

CREDIT RISK MANAGEMENT IN TERMS OF BASEL III

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ABSTRACT

As volatility has become the dominant environment in which banks operate, they were put in a position to meet new challenges and to face greater risks, reason for the Supervisory Institutions to develop complex models for credit risk management. On the other hand the financial crisis has shown that Basel II has several shortcomings and must be upgraded so the Basel Committee on Banking Supervision (BCBS) proposed in the end of 2009 Basel III, a comprehensive strategy for regulation, supervision and risk management of internationally-active banks.

KEYWORDS: *credit risk, management, financial crisis, Basel III*

The characteristic of the contemporary world is the uncertainty. Banks are regarded today as institutions that manage the risk, since any banking transaction both domestic and international is subject to a set of independent risk factors. Banking operations encompass a wide range of activities, all of which contribute to the asset and liability profile of a bank. Credit risk, also known as basis risk and asset quality risk, is considered as a risk of insolvency of the debtor's failure manifested by customers under the bank credit agreements in terms of repayment to the bank. Bank asset and liability management, an art as old as banking itself, is a cornerstone of financial risk management.

Uncertain macroeconomic environment, the deceleration of economic activity, visible with the last quarter of 2008, currency devaluation and liquidity problems in international markets, marked slowdown of growth rate of non-government loans. Consequently, the dynamics of bank assets (Figure 1) decreased significantly in 2009 year, 5% to 26% in 2008.

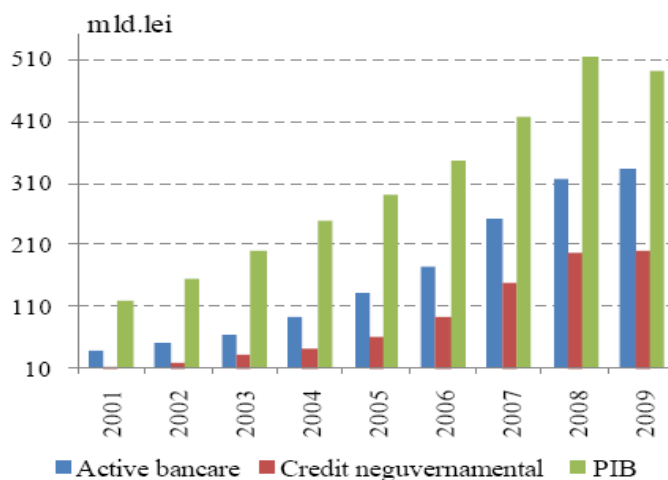


Figure 1 Evolution of banking assets and non-governmental credit share in GDP
Source: NBR

The analysis of capital adequacy indicators (Figure 2) allows us to formulate the following conclusion:

- The year 2008 witnessed slow downward trend of the solvency ratio calculated at the aggregate level for credit institutions, and reached 12.3% at the end of December. At the end of March 2009, the indicator stood at 13.2%, followed by a slight increase by March 2010.

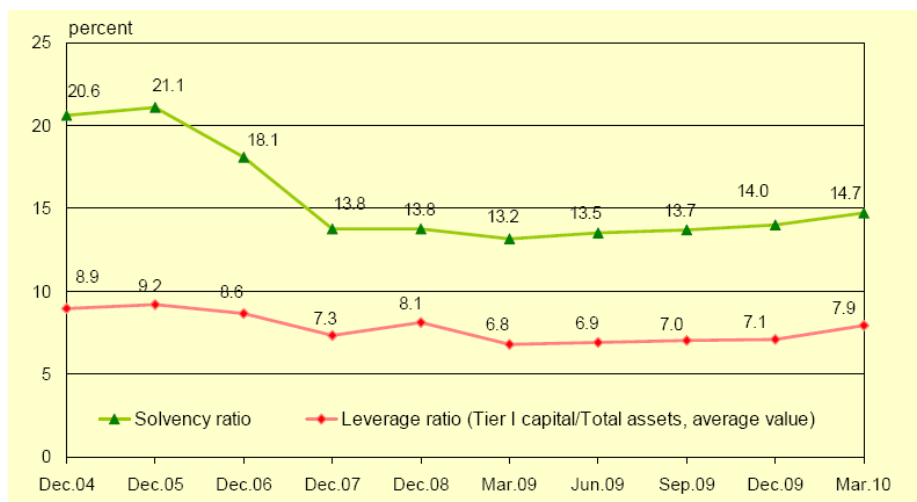


Figure 2 The evolution of capital adequacy indicators
Source: Florin Georgescu - *Macroeconomic indicators and developments in the recent Financial Sector Crisis context*, Bucharest, 2010

Determining factors for this situation were to increase the capital stock of credit institutions, as well as slower growth rate of non-government, especially in the latter part of 2008 and first quarter of 2009.

Even in terms of maintaining a generally downward trend, the solvency ratio stands at an appropriate level for all credit institutions, being higher minimum threshold required by prudential regulations applicable in Romania (8%) harmonized with EU standards. Calculated at the aggregate level for the Romanian banking system, the solvency ratio stood in December 2009 at a level comparable to many EU countries.

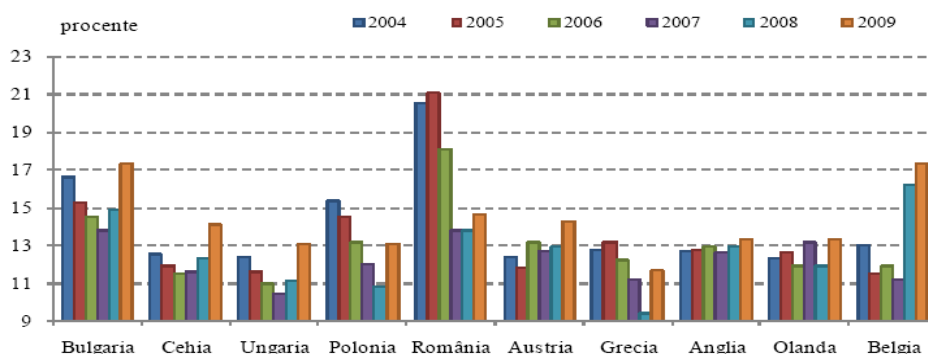


Figure 3 Comparative evolution of the European Union solvency ratio

Source: IMF - Global Financial Stability Report (April 2010), NBR

For countries from the European Union solvency ratio is the most important indicator of banking prudence, with the objective to provide capacity to cope with failures of banks and to mitigate competitive inequalities between different national systems.

The new Accord Basel III - a modern approach of banking risks

Implementation of Basel II from 1 January 2008, required the acquisition and adaptation of reporting forms developed by the Committee of European Banking Supervisors (CEBS) and ensure comparability of financial information reported to the supervisory authorities of the European Union.

The financial crisis has shown that Basel II has several shortcomings, which is why it needs an update. The most important items concerned are:

- The average level of capital required by the new discipline is inappropriate and this is one of the reasons for the recent collapse of several banks;
- Capital requirements under Basel II regulations are cyclical and therefore tend to reinforce the business cycle fluctuations;

- Under Basel II, credit risk assessment is delegated to non-bank institutions such as rating agencies, which can lead to potential conflicts of interest;
- Key hypothesis that internal models to measure risk exposures are above proved to be wrong ;
- The new framework provides incentives for intermediaries to weak the balance of some very risky exposures;
- Pillar I and Pillar II were given very little attention. It requires a transparency of a bank's risk profile and a good understanding of both the risk profile, and the risk positions of a bank.

Committee on Banking Supervision Basel (BCSB) has proposed a comprehensive strategy to address the fundamental weaknesses revealed by the crisis on financial market regulation, supervision and Risk Management of bank assets internationally.

The main objective of this strategy is to strengthen the capital reserves and also to promote stronger risk management and governance practices to limit concentrations of risk in banks. Finally, the main objective of the Basel Committee is to ensure that the banking sector serves its traditional role as shock absorber for the financial system, not an amplifier of risk between the financial and real economy.

In the end of 2009, the Basel Committee has issued two papers for consultation: Strengthening the Resilience of the banking sector and International Measurement framework for liquidity risk, Standards and Monitoring. These documents contain two sets of proposals to strengthen the global capital rules liquidity in order to promote a more resilient banking sector. The main purpose of these packages was to address the advisory lessons of the crisis about regulatory, supervisory and bank risk management worldwide.

The main elements contained in the first document, Strengthening the Resilience of the banking sector are:

- First, the quality, consistency and transparency of the capital will be raised. This will ensure that international banks assets are in a better position to absorb losses.
- Secondly, operational risk capital will be strengthened. The Committee also seeks to strengthen capital requirements for counterparty risk exposures arising from derivatives, repurchase agreements, securities and financing activities. These items will enhance the resilience of individual banking institutions and reduce the risk of transmission of shocks from one institution to another through derivatives and financing channels.
- Thirdly, the Committee will introduce a leverage ratio as an additional measure in order to migrate to a pillar and calibrated based on proper analysis. To ensure comparability, the details of the leverage ratio will be harmonized internationally fully adjusted for any remaining differences in accounting. The report will be calibrated so as to serve as

an additional credible risk-based requirements, taking into account future changes in the Basel II framework

- Fourthly, the Committee will introduce a series of measures to promote the establishment of capital reserves in good times, which can be used in times of stress. A cyclical capital framework will contribute to a more stable banking system, which will reduce the financial and economic shocks. In addition, the Committee will promote the provisioning based on expected losses.
- Fifthly, it will introduce a global standard minimum liquid assets of international banks, which include the calculation of rates for 30-day liquidity; this will demand a sustained and long-term reporting. The framework also includes a set of measures for monitoring by supervisors to identify and trend analysis of liquidity risk in the entire system. These standards complement the principles Monitoring Committee management and supervision of liquidity risk issued in September 2008.

According to Basel III, signed by the Committee of Banking Supervision Banks need to triple by 2015, capital reserves of high quality, up to a 7% capital adequacy. Thus, banking authorities and major global central banks decided to increase the capital base rate ranking first (core Tier 1) to 4.5% from 2% at present. However, the total rate was established at Tier 1, 6%, compared with 4% today. Banks will need to build a new type of reserve, the "preservation of capital, of 2.5%, along with Tier1 rates, consisting of common equity and if the banks will be reported as having "excessive credit conditions" that will create "a counter-book", of 0 - 2.5%.

The second document, the International Measurement framework for liquidity risk, Standards and Monitoring, is considering several key principles of a robust framework for managing liquidity risk at banks to protect depositors and enhance the overall stability of the financial system.

These principles are listed below:

- management and supervisory board;
- establishment of policies and risk tolerance;
- use of instruments of liquidity risk management, such as comprehensive cash flow forecasts, liquidity limits and stress testing scenarios;
- robust and comprehensive development plans for emergency funding;
- maintaining a high level for assets easily converted into cash to meet liquidity needs quotas .

Announcing the review proposal for Basel III contains very important information, which as it seems, went unnoticed. At first view document contains only rules that, in general, have become less stringent in comparison with the December version of the document. Obviously this gives a very optimistic perspective of banks, especially those from Australia and Japan will see a return their short-term.

Since last year, European nations like France and Germany have lobbied for regulations Basel III to be less severe and the Basel Committee on Banking Supervision has responded by reducing the number of exclusions and by establishing a satisfactory transition period.

The main changes:

- Core capital ratio (Tier 1 capital ratio) – excluding less stringent rules. Two points were removed from the list of mandatory exclusions announced in December, namely: intangible assets and deferred tax assets. Other points are now partially returned to the capital ratio, after initially have been removed: deferred tax assets and investments in common shares of financial institutions should be allowed. For both elements prescribed limit is 10% of the common stock component of the bank.
- The definition of leverage (Leverage ratio) – the minimum leverage effect is 3%.
- Liquidity coverage ratio – the run-off rates were low, while the rate term loan financing available for longer term was extended. The proposal includes a response to country risk, which has worried the market lately, a 15% discount on certain bonds.
- Gradual introduction period. Implementing the new regulations will begin in January 2013 Tier1 and should be completed by early 2015 and implementation of new conservation reserves of capital out of phase will be introduced in January 2016 - January 2019. The transition period, older for Basel II, appears to be due to lack of evidence of a real recovery in the global economy and the current situation in various countries.

Relaxation and long introduction period should cause concern because the banks earnings will be revised, so they will have to provide more capital reserves. The fact that relaxation is more significant in comparison with the original version of the document in late 2009, should generate long-term concern in financial sector, especially in Europe and USA.

Presently in these regions there are taken action to repair the balance sheet, but this process can be revived simply by considering a higher level of risk and considering the regime of very low interest rates, which would be truly tempting. In the short run this will have a major effect on the institution both in terms of earnings and balance sheet repair and in the long run will attract serious risks for a new banking crisis caused by excessive risk taking, so that European and U.S governments so indebted will find extremely difficult to help others.

Basel II has proven to be a milestone in international banking supervision due to the complexity and the need to coordinate regulations in many countries. It is designed to align the bank's capital against the risks. Due to developments in the financial crisis - bank failures, massive capital injection by governments – there are expected changes by the Basel Committee. As a result, will be giving up certain asset classes and there will be increasing in others. In this way, banks will allocate

capital to sectors that offer the best return on capital. Basel III aims to reconfigure the entire regulatory and supervisory framework for banking activity, with emphasis on early warning component of the risk of escalation.

In terms of economic production new regulations on capital liquidity banks will have only a modest impact in the period that will be introduced, but will bring substantial benefits in the long term, according to the institutions charged with drafting rules Basel III.

Basel Committee for Banking Supervision and Financial Stability Council (FSC) believe that the regulations will tighten credit conditions and reduce investment in the transition period in a much lower level than what banks expected.

Also, new rules will significantly reduce the incidence of financial crisis and implicitly of economic slowdown that they cause- benefits that will exceed by far the modest loss of production that will be seen in the years to be introduced. FSC President considers that the macroeconomic cost analysis shows that the implementation of more solid standards will be tolerable while long-term benefits of financial stability and stable economic growth will be substantial. According to the FSC studies, the overall gross domestic product will decline by 0.2% for each percentage point of growth in the ratio tangible capital to risk weighted assets for the next four years.

Most financial institutions have now much higher reserves than the minimum required by law, therefore the new set of rules Basel III, will require, most likely, a capital adequacy ratio of 4-6%, a realistic level for banks capital.

In conclusion we can say that banking supervisors should periodically evaluate the effectiveness of policies for bank credit risk and practices used in assessing its quality. Also they must have confidence that the methods employed for calculating bank reserves against losses will produce an accurate measurement of potential losses on loan portfolio, losses will be revealed in due time. A banking strategy should include performance management programs and procedures designed to minimize the likelihood and potential exposure risks to the bank. The main objective of these policies is to reduce losses or additional expenses incurred by the bank and central bank activity objective is to achieve a higher profit for shareholders.

Economic and financial crisis takes a big surprise to us all. Degradation global situation continues, so that measures taken yesterday appear to be insufficient today. This leads to loss of confidence, which greatly complicates the management of economic and monetary policy. It requires clear objectives and milestones, prudent and realistic. In this sense nothing could be more negative than the continuous change of parameters. Should the authorities to focus on all means of protection for achievement, and this is especially true in matters of commercial banks.

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