend on their risk management capabilities and will be subject to approval by the relevant supervisor, based on standards set by the Basel Committee.

## BASEL II TIMELINE

**1988** Basel Committee, consisting of the central banks of 13 of the world's biggest banking countries, established Basel I, or the International Agreement on Capital Adequacy. Implementation of Basel I was then done in each country, either by enactment or, as in the UK, through a government agency.

**1996** Basel I was updated to include the impact of market risk and to clarify and extend the first accord.

**1998** Discussions and ideas of how to update the original accord began. The aim was to make Basel II (officially named the International Convergence of Capital Measurement and Capital Standards: A Revised Version) more risk-sensitive.

**2004** After two consultative papers and the release of many other studies, the final version of Basel II was set.

Since then banks across the world have attempted to organise and arrange a realistic implementation date. While the US has put back its date of implementation to the beginning of 2009, the UK is scheduled to kick off with the new accord at the beginning of 2007, with a transitional process ending at the end of that year. Companies in the UK go live with IRB approaches in 2008.

O'Donovan says: "In the end people will still borrow money and, taken as a whole, they will still pay roughly the same rates. But in order to squeeze the best out of what they do borrow, the whole issue of bank relationships and who you deal with is going to change."

There is, however, another school of thought, which says that shopping around to get the best risk weighting is not an easy task and may simply not be worth the hassle.

Those banks adopting the foundation and advanced internal ratings-based approaches will clearly be required to use detailed analysis to produce the risk weighting for the borrower.

If the banks have to do extra analysis in order to put the borrower in a certain category, they are going to want a lot more information from companies so they can undertake a more rigorous credit assessment.

Because of this borrowers may simply not have the time or the inclination to provide vast amounts of information just for the possibility of getting a slightly better interest rate.

O'Donovan says: "They have always had to do an assessment to make sure they aren't junk bond status, but I suspect at the higher level they are less rigorous. So the banks might start asking more questions and requiring more information."

Choice between banks and financial instruments could clearly make very obvious changes to the way that borrowers select a bank from January 2007.

**REGULATORY SETBACKS** Implementing regulations such as Basel II is no easy task and there have already been a few setbacks. For example, in September 2005 the US announced a delay of one year in its implementation due to uncertainty about capital reduction for those banks using an internal ratings-based approach.

What impact will this have on those banks operating in countries which will already have commenced with the new regulation? The situation with US banks could mean that they become more competitive in that year window. If this happens, the relationships with certain banks which a treasurer has built up may be put to one side in favour of a US bank.

New ways of structuring deals may become even more sophisticated to provide greater advantages to the borrower. Internal calculations mean that banks may be able to develop ways to ensure the borrower's costs are low by using certain instruments in a particular way.

Some banks may also try to bring in more complicated structures. They may suggest you dress your debt up in certain ways to get better deals. The scope for adventurous and complex financing, perhaps by giving security or credit enhancements, may increase.

Implementation of Basel II has caused a lot of speculation about how it will change the way treasurers borrow and how banks treat risk. The truth is that no one knows for sure just how different things will be and whether or not there is a desperate need for concern right now.

However, it may pay off to be cautious and to think of the possibilities sooner rather later.

O'Donovan says: "If you have not done so already you should be looking at the loan agreements you currently have. Do they leave room for the banks to load you with costs after the new rules are implemented? If they do, you either want to start negotiating to change the clause or tear up the whole thing and start again."

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*The Treasurer is planning a series of articles on the implications of Basel II. If you have any comments or contributions please email us.*