

The Benefit of Discrimination!

Discrimination has often led to conflicts hindering the progress of society. Amidst this controversy, banks and their corporate clientele are well positioned to benefit through the implementation of Basel II which is primarily based on the concept of discrimination. Basel II which is aimed at aligning the risks of a bank to its capital will in turn benefit the low-risk high-quality corporate loan holders through reduced lending rates.

The nature of a bank

Banks' mainstream profits flow through the interest rate disparity between lending and borrowing. Main tasks of a bank are spread around its intermediary role in the financial market. Corporate lending, foreign exchange transactions and retail credit transactions are some of the main operations in a traditional bank. By the very nature of these operations, banks are intermediated with various types of risks including credit risk, exchange rate risk, interest rate risk and liquidity risk. Because of these risks and the special role that banks play in the financial system, banks are singled out for special regulatory attention.

Basel Capital Accord

In an attempt to make the banking sector regulation more uniform, Basel accord was introduced in 1988, commonly referred to as Basel I. This aims to manage the bank's gearing by funding a proportion of assets (10% of the risk weighted assets) through shareholder's funds. In simple terms, a bank has to maintain Rs 10 as shareholders' funds for every Rs 100 of loans it disburses (where loans are risk-weighted 100%).

However lack of discrimination among credit risk borrowers and lack of focus on risks other than credit risk seemed to be a significant drawback of Basel I. For example, an individual borrower's credit risk was equivalent to that of a large multinational.

Hence, Basel II was introduced with three mutually reinforcing pillars for the maintenance of capital adequacy, viz. minimum capital requirements, supervisory review process and market discipline. Pillar II which deals with minimum capital requirements, divides bank's identifiable risk into operational, market and credit risk where the latter accounts for bulk of the risk. In order to analyse the credit risk, banks should measure the risk of each potential loan holder before issuing a loan. Thus each loan holder will be discriminated according to their credit rating and shareholder's funds required in issuing loans will be varied accordingly. In Sri Lanka, the regulator--Central Bank--will require the implementation of the standardized approach where banks are required to recognize the credit rating assigned by external credit agencies.

Benefits to Banks

Through a risk analysis of its portfolio, banks would be able to better price its loans to suit the credit risks of its clients. Below is an extract of Basel I asset risk weights.

Balance-Sheet Assets	Basel II Risk Weights
Loans secured by primary mortgages over residential property	35%
Qualifying retail portfolios- loans to individuals	75%
Loans and advances to corporates depend on respective credit ratings:	
AAA to AA ₃	20%
A ₁ to A ₃	50%
BBB ₁ to BB ₃	100%
Below B ₃	150%
Unrated	100%

As a result, banks wanting to optimize returns, are likely to favour companies that have sound credit ratings. To provide an extremely simplified illustration, a bank which lends Rs 100 million, at 5% interest, to an unrated company will need to set aside Rs 10 million of shareholders' funds (Rs 100 million x 100% risk weight x 10% capital adequacy). In this case, the return on equity ("ROE") will be 50% (Interest /shareholders' funds).

This same loan, if extended to a AAA-rated company assuming the same interest rate, would require a capital allocation of only Rs 2 million (Rs 100 million x 20% risk weight x 10% capital adequacy), resulting in an ROE of 250%. Thus, the bank will earn 5 times the returns, based purely on the rating of the borrower. This will enable the bank to balance its loans between the different rated corporates and achieve an optimal risk-return portfolio.

Further, banks lending base will also expand with high quality corporate loan holders. In a simplified example, if the bank has Rs 40 million in shareholders' funds, this will be sufficient to serve Rs 100 million loans to 4 unrated corporates (Rs 100 million x 100% risk weight x 10% capital adequacy x 4) resulting in a loan base of Rs 400 million.

However if the banks had high quality AAA rated companies as its clients, shareholder funds worth Rs 40 million would have been enough to serve Rs 100 million loans to 20 corporates (Rs 100 million x 20% risk weight x 10% capital adequacy x 20 = 40), thus expanding the lending base to Rs 2 billion.

Hence the banks will gain the capacity to pass-on some of the benefits from its cost savings to a better rated corporate and still be able to retain its margins by increasing the volume of its business as discussed above.

Benefits to Loan Holders

Basel II also paves the way for a conscious corporate sector by empowering quality loan holders with higher bargaining power, hence pressurising banks to charge a lower interest rate for a AA1 rated corporate than an unrated corporate.

Given these conditions, corporate loan holders with strong externally assigned credit ratings could gain significantly through the implementation of Basel II which is likely to come into effect from January 2008. Therefore, companies which have sound financial and business profiles will be well poised to benefit from this by obtaining credit ratings from approved rating agencies. Moreover, corporates with strong credit profiles will have the added advantage of funding from traditional banking facilities as well as the corporate bond market.

Through flexibility in risk weights, Central Bank will also gain more influential power over regulation of capital allocation. Acting as the regulator, Central Bank will be able to change risk weights to suit the economic conditions prevailing in the country and thus direct lending to the most needed sectors in the economy.

Hence, even though discrimination has often resulted in spiteful divergence, discriminative aspects of Basel II will assist convergence in the financial sector forming strong risk adjusted banks and an energetic and risk conscious corporate sector.

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