Basel II: A new way to be a bank & an enterprise

Part I: The Basel II agreement will become effective in Hungary as of 1 January, 2008. With just a year until the definitive launch, larger banks have already begun to adopt the criteria of the agreement, and companies should also start to seriously evaluate the consequences.

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In recent years television, newspapers, and the media in general have spoken more and more often about disastrous situations in the economic and financial world. The necessity for reform has become increasingly clear: a radical and deep change for greater stability and transparency of the economic world and therefore for the protection of the whole of society. In such a context, although work on it started much earlier, the Basel II agreement has been gradually reached. The agreement represents an innovation of general significance, which will have a meaningful impact on local economic systems and will bring about deep changes in the various actors operating on the market (institutions, banks, enterprises, professionals) and in their mutual relations, and, more generally, in the culture of banking and business.

The birth of Basel II

The agreement takes its name from the Swiss city of Basel where the International Settlements Bank is based. The Committee of Basel has operated there since 1974 with representatives from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Spain, Sweden, Switzerland, United Kingdom and the USA, in order to promote and favour monetary and financial stability and collaboration between central banks. The Committee only formulates guidelines and recommendations and does not have any authority over the member states, but its proposals have been accepted - almost entirely - like binding norms for more than thirty years in nearly 120 countries.

In 1988 the first agreement was stipulated, known as Basel I. Initially, a few countries signed up but today it has more than 100 members. With this agreement a practical rule to control the banking system was defined, requiring that 8% of capital lent be set aside, in order to guarantee stability to the activities carried out. In the following years some amendments were introduced, until January 2001, when the new Basel II international agreement was born. This document opened the way to negotiations for the new formulation of the agreement, which led, among other things, to the introduction of the use of the rating concerning enterprises.

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In more detail, the new version of the agreement is founded on three "pillars".

The first pillar provides improved risk sensitivity in the way that capital requirements are calculated for three major components of risk that a bank faces: credit risk, operational risk and market risk. In turn, each of these components can be calculated in two or three ways of varying sophistication. Other risks are not considered fully quantifiable at this stage.

The second pillar deals with the regulatory response to the first pillar, giving regulatory authorities much improved "tools" over those available to them under Basel I. It also provides a framework for dealing with all the other risks a bank may face, such as name risk, liquidity risk and legal risk, which the accord combines under the title of residual risk.

The third pillar greatly increases the disclosures that the bank must make. This is designed to allow the market to have a better picture of the overall risk position of the bank and to allow the counterparties of the bank to price and deal appropriately.

In order to evaluate the risk the rating was introduced, aimed at setting insolvency risk level, in which a company can be classified.

In this way the lower the rating obtained by a company, the higher will be the set aside the bank has to make in order to face the higher risk, therefore the bank could ask for higher interest rates. The rating might be assigned externally from private agencies or determined inside the bank according its own methods. The rating will be assigned based on the credit history of the company and according to other parameters like liquidity or profitability.

The criticism

The Basel II Accord has also received some criticism.

The first critical observation is that the more sophisticated risk measures and instruments of analysis will unfairly benefit the larger banks that are able to implement them, giving them an additional competitive advantage.

Another criticism is that Basel II will lead to a more pronounced business cycle. This is because during a downturn in the business cycle, banks would need to reduce lending, increasing the magnitude of the downturn.

Finally, others think that for small and medium-sized enterprises the rating will simply be an additional restriction to accessing credit.

The role of finance

The agreement will however soon enter into force and small and medium-sized enterprises (SMEs) have to prepare themselves for the event, taking seriously into consideration the role of finance, which they always underestimate. Undoubtedly the challenge of Basel, if correctly used, will represent a great opportunity for SMEs. It will lead to continuous improvements of companies' financial systems, and therefore the ability of companies to adequately foresee, prevent and face periods of crisis and market turbulence, and, for companies within specific parameters, it will represent an important opportunity for decreasing costs.

Therefore the role of business financial planning and management control will have greater importance. SMEs rarely have an appropriate finance function to deal with such aspects inside the company.

Often the entrepreneur personally manages the relationships with the banks and often goes to the bank only at the very last moment.

Basel II will therefore lead companies towards thinking thoroughly about the state of their capital structure in terms of risk.

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