HOW BASEL II IMPACTS ON THE WAY THAT BANKS DEAL WITH BUSINESS CUSTOMERS

IRISH BANKING FEDERATION

Introduction

Business customers will have noticed that banks have adopted a more standardised approach in their dealings with them. New banking regulations have driven this change.

Just as money laundering legislation requires banks to obtain documentary evidence of proof of identity and proof of address from businesses who deal with them, the European Capital Requirements Directive (often referred to as BASEL II) requires banks to make noticeable changes in their dealings with customers who borrow from them.

BASEL II has introduced new regulations relating to the capital which banks must hold to support credit risk.

More capital is now required if customer credit risks increase, because defaults would be more likely and higher bad debts would be borne by banks.

Thus, comprehensive and up-to-date information, such as the Annual Accounts and the business's prospective performance, need to be provided to banks in order to ensure that credit risks are properly assessed.

Basel II encourages the use of bank internal credit scoring systems to assess credit risks. These systems, also called internal ratings, depend greatly on accurate and comprehensive customer information.

The regulations also require that documentary evidence supporting internal ratings decisions is kept by banks and that banks can explain their internal rating decisions to customers if requested. Further details on the credit rating process can be found in The Credit Rating Process for Business Customers Explained at http://bit.ly/IBFBasel2.

Therefore, business customers should ensure that relevant information is provided, not only at the time when credit is being requested but also on an ongoing basis, to ensure that credit ratings are updated as circumstances change.

Compliance with Basel II is in the interests of Business Customers

Basel II requires banks to apply conservative assumptions where information is not sufficiently adequate to support high customer credit ratings. These assumptions are subjected to inspections by the Central Bank.

So business customers who do not provide timely and accurate information may not benefit from as high a credit rating as might otherwise be the case.

In many instances a more comprehensive understanding of credit risks has facilitated a more supportive approach to requests for credit facilities due to a better understanding of business prospects. returned unpaid. Statistically, this approach has been shown to be more consistent in identifying acceptable credit risks to banks than manual assessments of borrowing requests. Behavioural scoring may be used in conjunction with application scoring to enable a lender to consider whether they should lend money or not.

It is important to note that lenders have different lending policies and scoring systems. As a result, applications may be assessed differently by banks.

Implications of Basel II for Business Customers

1. Credit risks vary according to the type of finance provided

The new regulations differentiate between loans depending on the purpose for which the borrowings are required. The amount of capital that a bank must set aside to support a loan reflects the level of risk assessed by the bank. For example, property development loans are proven to be riskier than property investment loans; mortgage loans which are secured by the owners' principal residence are seen by the bank to have lower risk than buy-to-let loans.

2. Credit regulations also vary depending on the level of credit facilities sought by the business

The capital regulations for retail business customers are different and higher for aggregate exposures over certain thresholds.

Corporate SMEs are defined as those businesses whose annual turnover does not exceed €50m. Corporates with greater turnover are classified as

Large Corporates and their loans are subject to different Basel II regulations.

Basel II regulations have also introduced a new requirement that capital is needed to cover all unutilised facilities.

3. Longer-term credit facilities are deemed to be higher risk than short-term credit

More stringent criteria have to be applied to the approval of long-term credit facilities due to the additional uncertainty associated with loans with longer maturities.

4. Past Due loans are classified as being in default

Basel II regulations stipulate that a business whose account is out of order for 90 days must be classified as being in default. As a consequence of this, intense activity now takes place when an account goes out of order so as to try find within the 90-day timeframe a solution that protects a customer's credit rating.

Also, Basel II attributes an increased danger of default where overdrafts are frequently out of order, so overdrafts should continue to be used only to meet seasonal credit requirements.

5. Comprehensive information on financial performance is required from businesses in order to ensure that credit risk is accurately measured

Credit assessments cannot be properly carried out without up-to-date financial information, as banks' own internal credit ratings are heavily dependent on such information. Improving trends need to be incorporated and, also, early identification of issues should facilitate timely remedial adjustments.

6. Security underpinning a borrowing can only be taken into account when collateral is properly in place

Legal documentation has to be in place in order for collateral to be recognised. While not an explicit Basel II requirement, existing practice - whereby documents prove compliance with the Family Home Protection Act - does strengthen the legality of collateral. Also, guarantees should continue to be witnessed by qualified persons.

Residential property and commercial property security arrangements are subject to different assessment and valuation procedures.

The Irish Banking Federation (IBF) is the leading representative body for the banking and financial services sector in Ireland, representing over 70 member institutions and associates, including licensed domestic and foreign banks and institutions operating in the financial marketplace here.

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