

BASEL II AND CREDIT MANAGEMENT

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MOTIVES FOR BASEL II

- Establish international benchmark for bank evaluation
- Strengthen global banking systems
- Identify inadequately capitalized banks
- Improve regulator coordination to avoid systemic international risk
- Implementation schedules vary by countries

THREE PILLARS APPROACH

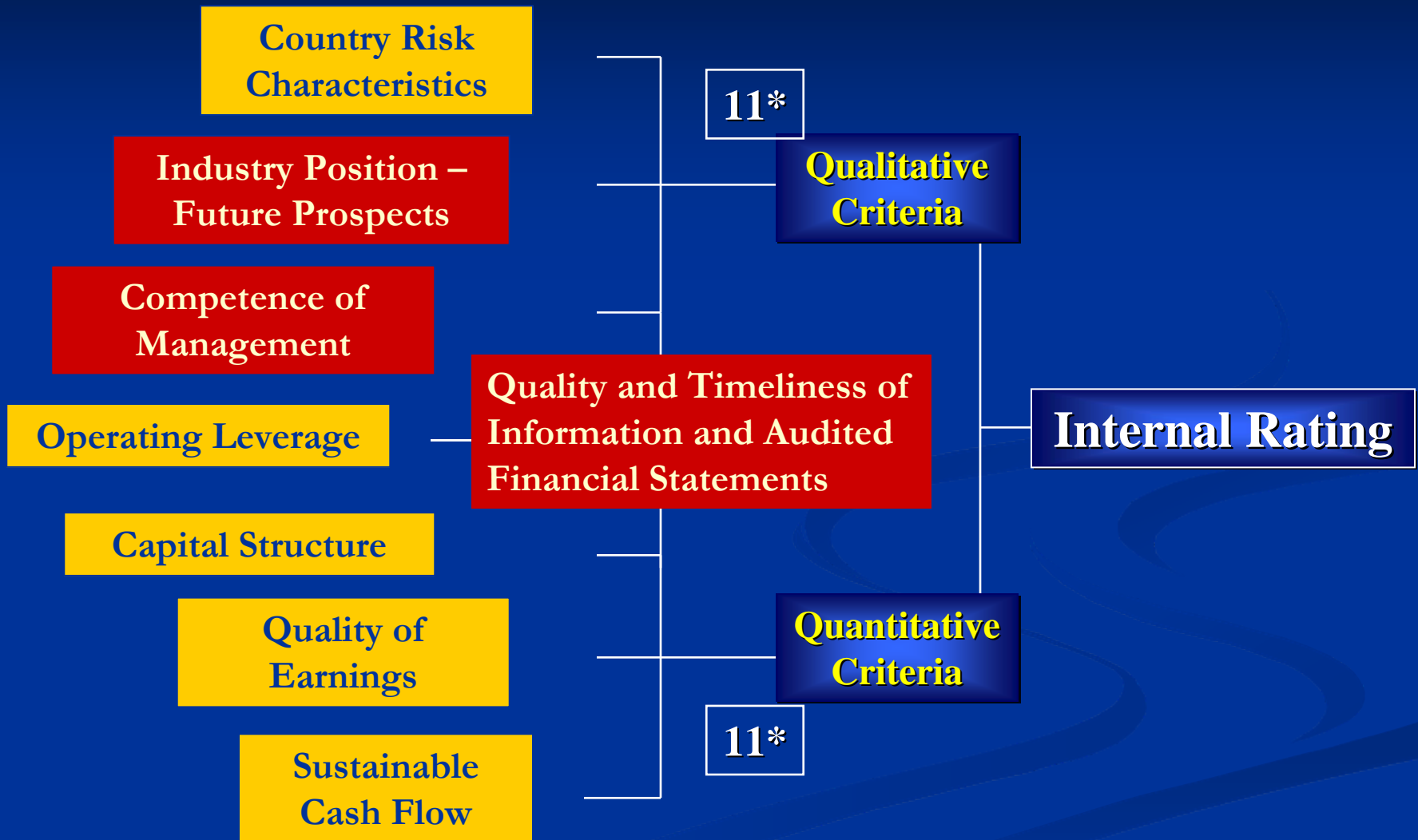
- 1. The formula: capital / weighted credit risk + OBS risks + operational risks
- 2. Regulatory responsibility
- 3. Market discipline

OPTIONS FOR MEASURING RISK

- **Standard ratings approach using external assessment (Rating Agencies)**
 - Current information
 - Accurate information
 - Eliminates banker's judgment in credit evaluation

- **Internal ratings approach**
 - Used by large banks with resources to develop their own risk models

BASEL II MINIMUM RATING CRITERIA



IMPACT OF BASEL II ON THE CORPORATE COMMUNITY

- Credit risk elements:
- Past and projected F/S
- Industry standing / historical data (D & B)
- Credit history / credit ratings (S & P, Moody's)
- = ACCURATE, RELIABLE, AND TIMELY INFORMATION

INTERNAL RATINGS APPROACH

- F/S: external audit, 3 year historical, 3 year projected
- 30 day submission for interim results
- 90 day submission for annual results
- Industry standing:
 - Market share
 - Peer comparisons
 - Management changes

BANK REQUIREMENTS FOR LOAN APPROVAL

- Up to date information
- Accurate information
- Information from reliable sources
- = Loan-seeking companies need to provide data

WHAT THIS MEANS TO COMPANY ACCOUNTING AND CREDIT DEPARTMENTS

- Frequent liaison with information and rating agencies
- Establish consistent paper trail of documentation to respond to details
- Forewarn bankers about any issues or discrepancies before bankers learn of these from other sources
- Keep abreast of credit terms with suppliers (avoid late payments reported to agencies)

OFF BALANCE SHEET RISKS

- Part of the denominator of Basel II formula
- OBS growth in recent years (5-10X assets)
- Loan commitments under lines of credit
- LCs
- Derivatives: forwards, swaps, options

LOAN COMMITMENTS UNDER LINES OF CREDIT

- Un-drawn amount is OBS
- Risks: interest rate risk for fixed rate loans / future liquidity risk / credit deterioration / aggregate funding risk
- Banks must allocate a portion of these risks to the Basel denominator
- Impact on CAR

OTHER OBS RISKS

- **Contingent liability of LCs adds to Basel denominator**
- **Derivatives: counterparty risk adds to Basel denominator**

WHAT OBS RISKS MEAN TO THE CORPORATE COMMUNITY

- Basel II costs of unused credit lines, LCs, and derivatives are built into bank pricing
- Use a sharp pencil to calculate your transactional needs
- Avoid bloating-up excess credit that may not be used

ISSUES OF TRANSPARENCY

- Western corporate culture: full disclosure, no secrets, SarOx
- Asian corporate culture: confidentiality, insider information, several sets of books
- Globalization is driving change towards “internationalized” business style
- Asian companies and SMEs moving towards more complete information disclosure about their operations

OLD DAYS OF BANKING IN EMERGING NATIONS

- Historical reliance on “name lending”
- Historical reliance on “SOE loans”
- Historical reliance on domestic bank monopolies
- No focus on risk management

NEW DAYS OF BANKING IN EMERGING NATIONS

- Analytical lending replacing name lending
- SME loans replacing SOE loans
- Global banking replacing domestic bank monopolies
- Risk management is king
- Risk management hinges on information availability

CONSEQUENCES OF INCOMPLETE DISCLOSURE

- Symmetric information demanded
- Lack of data will discourage banks to lend
- Companies must turn to suppliers for credit terms or alternative financing
- Supply chain sellers: heavier burden of providing in-house financing for customers
- Supply chain buyers: higher costs of doing business over normal bank financing

CONCLUSIONS

- **Basel II: A bank AND a corporate issue**
- **There is a penalty for lack of transparency:**
 - Companies need to provide accurate, current, and consistent information to banks, information agencies, and rating agencies
- **Practice what you preach:**
 - Credit managers seek disclosure and transparency from buyers
 - Likewise credit managers should practice disclosure and the art of transparency to their suppliers and banks

CONCLUSIONS

- Information sharing improves transparency:
 - Information companies should encourage businesses to provide peer ratio benchmarks, market share data, payment trends, and market potential as part of the information sharing process

CONCLUSION

- Lack of information = increases risk for banks
- Increased bank risk = higher capital provisions of Basel II
- Capital is a cost
- Bank loans, credit usage, access to data, transparency and information sharing are all viewed as mutually dependent business priorities



Bottom line: Good corporate governance