

Basel II Capital Accord and its Impact on Corporate Borrowers

By Lanka Rating Agency Ltd

Background on Basel

In the wake of the banking crisis in the early 1980s, the G10 central banks introduced a capital accord in 1988; this is commonly referred to as Basel I because the committee that had formulated it had convened in Basel, Switzerland. Even though this accord is non-binding, it has been accepted almost throughout the world. Basically, Basel I dictates the minimum level of capitalisation for a bank. This regulation, together with other prudential norms, has strengthened the fundamentals of banking institutions and stabilised the financial system, thereby protecting the depositors as well.

The Basel I capital accord aims to manage a bank's leverage, by requiring it to keep 8% (the Central Bank of Sri Lanka sets this requirement at 10%) of its risk-weighted assets in the form of shareholders' 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%).

Over time, however, the capital allocation under this accord had been found to be deficient as it did not discriminate among the credit risks of borrowers. As an illustration, an individual borrower's credit risk was equivalent to that of a large multinational.

To address this drawback, the Bank of International Settlements ("BIS") issued Basel II in June 2004. The new accord is more sensitive to credit risk and seeks to incorporate operations and market risks into the allocation of capital. Furthermore, the accord places more emphasis on the supervisory role of the regulator and encourages transparency as well as better disclosure practices. The Central Bank of Sri Lanka has earmarked the implementation of this accord by January 2008. This will affect not only the banks but also the corporate sector, especially in the absence of a developed corporate bond market.

Although Basel II addresses 3 types of risks, the implications for companies mainly stem from the angle of credit risk. In measuring credit risk and setting aside capital, a bank will depend on the credit quality of its borrower. Thus, the credit standing of such borrowers will have to be rated, either internally or externally.

In Sri Lanka, the Central Bank will initially require the implementation of the "standardised" approach. This method requires the banks to recognise the credit ratings assigned by external credit rating agencies.

Impact on Corporate Borrowers

In view of the above, borrowers with different credit ratings will be assigned different risk weights (refer to Table 1), resulting in different amounts of capital being set aside.

Table 1: Extract of Basel II Asset Risk Weights Recommended by BIS

Balance-Sheet Assets	Basel I Risk Weights
Loans secured by primary mortgages over residential property	35%
Qualifying retail portfolios	75%
Loans and advances to corporates depend on the their respective credit ratings	
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 are likely to favour companies that have sound credit ratings. To provide a simplified illustration, a bank which lends Rs 100 million, at 5% interest, to a BBB-rated 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 at the same interest rate, would require a capital allocation of only Rs 2 million, resulting in an ROE of 250%. Thus, the bank will earn 5 times the returns, based purely on the rating of the borrower.

By the same token, a corporate with a high investment-grade rating should be able to obtain credit terms that commensurate with its credit risk. Given the competition, the banks will pursue highly rated customers and will eventually need to price their loans according to the credit risks of the borrowers.

Under the circumstances, companies with strong externally assigned credit ratings could benefit from the new Basel II accord. Therefore, companies which have sound financial and business profiles will be well poised to benefit from this by obtaining credit ratings from an approved rating agency. Moreover, corporates with strong credit profiles will have the added advantage of funding from traditional banking facilities as well as the corporate bond market. In view of these developments, corporate leaders will do well to familiarise themselves with the potential impact of Basel II on their businesses.

[13.11.2006]

www.lankarating.com