Panagiotis Thomopoulos: Impact of the Basel II requirements on banks and their business customers

Introductory speech by Mr Panagiotis Thomopoulos, Deputy Governor of the Bank of Greece, to the Alumni Association of the London School of Economics, Eugenides Foundation, London, 20 April 2005.

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It is an honour for me to address such a distinguished audience and to introduce an expert on the subject , Mr Edward L. Harris, who has participated in the preparation of Basel II and who, I am sure, will make very interesting comments on the effects of Basel II on shipping.

The new, more risk sensitive framework for the calculation of banks' capital requirements, introduced by the Basel Accord and known as "Basel II", was initially intended for the internationally active banks. In Europe it will take the form of the Capital Requirements Directive and it will be implemented by all banks irrespective of size and focus as well as by investment firms. The approaching implementation of the new framework has intensified the discussion on its effects on the stability of the financial systems as a whole, on the health and the behaviour of individual banks and, last but not least, on the access of businesses to banks' financing.

Since the first draft, in 1999, arguments have appeared both against and in favor of the Accord. The former highlighted its complexity, its costly implementation as well as its technical integrity, such as the problem of procyclicality. The arguments in favor emphasized the incentives it gives for better risk management, the reduction of regulatory arbitrage opportunities and the attainment of capital requirements that better reflect the risks of the banks. After a long and heated discussion, three impact studies and revisions of the Accord, we can say that now the balance seems to have tipped towards the advocates of the Accord. Its cited shortcomings have either been addressed or by far outweighed by the favourable effects it will bring to the banks, their customers and the economy as a whole.

Effects on banks

In order to better understand Basel II effects on banks, it is worth reiterating the objectives of the Basel Committee regarding the overall level of minimum capital requirements. According to the introduction of the new Accord, issued in June 2004: "The objectives are to broadly maintain the aggregate level of minimum capital requirements, while also providing incentives to adopt the more advanced risk sensitive approaches of the revised Framework"

The new framework intends to achieve this objective through three Pillars:

The first pillar aligns the minimum capital requirements more closely to banks' actual underlying risks and allows banks, under certain preconditions, to rely on their own measures of those risks. It changes significantly the calculation of capital requirements against credit risk and introduces capital requirements against operational risk.

The second pillar, supervisory review, requires that banks enter into a dialogue with their supervisors on the methods and internal estimates, that they develop in order to determine how best to manage all their risks, including how much capital beyond the minimum requirement a firm should hold.

The third pillar, market discipline, by enhancing transparency, strengthens the ability of marketplace participants to reward well-managed and capitalised banks As intended by the Committee, the overall capital requirements of banks are not expected to fall significantly. The capital requirements for credit risk should in most cases decrease, more so if the most advanced approaches are used, but this should be largely counterbalanced by additional capital set aside against operational risk.

According to the Quantitative Impact Study of the Basel Committee in 2003, the average decrease of capital requirements for European Union institutions should be around 5.3%, ranging from an increase of 1.9% for banks using the standardized approach for credit risk to a decrease of 8.7% for the ones using the most advanced A-IRB (internal rating based) approach. For banks using the standardized approach the increase of capital requirements stems solely from the operational risk charges, amounting to 10.3%, which were not counterbalanced by the reduction in credit risk charges. For banks using the more advanced approaches the reduction of credit risk charges far outweighs the additional charges for operational risk. In total, for the EU banks using the standardised approach, mainly small banks, even after allowing for the 10.3% reduction, their capital adequacy ratio will remain well above 10% and only a few, with a share in total banking sector assets of 0.2% may experience some difficulties. However, these banks may be able to raise some additional capital or merge with more capitalised banks, and in any way as their market share is insignificant they do not pose a systemic risk.

Regarding Greek banks, this QIS showed an increase of capital charges by 7.5% stemming by a decrease of credit risk charges by 2.5% and an increase of operational risk charges of 10%. It should, however, be noted that the Greek banks which participated in the QIS used the most simple (standardized) approach. However, since then Greek big banks (with a market share of 70%) are gradually introducing IRB methods, so that when the new framework will be introduced, they will be able to reduce their credit risk charges. All the more so, that mortgage credit and consumer credit, as well lending to small business, which have under the new accord a preferential treatment in relation to capital requirements, are growing much faster than the rate of growth of total credit. This, in combination with the starting high level indicates that the capital adequacy ratio in Greece should remain on average above 12%.

Of course the individual banks' capital requirements reductions depend not only on the type of approach used but also on the composition of the portfolio and its quality. Banks with a larger proportion of retail credit, including credits to Small & Medium sized Enterprises (SMEs) will experience a larger reduction of their capital requirements. Also banks with collateralized exposures or with customers having a better, external or internal, rating, which, of course, reflects better quality, will have a larger reduction.

The largest reduction will of course be for banks with good quality portfolios that use the most advanced approaches for the calculation of capital requirements. It is only natural and fair that banks using the more advanced approaches will benefit most. After all, the new framework is intended to provide incentives for the upgrading of the banks' risk management systems.

However, the reduction of capital charges for credit risk should not be expected by itself to motivate banks to adopt the more advanced methods. The high costs for the implementation of the more advanced systems will discourage a number of banks. In a study conducted by PriceWaterhouseCoopers for the European Commission, the implementation cost in Europe was estimated at about € 20-30bn, with individual banks spending € 30 - 150 m, depending on their size, sophistication and approach used.

Although one cannot deny that a significant amount of these costs result from the need for regulatory compliance to the new framework, an equally large part are the result of improvements in credit risk and operational risk management systems that would have been introduced even in the absence of Basel II. Basel II has accelerated the process and should, with time, both increase shareholder value and strengthen the financial systems worldwide.

In a globalised world, without many financial frontiers, the competition driven need for improved risk management systems are motivating banks to move more and more to the more advanced approaches. And this because the better measurement of credit risk would allow banks to better evaluate the return of their main product i.e. credit and the profitability of their business lines. Accordingly, banks are introducing the advanced approaches for the calculation of capital requirements so as to be better placed to identify opportunities in the credit market and be able to exploit them through more focused marketing initiatives and better pricing.

Traditionally, banks use some discrimination in their pricing decisions but mostly, because of their inability to adequately differentiate the credit risk of their individual obligors there is a cross-subsidisation of products and customers. Therefore, the system irrespective of the credit worthiness of the borrower was contributing to rather level pricing, especially as regards capital requirements.

For example, consider two unsecured corporate loans, one to a rather good customer, with external rating A and an internally estimated probability of default of 0.12% and another worse one with an external credit rating of BB and an internally estimated probability of default of 1,5% . According to the current framework the required capital to be set aside against both customers would be 8% of the amount lent. According to the new framework:

- If the standardized approach is used the capital to be set aside the first customer would be 4% while the capital set aside for the second customer would be 8%.

- If the Foundation IRB Approach is used the capital required against the first customer would be 2.7% for the first and 8.9% for the second.

The new framework allows, therefore, greater differentiation of the amount of capital to be set aside against loans to each of these customers.

In addition, the current framework required the same amount set against lending irrespective of the type of obligor (corporate, small business, retail customer). Only mortgage were allowed, under certain conditions lower capital requirements. The new framework makes a distinction between corporates, small businesses (those with exposures of less that € 1m to the banking group) and individual (retail) customers. For the advanced approaches a further differentiation exists for corporates with sales of less than € 50 mil. To summarize, the new IRB framework is a customer-tailored system, whereas the existing one is essentially “one size fits all” irrespective of the weight and height of the customer.

Effects on businesses

There is a lot of discussion regarding the effects of the new Accord on lending, especially to SMEs (small and medium sized enterprises), which in Greece are the great majority of firms. After some adjustments, to take into account these concerns, the reduction in capital charges for small and medium enterprises (exposures below € 1 million) and well-provisioned past-due loans as well as the recognition of credit risk mitigants, such as collateral and guarantees, render the new framework much more favourable than the existing one.

Generally the capital requirements for loans to corporate are likely to fall significantly (up to 80% in some cases) for excellent credit quality with credit risk mitigants, such as eligible collaterals. In the QIS it was found that corporate, non-SME lending would benefit in a pan - European level from a reduction of capital requirements of 2.5%. The reductions would be more for corporate SMEs i.e. corporates with annual sales lower than €50m, and would amount to 4%.

Enterprises with exposure of less than € 1 m can be treated as retail customers, resulting to a further decrease by a significant amount of capital requirements, eventually passing the benefit onto companies themselves. Under the advanced approaches, the capital requirements for a loan to a corporate with PD =1.5% and LGD = 45% would be as much as 8.9%, whereas if the customer was an SME treated as retail would be only 4.52%

Of course the requirement for reliable data on the basis of which the banks would be able to judge the creditworthiness of their customers, may create an additional burden to SMEs to produce timely and accurate accounting and other financial information. However the availability of such information might also lead to more efficient management of such companies based on more informed and less intuitive decisions.

What is more important is the fact that the meaningful differentiation of risk will lead to a more efficient allocation of capital. Banks will be able to identify companies of high creditworthiness and offer them credit, at preferential terms, supporting thus their growth. This would benefit, not only healthy companies, including SMEs, which will find it easier and less costly to borrow from banks, but also the economy as a whole.

However, starts-up may find some difficulties in raising loans and, therefore, other means of finance have to be further developed. Especially for new technologies, where Europe is lagging, venture capital is not readily available: the sums raised in 2003 were 1/3 below of those raised in the US and the average technology investment almost 1/10 of the US, thus further underlining the need in Europe to lift the financing obstacles for the dynamic technology sectors.