In perfect accord?

Basel II aims to level the playing-field by ensuring that everyone holds reasonable amounts of capital relative to their risk – but does it run the risk of widening the gap between the haves and the have-nots, asks **Neil Baker**?

Bankers have been arguing for years about the Basel II Capital Accord. Will the international agreement on minimum capital standards be a boost for their business or just an expensive compliance nightmare? The time to debate these questions is just about over. Parts of the Accord take effect at the end of this year and banks need to decide whether to steam ahead and adopt the full Accord as soon as possible, or take a more cautious approach. There is a slow lane for the faint-hearted, but do they risk being left behind in an increasingly two-speed industry?

On the face of it, the revised Accord looks like good news for banks. The Basel Committee on Banking Supervision says its new rules will result in a clearer link between the amount of capital banks set aside to cover risks and their ability to quantify and manage those risks. That will mean that banks can lend more money from the same capital base, which should produce higher returns on equity and rising share prices.

The change could unlock huge amounts of capital. The original Basel I Accord – released in 1988 – uses crude risk-weighted measures to determine minimum capital levels. Banks have to back up every EUR 100 of lending with at least EUR 8 of capital, according to PricewaterhouseCoopers (PwC). In a recent study, the firm predicted that Basel II could unlock some 5% of that capital in Europe – approximately EUR 100 billion. But these rewards do not flow automatically. To get the full benefit, banks need to invest heavily in information technology and management time. The concern is that smaller banks won't be able to afford it – and that early adopters, namely the larger banks, will be 'guinea pigs' for the rest of the industry.

The new Accord allows banks to choose one of three approaches to measuring risk-based capital: standardised, foundation or advanced. The foundation and advanced approaches rely on internal ratings data collected by the banks themselves. The standardised approach allows banks to use simple estimates. European financial institutions are scheduled to go live with the simpler approaches for calculating operational risk exposures under Basel II from 1 January 2007. The full range of approaches will be implemented from 1 January 2008.

Banks are rewarded for adopting more sophisticated approaches, but these require complex information technology and business systems. Banks implementing these approaches will need risk models that use detailed loss histories at an individual loan level with at least seven years of back data. PwC estimates that a large international bank could face implementation costs of between EUR 100 million and EUR 150 million over a five-year period. Compare that with a survey last year from Atos Consulting that found that eight out of 10 chief financial officers at European financial services firms had not even started work on Basel II systems.

Compelling case to adopt?

If banks are being cautious about the investment needed, that's understandable, says Helen Townsley, an analyst with Chartis Research, which provides information on risk technology. "The cost-benefit argument for adopting the advanced approach is not as clear and compelling as originally thought," she says. "Many organisations underestimated the costs and overestimated the benefits in their original assessment of their Basel II programmes."

Even those that have run their analyses face a clear dilemma, says Michel van Leeuwen, chief executive officer, risk management, Misys Banking Systems. "Should I jump on board now and take advantage of

being in the first wave – or should I save myself the trouble, take the higher capital charge for a while, wait for the software to standardise and jump on later when everything is much cheaper?" he asks. "There is always this conundrum: which road do you take?"

Chris Marrison, Risk Integrated

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Some banks will be in the slow lane, following the standardised approach set out by the Accord, but that needn't be such a bad option. Such banks will find that a gap emerges between them and their competitors, but allowing such a gap to emerge may be a valid business decision, says van Leeuwen, at least in the early days of the new Accord. Banks are also allowed to gradually shift parts of their loan book from the standardised approach to more complex measurement approaches. "This graduated approach is a sensible one that allows a bank a good deal of flexibility," says Savita Verma, a colleague of van Leeuwen's. But banks that decide to join the Basel II vanguard may benefit from their battle scars. The experience of dealing with early-adopter problems will contribute to a valuable store of organisational know-how. "That will help you go faster and better in the future," says van Leeuwen. "If you wait, then when you decide to jump in you are going to have to pay for that knowledge because you won't have it in-house."

Smaller banks face two main problems, says Chris Marrison, CEO of Risk Integrated. Firstly, the creation and management of risk tools of a given quality has an almost fixed cost that varies little with the size of the bank. Secondly, banks with few assets have less historical data, which makes it more difficult to make good risk models.

Misspent youth

Even without the Basel II regulations, banks with sophisticated risk measurement tools have a better view of their operations and can manage themselves better, and they have a

strong competitive advantage when creating new assets, Marrison continues. If they have a better understanding of risk, they can structure deals more tightly than their competitors and walk away from deals where they see the risk is greater than the return. That leaves the low-priced, risky deals to be done by banks that cannot differentiate the risk so well. "A good analogy is to think about options traders," says Marrison. "If one bank had option traders using their gut, and another bank had option traders using their gut plus option pricing models, which would you expect to win?"

But is this just a question of scale? There is a competitive distinction between banks that invest in sophisticated risk management and those that don't, says PwC director Richard Barfield, "but their ability to do so is not simply a factor of their size." A quick-footed small bank with vision can manage risk just as well as any large well-capitalised and technologically sophisticated bank.

While the Basel II Accord has a European base, its implementation is international. But regulators in other major financial markets, notably those in Asia and the United States, have been much less enthusiastic about its impact. Most Asian banks would have to invest millions of dollars in the data collection systems needed to predict loan defaults accurately. And they wouldn't have the necessary historical data. In fact, the Hong Kong Monetary Authority, the territory's central bank, warned recently of an unhealthy focus on the advanced Basel II risk approaches and said small and medium-sized banks should not go down that route because it offered the least clear long-term benefits.

Daniel Bouton, Société Générale.

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And in the US, after much wrangling, the four federal banking regulators announced last year that the country's banks would be expected to comply with the new Accord, but they would do so by 2008, a year after European banks. The delay for US banks is "a double edged sword," says Townsley of Chartis Research. European banks will have a headstart over US banks and will be able to take advantage of the capital reduction incentives sooner. But it also gives US firms time to think and consider their strategies and to learn from the mistakes of European firms. Townsley maintains that European firms have already "misspent millions on external consultants and technology. Much of this expenditure was knee-jerk and added little value to the real practical challenges of Basel II."

More widely, the fact that regulatory jurisdictions around the world are adopting Basel II on different timescales is cause for concern, says the Washington-based Institute of International Finance. "We believe that adoption of inconsistent versions of the Accord could ultimately disrupt the successful implementation of Basel II, undermine its basic fabric and create serious level-playing-field issues," says Daniel Bouton, chairman of the organisation's Regulatory Capital Committee and chairman and CEO of Société Générale. Bouton says these concerns are not just about Europe being out of sync with the US – regulators around the world, he believes, need to co-ordinate the introduction of the Accord more closely.

The Accord will widen the gap between the haves and the have-nots of the banking world, but Townsley says that is not a factor of the sophistication of the risk model that a bank deploys, or the amount of money that it throws at the problem. "The real gap will be between those banks that treat Basel II as a tick-the-box compliance project and do the minimum possible to comply, versus those that use it as a catalyst to improve," she says. Those that get it right will move beyond compliance and link risk information to everyday business decisions, such as better pricing, better targeting of customers and better capital allocation But that's if they get it right. As van Leeuwen says: "You'll only find out which was the right choice in the end – by which time it won't matter any more." //