

CREDIT RISK - BASEL II RULES AND STANDARDIZED APPROACHES

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Abstract:

Credits are one of the most important sources of financing. Determining the cost of credit that will be granted to companies is determined based on the risks associated to them. The banks take all necessary measures to ensure efficiency of warranty contracts and to manage all afferent risks, at their conclusion and during the development period.

Key words: credit risk, guarantees, banks, Basel II agreement.

JEL classification: G21

1. INTRODUCTION

The changing environment in which banks operate generates new business opportunities, but they also involve higher and more complex risks that, in return, it is a real challenge, as it is threatening to the traditional approaches of bank management.

The scope of comprehensive warranty management is to minimize the additional risk that arises from accepting warranty such as assessment risk, management risk, etc.

The measures for diminishing credit risk, specific for banking entities refers to those techniques for diminishing credit risk as part of the guaranteed loan and basically follow these purposes:

- Including all relevant requirements of EU Directive Basel II on the eligible guarantee instruments and the attenuation techniques in credit risk within the rules regarding the minimum capital requirements;
- Revaluating guarantees under the uniform procedures and methods of the Group;
- Ensuring the strength, the legal applicability and implementation of revaluated warranties considering the legal provisions on diminishing risk techniques, used by credit institutions or investment companies;
- The guarantee' s adjustment level, taking into consideration the local conditions and the risk management process;
- Continuous monitoring of warranty value.

Guaranteed crediting is a transaction in which the bank owns a credit application or possible credit application and it is totally or partially covered by a guarantee of a borrower or a third party in favor of the borrower.

2. OBJECTIVES AND TECHNIQUES FOR DIMINISHING CREDIT RISK

The purpose of warranties acceptance is to minimize losses from occurrence of an event of default (credit risk) by avoiding losses or by transferring risk.

The main objectives in order to provide the warranties are:

- a. for tangible guarantees, the credit value relevant for the risk is reduces by the revenue estimated to be realized from pursuancing guarantees and such losses can be avoided;

- b. for letters of guarantee or other type of commitments, the risk is transferred to the supplier of the guarantee in question.

Assuming a guarantee from the debtor leads to its full acceptance of the business risk.

Risks that can arise from the acceptance and evaluation of the guarantee are:

- The **risk of price modification** occurs if the market value used to determine the material value is not a real one;
- **Currency risk** occurs if the credit currency is different from the one of the related guarantee;
- **Legal risks** if the guarantee is not legal from a juridical point of view;
- **Country Risk / Transfer** refer to the place of origin of the guarantee, the political and economic conditions of that country;
- **The guarantees' execution risk** refers to liquidity risk. If the executed warrant can be valued at the expected price and at opportune time considering the execution costs;
- **Correlation risk** refers to the fact that the guarantee's value may decrease with the decline of borrower's credit rating;
- **Residual risks** that arise if administration or management mistakes were made.

The net revenues realized from the execution of guarantees will be lower than the material value of the originally calculated guarantee, if these risks are not considered or are considered partially in determining the material value of the guarantee. Consequently, the uninsured part of the credit will increase further.

Therefore, these risks must be minimized, measured and controlled.

The techniques used to protect credit, together with the actions and the followed steps, procedures and policies implemented by a banking company will be in a way so that they will have as a result agreements for credit protection with legal and enforceable power in all relevant jurisdictions.

The Banks shall take all measures necessary to ensure the efficiency of warranty contracts and to manage all risks, when they are concluded and during their ongoing period.

Regarding the credit's financial protection, in order to be eligible guarantees must meet the following characteristics:

- to be sufficiently liquid;
- their value in time should be sufficiently stable.

If the event of credit default occurs or the appearance of any unjustifiable event, the banks have the right to liquidate or retain in time the derivative asset of collateralized exposure.

3. WARRANTIES USED IN THE REDUCTION PROCESS OF THE NEED FOR CAPITAL

For credit institutions, in 2008 came into force a new Capital Agreement (Basel II), which on the one hand makes the capital needs more dependent than before the risk assumed, and on the other hand properly takes into account the modalities of the financial markets and the risk management.

In the future banks will have basically three modular approaches available for calculating regulatory capital:

- standardized approach;
- fundamental approach;
- advanced approach.

In the case of the standardized approach, calculating weighted value of the rated assets in terms of risk is done by allocating the risk ration. The standardized approach under Basel II offers a wider variety of coefficients by allocating risk ratios for

individual credit positions considering the external ratings from the known rating agencies. Depending on the external level of rating the externally rated exposures receive a risk coefficient of 0%, 20%, 50%, 100% or 150%. The unquoted exposures receive a coefficient of 100%.

All accepted guarantees are registered in the registration system of guarantees under an appropriate specific form.

In the table below there are represented the types of guarantees accepted by banks.

Table 1 Types of guarantees

GUARANTEE CATEGORY	TYPE OF GUARANTEE	ELIGIBILITY Y / N
Personal Guarantees	- warranty / downstream - bill supplied by others - direct repurchase agreement - solid letter issued outside the bank - risk assessment	Y
Credit derivatives	- Standard Credit Default Swap Operations - Total Return Swap Operations	Y
Life insurance	Life insurance guarantee with indomitable redemption value.	Y
Financial Guarantees	- Guaranteeing with deposits of securities - Guaranteeing with cash warranty - Gold Guarantee	Y
Residential Properties	Rank I mortgage on residential real estates occupied or rented by the owner.	Y
Balance sheet compensation		Y

Source: Banking rules for credit risk. Basel II standardized approaches (R 077/ 2008)

The guarantee is a secondary source for credit repayment. Warranties may consist of:

- Assets that are guaranteed or mortgaged in favor of the bank;
- Rights issued in favor of the bank.

The guarantee contracts must be mandatory and legally enforceable ("title" and "modus") for all parties in all legal systems relevant for material or eligibility evaluation of the warranty to reduce capital requirements. The basic requirement for the material assessment of the guarantee is therefore legal certainty and stability. Regarding the necessary solidarity special attention should be given to insolvency or the law on appeal or other problems (protection of third parties) that could raise questions about the legal enforceability and also the timely fulfillment of the guarantee.

Therefore, they must ensure that the non-execution of the guarantee doesn't take place due to legal reasons. Moreover, the applicable national law is therefore of decisive importance for these guarantees to be legally enforceable. In the case of cross-national

transactions guarantee (the guarantee's country of origin differs from the borrower's home country) legal issues must therefore be carefully checked.

During the acceptance of the guarantee, or if a change in administering the existent warranty occurs, the legal applicability should be checked enough every time, considering the political and economic risk factors (country risk).

In terms of guarantee contracts, a distinction can be made between standard contracts and the individual ones.

All contracts internally generated in banks and centrally administered by documents generation systems are considered standard contracts. The juridical security of these contracts should always be checked before by the local legal department. The standard contracts used must be identified by a version number. All the other guarantee contracts are considered individual contracts. These contracts must be verified by the local legal department, or by a suiting outside lawyer as to its enforceability from a juridical point of view.

A written guarantee contract is a basic condition for material assessment of the accepted guarantee. The guarantee contract must be concordant documented and it should provide a clear and solid procedure for the execution in time of the guarantee .. If changes arise regarding the legal framework, guarantee contracts must be replaced depending on the circumstances.

Counterparty risk (business risk) includes the implicit risk of default. Country risk (political risk) includes the facts in which the political situation is causing a non-compliance with an obligation. This includes transfer risk, in the situation related to the currency of a country; it may cause a failure to pay the owed amounts. In general, a warranty should cover both risks. The exception when a guarantee agreement covers only one of these risks happens only in the case of certain debts and credit insurance (for example the guarantee from export credit agencies).

Regarding the monitoring of enforceability, in the event that relevant changes of legal rules in a country with a resident bank take place, there should be a proper exchange of information between the local legal departments of the banking group.

At the first signs of prolonged deterioration on the creditworthiness of a customer, based on the right of termination, guarantees must be collected immediately from the debtor's assets to secure an existing loan commitment.

While the guarantee reduces credit risk, at the same time it increases other risks (residual risks) to which the bank is exposed by accepting the guarantee.

In banking entities it was considered the implementation of robust measures and procedures to control these risks. These include:

- defining specific strategies regarding the guarantee's acceptance process as Measures for Diminishing Credit Risk starting with the first phase of the loan process;
- defining the assessment principles for the related procedures;
- implementation and re-parameterization the existing guarantee administration system;
- controlling if the contract terms were realized.

As it is known, credits are one of the most important financing sources. The cost of the credit that will be granted to companies is determined based on the risks associated with them. As such, evaluating the clients' trustworthiness in accordance with the classification systems implemented by international agencies recognized by rating, could impose excessive costs of the loan capital, especially regarding small companies, unlisted in Stock exchange or relatively new companies, which can not follow a historical evolution in time of the financial indicators associated with them.

4. CONCLUSIONS

The standardized approach and the banking rules on diminishing credit risk, demonstrates the importance which regulation and supervision on prudential basis of the main components of a banking system is shown for ensuring the economic and financial health of a country.

Only the development of a coherent and robust framework in the prudential supervision domain, will allow Romania to strengthen a modern and efficient banking system.

The legislative framework specific for prudential supervision domain must be correlated with the requirements of European directives, as well as with close cooperation at regional level between the regulatory institutions in banking.

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