

Objectives and History

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Basel II is an accord between the banks and their national supervisors. It was developed by the Committee on Banking Supervision hosted by the Bank for International Settlements (BIS) in Basel. Its present and, for the time being, final version was published in June 2004 on the BIS website www.bis.org. As per its opening paragraph:

*This report presents the outcome of the Basel Committee on Banking Supervision's ("the Committee") work over recent years to secure international convergence on revisions to supervisory regulations governing the capital adequacy of internationally active banks. ... The present paper is now a statement of the Committee agreed by all its members. ... This Framework and the standard it contains have been endorsed by the Central Bank Governors and Heads of Banking Supervision of the Group of Ten countries. (1)**

Basel II aims to make banking safer and more profitable, especially by removing competitive inequalities. It does not advise banks on how to adjust to the new regimen. Consequently, perusing the copious documentation of the Basel proceedings will yield little of practical relevance to your search for finance. The overview included here is intended chiefly to help you understand the change in your bankers' attitude towards you and your business.

The Basel Committee on Banking Supervision was established in 1975 by the bank governors of the Group of Ten (G-10). The appointees to the Committee are senior representatives of the bank supervisory authorities and central banks of the Benelux countries (Belgium, the Netherlands and Luxembourg), Canada, France, Germany, Italy, Japan, Sweden, Switzerland, the United Kingdom and the United States.

As a group, banks perform a function of singular political importance in that they determine the amount of money circulating through the economy. This is why they operate under the strict supervision of a public authority which, in many countries, is the national reserve bank. As individual enterprises, banks carry on the business of distributors, that is, wholesalers and retailers of funds: they borrow funds to lend them out for a profit margin on interest. To protect their creditors, banks are generally required by law to maintain a level of own means relative to their lendings which their supervisory authorities consider an adequate insurance against some of their debtors defaulting. By this legal constraint a bank's lending volume is effectively limited to a certain multiple of its equity. Differences in capital charges create competitive inequalities especially for internationally active banks. From the outset, a priority objective of the Basel Committee was to redress these inequalities by harmonising the standards of capital adequacy to be observed by banks across the jurisdiction of its member countries.

* Quotes from the published text are followed by the respective number of the source paragraph in brackets.

The effort of the Committee resulted in the accord of June 1988 entitled *International Convergence of Capital Measurement and Capital Standards* and generally referred to as the Basel Capital Accord (also as Basel I). The accord which became effective at the end of 1992 stipulated a 'target standard ratio' of unencumbered capital to risk weighted assets of 8%. Although primarily aimed at internationally active banks in the G-10 countries, it has since become a quasi-international standard applied throughout the world not only to internationally active banks, but, in many countries, to domestic banks as well. The Committee's press release of 26 June 2004 announcing the agreement on the new capital accord mentions that the 1988 accord 'is believed to have been adopted in some form by more than 100 countries'.

Since then, internationalisation of business, now more aptly termed globalisation, has advanced in leaps and bounds. For internationally active banks with globally expanding asset portfolios this necessitated new approaches to risk management. One of the innovative ways devised by banks to make their exposure to risk more manageable is 'securitisation'. This is the practice of packaging several compatibly structured assets into one legally defined tranche and issuing participating claims against it to other financial institutions. As reliable measures of risk in this and other contexts, the broad asset classes by which risk weights were assigned by the 1988 accord were fast losing practical relevance. They were proving increasingly unsatisfactory also for judging the adequacy of a bank's capital base. In recognition of this, the Basel Committee proposed a new framework of capital adequacy based on more sensitive and, thus, more realistic measures of risk (5). It outlined the principles of its proposal in a consultative document entitled *A New Capital Adequacy Framework* in June 1999. The Committee referred to the framework as *The New Basel Capital Accord* which the interested public dubbed Basel II.

In recognition of the international acceptance of the Basel I standard, the Committee invited comments not only from banks and bank supervisors in the G-10 countries but from major banks all over the world. Subsequently two more consultative documents were issued in January 2001 and in April 2003 reflecting the results of impact studies conducted along the way. Due to the Committee's outgoing consultative policy the new standard of Basel II not only enjoys unanimous endorsement by its members but a broadly based support in the international banking sector.

New Rules and the Consequences

The structure of Basel II rests on the ‘Three Pillars’ so called by the Committee, namely:

- Pillar 1 Minimum capital requirements
- Pillar 2 Supervisory review process
- Pillar 3 Market discipline.

Only the first pillar will concern us here since it contains the rules governing the credit rating of bank customers which is the central topic of this book.

Approaches to rating your risk

The central instrument by which Basel II aims to realise its concept of risk-sensitive asset weighting is credit rating. Credit risk is the risk of borrowers failing to pay interest and repay principal on the dates agreed. More specifically, and in terms of Basel II, credit risk is the borrower’s ‘Probability of Default’ (PD), where default is defined as follows:

A default is considered to have occurred with regard to a particular obligor when either or both of the two following events have taken place.

- *The bank considers that the obligor is unlikely to pay its credit obligations to the banking group in full ...*
- *The obligor is past due more than 90 days on any material credit obligation to the banking group ... (452)*

Its definition as probability gives risk an objective, that is, statistically quantifiable, dimension. The quantification enables the derivation of risk weights by which to adjust the assets that enter the calculation of a bank’s minimum capital requirement.

The traditional practice of credit rating is to assign borrowers or assets to risk categories conveniently calibrated for the practical purposes of risk evaluation and risk management.

Throughout the text of the accord Basel II makes abundantly clear that by its use of the terms credit assessment or credit rating it implies professional standards compatible with those of established rating institutions. The Committee initiated a study of professional rating practice published in a working paper entitled *Credit Ratings and Complementary Sources of Credit Quality Information* in August 2000.

Worldwide, the largest rating institutions are Moody's and Standard & Poor's, operating in their current form since 1962 and 1941, respectively. The definitions of their rating categories which are broadly compatible have set a standard adopted by most rating agencies throughout the world.

Conventions of categorising credit risk

Borrower or asset attributes for example	Moody's	S & P
Investment grade		
Premium quality, compatible with first rate sovereign issues	Aaa	AAA
High quality, but some sensitivity to world economic conditions	Aa 1 Aa 2 Aa 3	AA + AA AA -
Good quality, but sensitive to cyclical downturns in the domestic economy	A 1 A 2 A 3	A + A A -
Medium quality, susceptible to changes in market environments	Baa 1 Baa 2 Baa 3	BBB + BBB BBB -
Speculative grade		
Currently able to meet obligations, but unlikely to withstand aggressive competition	Ba 1 Ba 2 Ba 3	BB + BB BB -
Highly speculative, high dependence on uncertain developments, high potential of loss at default	B 1 B 2 B 3	B + B B -
Unable to meet obligations, high danger of default, requires financial restructuring to survive	Caa Ca C	CCC + CCC CCC -

Panel 1

For purposes of illustration Basel II uses Standard & Poor's notation throughout, emphasising that its choice implies no preference for the notation or the institution (50, footnote 13).

Rating subjects

Through Basel II, systematic risk rating becomes the obligatory foundation of all lending or investment decisions made by banks. By its rules, rating has a dual focus: it estimates the risk of an exposure not only by relevant attributes of the borrower but also by those of the associated facility:

For corporate ... exposures, each borrower and all recognised guarantors must be assigned a rating and each exposure must be associated with a facility rating as part of the loan approval process. ... (422)

Each separate legal entity to which the bank is exposed must be separately rated. ... (423)

Basel II does not expect every bank to be able to set up an internal rating system meeting its high quality standards by the time the transition period for implementing the new framework expires at the end of 2006 (2). Banks are, therefore, offered two optional approaches:

The Committee proposes to permit banks a choice between two broad methodologies for calculating their capital requirements for credit risk. One alternative will be to measure credit risk in a standardised manner, supported by external credit assessments. (50)

The alternative methodology, which is subject to the explicit approval of the bank's supervisor, would allow banks to use their internal rating systems for credit risk. (51)

The first option is called the Standardised Approach and the second the Internal Rating Based (IRB) Approach. There can be no doubt, however, that Basel II favours the IRB Approach, and, within that approach, the more advanced variety. Banks adopting the advanced approaches benefit by generally lower capital requirements.

The ratings obtained by either of the two basic approaches are processed into risk weights applied to the rated exposure. The bank's capital requirement is then calculated on the sum of its risk weighted assets (44, 45).

For the purposes of rating Basel II distinguishes five major classes of banking-book exposures (215) summarised overleaf. The corporate class is subdivided into five sub-classes (218–228) and the retail class into three sub-classes (231–233).

The scope of Basel II borrower rating

Major classes of exposure to risk

- **Corporate** – in general, debt obligations of corporations, partnerships or proprietorships in excess of 1 million euros. For special lending, typically to 'special purpose entities', see the sub-classes below.
- **Sovereign** – including reserve banks, certain development banks and other public sector entities.
- **Bank** – banks and securities firms operating under a supervisory authority.
- **Retail** – see the definition by sub-classes below.
- **Equity** – direct and indirect ownership interests, voting or non-voting, in assets and income of commercial or financial enterprises.

Corporate exposures

Sub-classes for special lending

- **Project finance** – usually for large, complex and expensive installations such as power plants, chemical processing plants, mines, transportation infrastructure, environment, telecommunications infrastructure.
- **Object finance** – in respect of physical assets such as ships, aircraft, satellites, railcars, fleets.
- **Commodities finance** – for reserves, inventories, or receivables of exchange-traded commodities such as crude oil, metals or crops.
- **Income-producing real estate** – such as office buildings to let, retail space, multifamily residential buildings, industrial or warehouse space, hotels.
- **High-volatility commercial real estate** – commercial real estate the value of which depends on conditions that are unpredictably volatile by nature.

Retail exposures

Sub-classes

- **Exposures to individuals** – such as revolving credits and lines of credit (for instance, overdrafts and credit cards), personal term loans and leases such as instalment loans and car leases.
- **Residential mortgage loans** – including first and subsequent liens, term loans and home equity lines of credit.
- **Loans to small businesses** – where the bank's total exposure to the business is less than 1 million euros.

Panel 2

It is important to note that Basel II includes equity investments among the five major classes of banking-book exposures. The definition includes 'debt obligations and other securities, partnerships, derivatives and other vehicles with the intent of conveying the economic substance of equity ownership' (237). Basel II applies to banks on a consolidated basis which means that, besides integrated investment units, bank-controlled investment companies also fall under its risk assessment framework (24), as do so called 'captive' investment funds managed on behalf of a bank by a specialist organisation.

The inclusion of retail exposures as a class of its own is an outcome of the consultation process the Basel Committee initiated with its first consultation paper in June 1999. The proposals contained in that paper do not include such a class as requiring separate treatment in establishing capital adequacy. The reason for including it among the revised proposals of the

second consultation paper in January 2001 is mainly one of administrative economy. By its definition, large numbers of small exposures with compatible risk features can be combined in suitably demarcated pools for summary treatment in the calculation of capital requirements and the purposes of risk management.

In the retail class it is not the individual exposure that is rated for credit risk, but the individual pool of exposures. Also there is no distinction between borrower rating and facility rating as in the other classes. This pragmatic approach to retail exposures would seem to indicate a more lenient treatment of small borrowers such as individuals and small businesses. However, Basel II requires that the segmentation of a bank's retail portfolio reflects distinctive risk characteristics. Consequently bankers will still need to apply adequate credit scoring methods to assign an individual borrower to the appropriate pool. We shall return to this subject in the context of small business later on.

Weighing collateral against risk

An important factor in assessing credit risk is the availability of collateral. Collateral can significantly affect a borrower's overall credit standing. The eligibility of any collateral offered is, therefore, a major consideration for potential borrowers as well as their bankers.

The effective measure of risk mitigation is obtained by risk-weighting the individual collateral instrument. In the treatment of collateral, banks using the Standardised Approach to rating may opt for either the 'Simple Approach', which substitutes the risk weighting of the collateral for the risk weighting of the collateralised portion of the exposure, or the 'Comprehensive Approach', which effectively reduces the exposure amount by the value of the collateral (121, 129, 130). The collateral eligible for risk mitigation under these two subsidiary approaches, which includes financial instruments (145, 146), guarantees (189f) and physical assets (72, 74), is summarised overleaf.

Eligible Collateral

for banks adopting the standardised method of calculating capital requirements

under the Simple Approach

- **Cash** as well as certificates of deposits and similar instruments.
- **Gold**
- **Rated¹ debt securities** issued by sovereigns or public sector entities rated at least BB-, or by other entities such as by banks and securities firms rated at least BBB-. Also short-term debt instruments rated at least A-3/P-3².
- **Non-rated debt securities** issued by banks which are listed on a recognised stock exchange and classified as senior debt.
- **Equities** including convertible bonds which are included in a main index.
- Mutual funds and UCITS³ if prices of units are quoted daily.
- **Guarantees/credit derivatives** issued by sovereigns, public sector entities, banks with lower risk weight than the secured exposure, and other guarantors rated at least A-.
- **Residential real estate.**
- **Commercial real estate** with certain qualifications.

under the Comprehensive Approach (in addition to the above)

- **Equities** including convertible bonds which are not included in a main index but which are listed on a recognised exchange;
- **Mutual funds and UCITS³** which include such equities.

for banks adopting the internal rating based method of calculating capital requirements

under the Foundation Approach (in addition to the above)

- **Guarantees/credit derivatives** issued by corporate issuers not externally rated¹, but internally rated to be at least A- equivalent.
- **Receivables** meeting certain minimum requirements.
- **Physical collateral** (other than real estate) meeting certain minimum requirements.

under the Advanced Approach no restrictions by eligibility criteria

1 by a recognised external credit assessment institution

2 Moody's and Standard & Poor's notation for short-term instruments

3 Undertakings for Collective Investments in Transferable Securities

Panel 3

For IRB banks adopting the subsidiary 'Foundation Approach' the definition of eligible collateral is extended beyond the instruments listed above to special instruments, known as IRB collateral, that meet certain minimum requirements. These include receivables as well as physical collateral such as specified commercial and residential real estate (289). Under the 'Advanced Approach' the more sensitive risk weighting techniques obviate eligibility criteria, and banks are free to accept any collateral of their choice.

To take account of special risks associated with a particular collateral instrument bankers are directed to apply commensurate adjustments (so called ‘haircuts’), for example in cases where the market value of an instrument must be expected to fluctuate significantly or where a maturity mismatch or currency mismatch exists between the instrument and the exposure it is intended to collateralise (*e.g.* 130). The eligibility of a collateral instrument is further circumscribed by criteria of legal certainty for ease of liquidation (117).

Generally, Basel II sets high standards for assessing and monitoring the risk mitigating capacity of accepted collateral to enable speedy liquidation in the event of the secured exposure defaulting.

Standards for raters and rating

As regards the quality standards of credit rating there is, of course, no difference between the Standardised and the Internal Rating Based Approach, and relevant directions given in the context of one may be read as equally applying to the other.

Concerning the Standardised Approach, which involves employing the services of external credit assessment institutions (ECAIs), Basel II states six general criteria of eligibility (90, 91).

Quality standards for Basel II raters Eligibility criteria for external rating institutions

- **Objectivity** – A rigorous and systematic methodology subject to validation by historical evidence.
- **Independence** – An organisation unaffected by political or economic pressures and free from conflicting interests.
- **International access / transparency** – Accessibility of individual assessments to both domestic and international institutions on equal terms and the public availability of the general methodology used.
- **Disclosure** – The supply of specific information on assessment methodologies used and the actual default rates experienced by rating category.
- **Resources** – The ability to perform high-quality assessments incorporating qualitative as well as quantitative aspects, in particular, through ongoing contacts at senior and operational levels within the assessed entities.
- **Credibility** – (In addition to what is already implied in the aforesaid criteria.) Customer references in respect of performance and conduct as well as internal safeguards against misuse of confidential information.

Panel 4

National bank supervisors will decide whether an ECAI is eligible for performing Basel II ratings or not. As a general rule, banks are directed to use solicited rather than unsolicited ratings from eligible ECAIs (108). This means that a customer cannot rely on a published or self-initiated rating by an ECAI to be accepted for the purpose. Exceptions from this rule are in the discretion of the supervisor. Banks will not be allowed to ‘cherry-pick’ the assessments provided by different ECAIs (395). Supervisors will also direct the ‘mapping’ of the assessment categories used by ECAIs to the risk weights applying under the Basel II risk weighting framework (92).

Obviously, the same stringent criteria which determine the eligibility of an external rating agency will guide the supervisors when scrutinising a bank's internal rating system for approval. These and other measures render the rating process highly resistant to attempts by interested parties to influence the outcome.

Rating procedures cannot, of course, ever be free of an element of human intervention. Many inputs are qualitative in nature and, of necessity, subjective. Even quantitative processes may require judgmental inputs. Basel II recognises that human judgement is essential to any form of rating and explicitly aims to prevent an undue reliance on mechanistic method. So in the context of scoring models:

... Credit scoring models and other mechanical procedures are permissible as the primary or partial basis of rating assignments, and may play a role in the estimation of loss characteristics. Sufficient human judgement and human oversight is necessary to ensure that all relevant and material information, including that which is outside the scope of the model, is also taken into consideration, and that the model is used appropriately. ... The bank must have procedures for human review of model-based rating assignments.... (417)

Consequently, there will always remain a potential for human error as well as deliberate manipulation. Basel II strives to minimise that potential by imposing strictly supervised operational rules.

Rating assignments and periodic rating reviews must be completed or approved by a party that does not directly stand to benefit from the extension of credit. Independence of the rating assignment process can be achieved through a range of practices that will be carefully reviewed by supervisors... (424)

Banks must have independent credit risk control units that are responsible for the design or selection, implementation and performance of their internal rating systems. The unit(s) must be functionally independent from the personnel and management functions responsible for originating exposures... (441)

For rating assignments based on expert judgement, banks must clearly articulate the situations in which bank officers may override the outputs of the rating process, including how and to what extent such overrides can be used and by whom. For model-based ratings, the bank must have guidelines and processes for monitoring cases where human judgement has overridden the model's rating, variables were excluded or inputs were altered. These guidelines must include identifying personnel that are responsible for approving these overrides. Banks must identify overrides and separately track their performance. (428)

The conclusion to draw from this emphasis on the integrity of the rating process is this:

In future, lending and investment decisions are less likely to be swayed by accommodating dispositions of bank executives towards individual customers.

Basel II categorically denies borrowers a favoured status not grounded on objectively validated risk assessments.

In Search of Guidance

Obscure implications

It is an elementary tenet of business economics that every profit-oriented enterprise will use bank credit of some kind. As we shall see later, not to do so would imply an irrational sacrifice of profit potential and, hence, managerial incompetence. It is more than likely, therefore, that your firm will, sooner rather than later, be due for a Basel II rating of some kind. It is equally likely that contemplating the prospect two questions will be foremost in your mind:

- What specific information will your bankers require for the rating?
- What precisely can you do to ensure the most favourable outcome?

Unfortunately, Basel II has no clear-cut answers to these questions. It requires banks to have well defined rating criteria, but leaves it to them to specify any detail regarding them in cooperation with their supervisors.

A bank must have specific rating definitions, processes and criteria for assigning exposures to grades within a rating system. The rating definitions and criteria must be both plausible and intuitive and must result in a meaningful differentiation of risk... (410)

As regards the information to be supplied by customers, Basel II merely states:

To ensure that banks are consistently taking into account available information, they must use all relevant and material information in assigning ratings to borrowers and facilities. Information must be current. The less information a bank has, the more conservative must be its assignments of exposures to borrower and facility grades or pools. An external rating can be the primary factor determining an internal rating assignment; however, the bank must ensure that it considers other relevant information. (411)

On the subject of rating criteria Basel II contains nothing more specific. Considering the thorough study of rating methods and their practical performance undertaken in preparation of the new accord, it would seem that at some time in the course of its consultations, the Committee decided not to involve itself in questions of methodology as a matter of policy. It confines itself to specifying the desired results, not the methods by which to obtain them.

The overarching principle behind these requirements is that rating and risk estimation systems and processes provide for a meaningful assessment of borrower and transaction characteristics; a meaningful differentiation of risk; and reasonably accurate and consistent

quantitative estimates of risk. ... It is not the Committee's intention to dictate the form or operational detail of banks' risk management policies and practice. ... (389)

In the circumstances it is of some interest to look at the broad outline of rating criteria included as paragraph 265 in the second consultative document of January 2001 under the heading *Criteria on risk assessment of a borrower*, but omitted from the third consultative document of April 2003. It is quoted here in full with key phrases emphasised in bold:

Banks should take all relevant information into account in assigning ratings to a borrower. This information should be current. The methodologies and data used in assigning ratings should be clearly specified and documented. As a minimum, a bank should look at each of the following factors for each borrower:

- **historical and projected capacity** to generate cash to repay its debts and support other cash requirements, such as capital expenditures required to keep the borrower a going concern and sustain its cash flow;
- **capital structure** and the likelihood that unforeseen circumstances could exhaust its capital cushion and result in insolvency;
- **quality of earnings**, that is, the degree to which its revenue and cash flow emanate from core business operations as opposed to unique and non-recurring sources;
- **quality and timeliness of information about the borrower**, including the availability of audited financial statements, the applicable accounting standards and its conformity with the standards;
- degree of operating leverage and the resulting **impact that demand variability would have on its profitability and cash flow**;
- financial flexibility resulting from its **access to the debt and equity markets** to gain additional resources;
- **depth and skill of management** to effectively respond to changing conditions and deploy resources, and its degree of aggressiveness vs. conservatism;
- its **position within the industry and future prospects**; and
- the **risk characteristics of the country** it is operating in, and the impact on the borrower's ability to repay (including transfer risk), where the borrower is located in another country and may not be able to obtain foreign currency to service its debt obligations.

We have noted the exacting quality standards Basel II applies in judging the eligibility of external rating agencies as well as the adequacy of the banks' internal rating operations. Possibly the Committee subsequently considered the listing of the criteria unnecessary seeing that they are elementary to any professional approach to rating, as we shall find confirmed later on. In any case, the conclusion is unambiguous:

As it stands, Basel II is not a source of specific information to guide entrepreneurs and business executives in their task of preparing their businesses for the rating prescribed by it.

A guidance of sorts – still a valuable one – can be inferred from the intentions of Basel II which are implicit in its directions to banks and bank supervisors.

Controlled compliance

Banks that opt for the Standardised Approach to risk weighting their assets will, in the main, do so because they are not yet ready to tackle the onerous task of installing and operating their own rating system to the exacting standards decreed by Basel II. Meanwhile the onus of meeting those standards devolves upon external raters, especially, as these are selected with supervisory approval.

This is why Basel II is explicit about appropriate rating practice mainly in the context of the Internal Rating Based Approach. Being the more beneficial of the two approaches from the banks' point of view, it is treated by Basel II somewhat like a concession a bank must show itself fit to receive.

To be eligible for an IRB approach, a bank must demonstrate to its supervisor that it meets the IRB requirements in this document, at the outset and on an ongoing basis. ... (392)

Once the IRB status is granted there is no return to the standardised procedures, unless there are fundamental changes in the bank's business.

Once a bank adopts an IRB approach for part of its holdings, it is expected to extend it across the entire banking group ... (256)

... supervisors may allow banks to adopt a phased rollout of the IRB approach across the banking group ... (257)

A bank must produce an implementation plan, specifying to what extent and when it intends to roll out IRB approaches ... over time ... (258)

Banks adopting an IRB approach are expected to continue to employ an IRB approach. A voluntary return to the standardised or foundation approach is permitted only in extraordinary circumstances, ... (261)

The major aspects of risk which Basel II requires raters to quantify and transform into risk weights are these:

... The risk components include measures of the Probability of Default (PD), Loss Given Default (LGD), the Exposure at Default (EAD), and Effective Maturity (M). In some cases, banks may be required to use a supervisory value as opposed to an internal estimate for one or more of the risk components. (211)

Basel II insists that the rating must be applied to the borrower as well as to the facility:

A qualifying IRB rating system must have two separate and distinct dimensions: ... (396)

The first dimension must be oriented to the risk of borrower default. Separate exposures to the same borrower must be assigned to the same borrower grade irrespective of any differences in the nature of each specific transaction ... (397)

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The second dimension must reflect transaction-specific factors, such as collateral, seniority, product type, etc. ... (398)

As mentioned earlier, rating practice assigns the rated entity to one in a range of categories denoting different degrees of risk and usually arranged in increasing order of risk (see Panel 1 on page 12). Basel II adopts the same structural principle:

A bank must have a meaningful distribution of exposures across grades with no excessive concentrations, on both its borrower-rating and its facility-rating scales. (403)

To meet this objective, a bank must have a minimum of seven borrower grades for non-defaulted borrowers and one for those that have defaulted. ... (404)

A borrower grade is defined as an assessment of borrower risk on the basis of a specified and distinct set of rating criteria, from which estimates of PD are derived. ... (405)

Similarly for retail exposures:

... The level of differentiation for IRB purposes must ensure that the number of exposures in a given pool is sufficient so as to allow for meaningful quantification and validation of the loss characteristics at the pool level. There must be a meaningful distribution of borrowers and exposures across pools. A single pool must not include an undue concentration of the bank's total retail exposure. (409)

Lenience for small business?

The modified treatment for retail exposures has already been mentioned (see page 14). For the purposes of calculating a bank's minimum capital requirements, retail exposures are not risk weighted individually but aggregated into pools. Since the introduction of this concept by the Basel Committee in its second consultative document of January 2001 this has led to expectations that businesses indebted to a particular bank for less than one million euros, that is, numerically, the vast majority of units in the corporate business sector, might escape the rigours of a Basel II rating. However, such sweeping conclusion is unjustified. As per the directives quoted on page 13 (422, 423) banks are required to segment retail exposures into pools in much the same way in which other exposures are assigned to a risk category. Thus, for the individual firm, the class distinction between corporate and retail exposure is largely academic. In practical terms, the assignment to a retail pool is a form of rating.

Basel II leaves no doubt about the standards of risk discrimination which pool assignments will have to meet:

The minimum requirements set out in this document apply to all asset classes unless noted otherwise. The standards related to the process of assigning exposures to borrower or facility grades (and the related oversight, validation, etc.) apply equally to the process of assigning retail exposures to pools of homogenous exposures, unless noted otherwise. (390)

... Banks must assign each exposure that falls within the definition of retail for IRB purposes into a particular pool. Banks must demonstrate that this process provides for a meaningful

differentiation of risk, provides for a grouping of sufficiently homogenous exposures, and allows for accurate and consistent estimation of loss characteristics at pool level. (401)

The actual purpose of the retail pool concept is not to make loan approval processes for retail exposures less stringent, but to economise their subsequent processing into risk weighted assets by using pool aggregates rather than individual exposures. These economies benefit the bank, not necessarily the business firm applying for a loan.

Nor does the assignment to a retail pool mean that the borrower will not henceforth receive individual attention.

A bank must review the loss characteristics and delinquency status of each identified risk pool on at least an annual basis. It must also review the status of individual borrowers within each pool as a means of ensuring that exposures continue to be assigned to the correct pool. ... (427)

In any case, banks are under no obligation to treat business exposures below the one million euro threshold as retail exposures. On the contrary, such treatment is premised upon certain conditions, such as compatibility with the bank's established business practice and a sufficient number of exposures to constitute an adequately risk differentiated pool.

The exposure must be one of a large pool of exposures, which are managed by the bank on a pooled basis. Supervisors may choose to set a minimum number of exposures within a pool for exposures in that pool to be treated as retail ... Small business exposures below €1 million may be treated as retail exposures if the bank treats such exposures in its internal risk management systems consistently over time and in the same manner as other retail exposures. ... However, this does not preclude retail exposures from being treated individually at some stages of the risk management process (232)

The conclusion is this:

In principle, and considerations of size and complexity aside, business borrowers below the one million euro mark must expect to be subjected to the same kind of credit risk assessment as other business borrowers.

No period of grace

Banks have until the end of 2006 and – in respect of the more sophisticated methods of risk assessment – until to the end of 2007 fully to comply with Basel II:

The Committee expects its members to move forward with the appropriate adoption procedures in their respective countries. ... The Committee intends the Framework set out here to be available for implementation as of yearend 2006. However, the Committee feels that one further year of impact studies or parallel calculations will be needed for the most advanced approaches, and these therefore will be available for implementation as of year-end 2007. ... (2)

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These dates do not, however, imply a period of grace for you as bank customer. In order to be operative by those dates, banks not only need to have the requisite procedures in place, but have all their clients passed through the rating routine. In the circumstances the implementation schedule is tight and forces banks to speed up their preparation. Not only in the G-10 countries, but virtually the world over, financial institutions have, for some time already, begun to gear up to the new accord – amid reports of a growing number of client casualties. Consequently you, the present or future bank customer, have no time to waste either.

Confronting the Raters

The preceding chapter endeavoured to squeeze from the 239 pages of the Basel II document information of some relevance to enterprises depending for their funding on banks and bank related equity investors. The collected gleanings, however, contain precious little in the way of answering the two practical questions which guided our search:

- What specific information will your bankers require for the rating?
- What precisely can you do to ensure the most favourable outcome?

Essentially, the implication of Basel II for you is that, in future, no bank will offer you financial assistance without first establishing your 'Probability of Default'. To this end it will apply a stringent rating procedure by which to place you in one of several risk categories, and, on that basis, decide whether or to what extent and under which conditions it is prepared to risk funds on you.

Basel II only states the general principles to be observed in setting up a rating system. It considers the procedural detail is as a matter to be agreed between each bank and its supervisory authority. As you approach a particular bank for finance, you will not, as a rule, know those specifics.

Our search has reliably established one condition:

The task of making a business fit for Basel II cannot be approached in terms of compliance with clearly defined rules. Such rules do not exist, not even in the form of general directives.

Nevertheless, there is no need passively to submit to a rating. This book will show you a way of maximising your rating results by proactively assembling the information to satisfy any rating system and preparing effective arguments for engaging raters in a constructive dialogue. This should be done, of course, with due regard for the practical circumstances in which your rating takes place. These will depend on the internal organisation of the particular bank, but certain general features of the credit assessment process are common enough for you to anticipate them and shape your preparations accordingly.

When considering your strategy for confronting your raters it is well to avoid a misleading abstraction: when you speak to a bank, you speak to a banker. The distinction is significant, because whatever the bank's policy, the banker is motivated, in addition, by personal circumstances and ambitions. It is one thing to generate new business, quite another to answer for losses incurred in consequence. For that reason alone you will expect a banker looking at your project to be conservative to a fault. The surest way of motivating a banker at first contact is by a

succinctly articulated outline of your project which comes straight to the points that matter most. Invariably these are your projections of return on investment and liquid assets.

In many if not most cases the first personal meeting takes place on the strength of the impression made by a preceding written communication. It may surprise you that most proposals and applications which fail do not do so because they lack merit, but because they are badly presented. The time-pressed bank executive is not inclined to wade through a lot of text in search of the critical features that might be of interest to him. Particularly de-motivating is a load of technical jargon the banker does not feel qualified to interpret.

If your request is not turned down within the first 15 minutes of the banker's attention to your introductory presentation you will have taken the first hurdle on the way towards an approval, though only the first.

There is another hurdle not always obvious to the prospective borrower and, perhaps, not meant to be. In the rarest of cases the banker you speak to is the person who alone decides your request. This is not a matter of your contact's seniority or position. An exposure of the bank in any significant amount is hardly ever the decision of a single person. It is that of a team. It is a case for the bank's credit or investment committee of which your banker is, at best, a senior member. The personal rapport you have established with the person you speak to will only go so far.

The diagram of the credit approval process (opposite) illustrates the elements of the process. Its actual organisation will, of course, depend on the bank's administrative structure and the complexity of your case.

The credit approval process

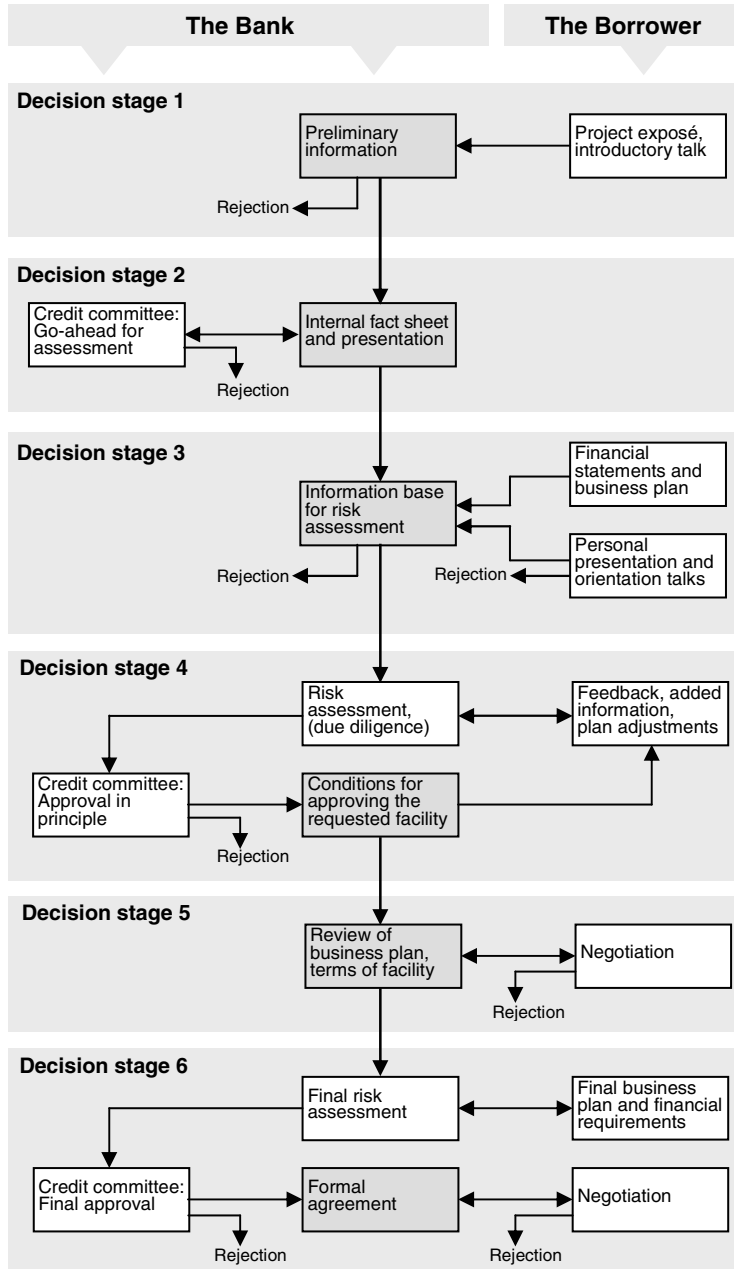


Figure 1

The important implication of the committee system is this:

Your project passes the decisive test of acceptability when you are not around to defend it. Approval of your request will largely depend on your ability to provide the banker willing to present your case not merely with relevant information, but with a tactically effective line of argument.

If your project survives its initial review by your protagonist's peers, it qualifies for entering the bank's credit assessment process as conditioned by Basel II rules. In all likelihood, your project will now pass to a specialised staff unit for the actual Basel II rating. Perhaps your protagonist, now your account executive, will coordinate the process and mediate between you and the rating unit. Possibly, though, you will meet and communicate with the lead analyst of the rating unit in person. Your case will have reached the critical stage where yet another set of circumstantial factors can significantly affect the outcome.

Over the exacting standards set by Basel II for the process it is easy to lose sight of the practical context in which credit rating takes place. As all other operational processes that constitute a bank's daily business, credit assessment, however important, is circumscribed by financial and physical constraints. A most obvious limitation is the amount of time a bank can afford to expend on processing an individual request for finance. Moreover, as Basel II reminds us, rating is not a one-off exercise but an ongoing and regularly monitored process.

Borrowers and facilities must have their ratings refreshed at least on an annual basis. Certain credits, especially higher risk borrowers or problem exposures, must be subject to more frequent review. In addition, banks must initiate a new rating if material information on the borrower or facility comes to light. (425)

The bank must have an effective process to obtain and update relevant and material information on the borrower's financial condition, and on facility characteristics ... (such as the condition of collateral). Upon receipt, the bank needs to have a procedure to update the borrower's rating in a timely fashion. (426)

These and similar cost generating conditions are bound to strain the banks' capacity to meet the exacting standards imposed on them by Basel II. You cannot expect banks to educate prospective borrowers in the skills of maximising their rating results. Those skills are not conveyed by instruction leaflets and questionnaires. Banks will prefer to do business with customers who prepare their projects in a manner that makes it easy to rate them. Generally they will follow the old rule re-emphasised by Basel II (411):

... banks ... must use all relevant and material information in assigning ratings to borrowers and facilities. ...

However:

... The less information a bank has, the more conservative must be its assignments of exposures to borrower and facility grades or pools. ...

In practice this means that banks will tend to make do with the information you provide as long as it is not patently unusable. Naturally, the quality of the input will be reflected in the outcome. Quality in the context of rating specifically means relevance of content and user-friendliness of presentation. Obviously, the outcome cannot improve on the substance of information provided by your data. But what can make a profound difference, and all too often does in a negative sense, is the ease with which your presentation allows raters and rating systems to absorb your information.

The possible consequences of inadequate preparation on the part of the borrower must not be underrated:

Underrepresenting your project, even if not causing it to fail the rating test outright, is likely to get it assigned to a grade below its merit.

The penalty for underrepresentation is reflected in the conditions of the desired facility, especially the rate of interest.

By no means does the need to make your information usable for a rating imply inordinate complexity. Rather, the rule – as simple as possible and as detailed as necessary – applies quite literally. This, of course, adds emphasis to the question of precisely what to do in preparation for a rating.

The remainder of the book addresses itself to that question. It outlines a practicable approach which strikes a pragmatic balance between depth and simplicity in compiling the relevant information and effectively presenting it. It serves you as a manual in doing the job yourself as it does in briefing and supervising staff or advisors.