Practical Implications of the New Basel Capital Accord for the European Banking System
Results & Analysis of an Industry Survey

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After five years of negotiations, the Basel Committee on Banking Supervision reached agreement in May 2004 on new global capital adequacy rules. Widely known as ‘Basel II’, the accord represents a major revision of the international standards for bank capital adequacy that were first established in 1988. This final agreement was made possible by a compromise that was proposed in the negotiations taking place in Madrid in October 2003, to allow banks to continue setting aside capital for unexpected losses only, rather than to make additional provision for expected losses, which had met stiff opposition from banks. By adopting a “more risk-sensitive capital framework”, Basel II permits a better alignment of regulatory and economic capital and promotes improvements in risk management, thereby underpinning banking solvency.

These new rules are expected to enter into force at the end of 2006. In Europe, all credit institutions and investment firms will fall under the new capital regulation. This will certainly bring new challenges for implementation not only for institutions but also for national supervisors.

In light of the Basel II process, CEPS has carried out a survey on the practical implications of the new Basel II Accord for the European financial system. A questionnaire was distributed to 250 participants at a conference jointly organised by CEPS with FESE (Federation of European Securities Exchanges) and PwC (PricewaterhouseCoopers) on The Changing Regulatory Regime in Europe: A Challenging New Business Concept in November 2003 in Brussels. This conference brought together market participants, regulators and academics to discuss the issues raised by the Basel II process almost a month after the Madrid compromise. Accordingly, in order to achieve a direct assessment of how deeply the current proposal has been understood and accepted, or eventually objected, throughout the European financial industry, CEPS undertook a statistical analysis of 54 relevant responses collected.

Representatives of the financial industry, mainly bankers and market supervisors, responded to questions in the following seven areas of major interest:

1. General aspects of the New Capital Accord
2. Impact of the New Accord on European banks
3. Impact on the financing of SMEs (small- and medium-size enterprises)
4. Competitive implications of the New Accord
5. Costs and benefits of the New Accord
6. EU and US implementation
7. Remaining issues and policy recommendations

Each area has been articulated in 23 question sets of varying lengths. The questionnaire has been structured in a multiple-choice format, but it also allowed for the ranking of different answers and explicitly invited comments.

The results of the survey are reported in the following pages, illustrated by graphs.
1. General aspects of New Basel Capital Accord

The CEPS survey confirms a certain sense of optimism, despite some elements of persisting hesitation, among the industry members.

1. How do you qualify the overall process surrounding Basel II?

The respondents showed a large approval for the overall Basel II process (Figure 1) and a general confidence in its implementation according to the time schedule (Figure 2).

2. How confident are you that Basel II will be implemented by 1 January 2007?

Bankers still harbour some uncertainty, however, are reflected in the face that 53% of the respondents indicated that an additional impact study would be necessary to recalibrate the Accord (Figures 3-4).

3. Do you think a QIS 4 is necessary to improve the calibration of the new Basel Capital Accord?
4. If yes, what are the main sources of improvement?

In addition, as shown by Figures 3-4, further refinements of the proposal and, in particular, a clarification of some controversial definitions would be welcomed by a significant share of the respondents.

Broadly speaking, banks are generally positive, but they expressed a cautious position on their ability to fulfill certain compliance obligations under Basel II. For example, they expect “significant difficulties” in processing the large volume of data generated by the New Accord (Figure 5).

5. Do you believe that there will be significant difficulties in handling the data volumes that will be generated by Basel II compliance applications?

Such reservations can probably qualify, but surely cannot undermine the general positive impression that banking practitioners have of Basel II (Figures 2-3).

2. Impact of the New Basel Capital Accord on European banks

The opinion that compliance with the New Capital Accord will entail major difficulties, especially in credit and operational risk modeling, is common within the industry (Figure 6). The survey also highlights how validation by regulators of the risk treatment processes is significantly viewed as a potential burden.

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1 For instance, 27.5% of the respondents asked for clarification of the distinction between expected (EL) and unexpected losses (UL) in the IRB approaches, consequently revising the treatment of provisions and risk mitigants.

2 25% of the respondents to question 6 placed the supervisory review included in Pillar 2 as their first concern about the implementation of the New Accord, and those who chose it as second were only slightly fewer (around 20%).

3 This result is consistent with the evidence addressed later in section 7, which shows fears of significant compliance costs related to cross-border operations (due to home-host supervisory coordination problems).
6. Which area of the Basel II Accord do you believe is going to be the most difficult to implement?

These worries should not necessarily be interpreted as referring only to the adoption of the more sophisticated approaches; a certain scepticism was also expressed concerning the capacity of small banks to meet the new regulatory requirements (Figure 7).

7. Do you think that small- and medium-sized banks are ready to implement Basel II?

In addition, while most respondents agreed on the strategic importance of utilising the advanced approaches as soon as possible (Figures 8-9), at the same time they also indicated that they anticipate onerous compliance costs (Figure 10), which will probably be largely due to the IT infrastructure and data treatment required by such methods.

Therefore, the survey points to a plausible scenario in which banks that cannot afford the investments necessary for IRB and AMA methods are priced out of certain markets because of their misalignment with the prevailing benchmarks (Figure 11).

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4 The Basel II competitive implications are more specifically addressed in section 4.

5 Even more significantly, almost 30% of the respondents to question 11 remarked that adherence to the Basel II’s more sophisticated standards cannot in itself provide any competitive advantage, since it is simply an essential prerequisite for acceptance in the market.

6 This idea is supported by the answers to question 18, which are shown later on in the text.
8. To what extent will the capital savings while using the IRB approaches offset the implementation costs?

![Bar chart showing the distribution of responses to the question about capital savings offsetting implementation costs.]

- Benefits prevail
- Benefits marginally outweigh costs
- Costs marginally outweigh benefits
- Costs prevail
- Cannot say

9. According to you, how important will achieving the highest possible implementation standards (AMA for operational risk and Advanced IRB for credit risk) be for banks?

![Bar chart showing the distribution of responses to the question about the importance of achieving the highest possible implementation standards.]

- Provides valuable differentiation
- Necessary for market acceptance
- Useful but initially too expensive
- Lower standards are enough

10. Give estimation of Basel II compliance costs for your bank (including both credit and operational risks).

![Bar chart showing the distribution of responses to the question about Basel II compliance costs.]

- From €1m-€5m
- Between €5 and €20m
- More than €20m
- Difficult to estimate
- Not applicable
11. Do you think that banks applying the standardised approach to assess their exposure will be disadvantaged compared to those applying the IRB approaches?

The overall picture drawn by Figures 6-11 suggests that both observers and market participants expect the new regulatory constraints to contribute to the trend towards of large-scale consolidation that characterises the banking industry today. Eventually, this might be particularly true in the case of specialised lending and in the retail sector, since it is in these segments that the IRB methods are commonly purported to be potentially more beneficial and, thus, the regulatory incentives should be more effective.

These conclusions need to be handled with extreme care, however, since there is still some uncertainty about the relative convenience of the advanced IRB methods and the standardised approach. This problematic aspect stands out clearly in the CEPS survey results, where 30% of the respondents declined to deliver an opinion on this point (Figure 8).

3. Impact of the New Accord on SME financing

In July 2002, the Basel Committee agreed to grant loans to small and medium-sized enterprises (SMEs) under a special and more favourable treatment. According to the current proposal SME funding by IRB banks will in general receive a lower capital requirement than loans to larger firms. This capital savings, which may be as high as 20%, results from the application of a reduction mechanism that corrects the asset risk weights on the basis of the borrower’s size. By permitting this special regime, the Committee has basically put an end to the long and heated debate that has been flaring up, in particular across Europe, after the release of the second consultation paper in January 2001.

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7 And by Figures 16-17 in section 4.
8 Indeed, similar to the US experience, further formation of larger European financial groups is already foreseen and viewed as desirable according to many, as a consequence of worldwide competition issues, such as full diversification exploitation and business or profitability consolidation.
9 In fact, besides the possibility that small banks may abandon these businesses and leave their market shares to larger competitors, it has also been claimed that the high standard of risk management practices dictated by Basel II may significantly improve the use of capital in these sectors such that a substantial amount of equity is freed, which could subsequently be reallocated to strategic acquisitions.
10 Defined as those firms with annual sales of less than €50 million, or, when these figures are not meaningful, as those with total assets below a critical threshold established at the discretion of the national authorities.
11 Banks adopting the standardised approach can also benefit from some reductions in the capital charges on SME loans. In fact, as long as these credits fulfil some ‘granularity’ conditions, they can be treated like retail exposures, exploiting a more parsimonious regime.
12 The firm-size adjustment factor is basically an algorithm that modifies the asset correlation in reverse proportion to the SME’s size.
In fact, since SMEs are generally attributed with having a higher idiosyncratic risk and a limited availability of guarantees, the former homogeneous treatment of SME loans had fostered the argument that burdensome risk assessments could structurally translate into an unfair penalisation of SME-oriented economies.

The survey confirms a widespread assessment of the political nature of this issue (Figure 12) but also indicates that the agreement on the special treatment reached in July 2002 appears beneficial to most respondents (Figure 13).

12. Do you think that SME financing has become a political issue in the ongoing EU debate?

![Pie chart showing 88% Yes, 12% No]

13. How do you qualify the concessions (factor size, etc.) made by the Basel Committee in the treatment of SMEs?

![Pie chart showing 70% Beneficial, 22% Neutral, 8% Negative]

Further evidence of a certain satisfaction for the current compromise is the relatively low proportion of respondents fearing worse financial conditions for SMEs (Figure 14) under Basel II. In fact, despite the fact that this is still a sizeable 36%, it is more than outweighed by those envisaging beneficial effects from Basel II, either in the form of better management (45%) or the restructuring of a company’s liabilities (19%).

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13 In addition, it has been purported that risk assessment of SMEs under Basel II would be even more problematic because of their accounting information and historical default records, which are regarded to be of a lower quality in many cases.

14 In Europe, these are typically considered the Mediterranean countries. Nevertheless, some continental European states may also be interested in monitoring the future prospects for SMEs. For example, half of the GDP in Germany derives from SME activity.
14. What are the potential impacts of the New Basel Accord on SME financing in Europe?

![Diagram showing percentages of respondents' views on potential impacts.]

In conclusion, the overall positive judgment on the current SMEs’ framework is strengthened by the results revealed in Figure 15, which suggest that around 70% of the respondents would support the hypothesis that fund-raising opportunities for high-quality SMEs may even be increased, given that Basel II will lend visibility to their sound managerial practices and transparency.

15. What are the main actions an SME should do to obtain a good rating?

![Diagram showing percentages of respondents' views on main actions.]

4. Competitive implications of the New Basel Capital Accord

As documented above, the risk that Basel II might change the conditions of market competition is a big issue for both bankers and regulators. In this respect, the analysis introduced in section 2, which the present section is intended to complete, hinted at the possibility that the New Capital Accord has sparked fears that small and medium banks will be penalised. When bankers were more directly questioned on this issue, however, their answers were not necessarily or uniquely consistent with the hypothesis mentioned above. In fact, even though 50% of respondents foresee harsh prospects for the small banks (Figure 16), and another 32% envisage consolidation as the cost of implementing the IRB methodologies (Figure 17). Still, 31.5% respondents have specified, commenting on question 16, that the losers from the Basel II challenge would be those banks whose strategies are based on high risk concentrations, particularly in lending to corporations or in exposures to emerging countries. Clearly, such a description does not suit the business of small banks.

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15. This number, which recalls the large approval rate in Figure 13, derives from the sum of the dotted and the striped areas in Figure 15, that is, from an aggregation of those answers that, in accordance with the spirit of Basel II, point towards active managerial strategies as an alternative to the traditional reliance on guarantees, to increase SMEs’ creditworthiness.
16. Who are the potential losers from the new Basel Accord?

![Chart showing potential losers from Basel II]

17. What are the effects of Basel II on competition in the European banking industry?

![Chart showing effects of Basel II]

Therefore, the suspicion raised in section 2 that the New Accord might be seen as undermining the solidity of small banks finds a relative confirmation and, in conclusion, the overall picture of the competition implications of Basel II remains rather controversial.

Perhaps a certain contradiction in the results is symptomatic of the general expectation that competitive conditions will change, although the direction and final outcome of these changes are not yet clear. If this is the case, a moderate but meaningful position would be the one expressed by the other 32% of the respondents to question 17 (see the dotted bar in Figure 17). In fact, these predict that all kinds of competitors will seek a strategic repositioning in the market, which, in turn, means that they believe that the new benchmarks established by Basel II will vary across the different segments.

5. Costs and benefits of the New Capital Accord

The survey confirms that the enhancements to IT infrastructure required for dealing with Pillar 1 capital ratios remain the major concern. In effect, it is safe to assume that databases of an adequate information storage capacity, integrated IT platforms and coordinated pools of risk specialists, which are all required for credit and operational risk modelling especially in case of high standard compliances, entail both a consistent initial investment and significant maintenance costs. Also the opportunity costs due to regulatory compliance deserve consideration, as they are ranked second in order of importance (Figure 18).
18. What are the costs of adopting the new Capital Accord?

The results from question 19 are also interesting, in which participants were asked about the benefits that may derive from a full exploitation of the opportunities offered by Basel II. In fact, while the first choices concentrate on the immediately appealing, and perhaps trivial answer of a “more efficient risk management and operation” (62%), the second preferences spread more uniformly over the range of benefits suggested. This reveals a somewhat mature appreciation by consumers and market members of even the less obvious advantages they may obtain from compliance with the New Accord, such as the positive long-run effects of higher transparency and external credibility (second column).

19. What are the benefits of fully exploiting the opportunities provided by Basel II?

6. The EU-US implementation of the New Accord

In Europe, a new Capital Adequacy Directive (CAD III) will convert Basel II into binding law, extending its application to all banks and investment firms. In fact, according to the European Commission, banks and investment firms must comply with equivalent rules on the grounds that they carry out similar activities; otherwise, competition in the Single Market would be distorted.

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16 Actually, the Commission’s proposal contains some differences, e.g. in contrast to banks, small- and medium-sized investment firms will continue to be exempt from the new operational risk framework.

17 Other ground cited by the Commission for bringing investment firms under the umbrella of Basel II are investor protection and systemic stability.
In order to smooth the transition to the new regulatory framework of such a large population of financial companies and to make risk-sensitivity achievable by institutions of all shapes and sizes, the Commission has ensured that the new Directive will allow for a great degree of flexibility. Indeed, besides the obvious incorporation of the three approaches defined by the Basel Committee into the CAD, the Commission has also recognised the need to further accommodate the European specificities by working out some additional ad-hoc solutions.

Broadly speaking, the survey illustrates a general appreciation for the Commission’s approach: only 20% complained of a “too rigid standpoint”, whereas almost half of the respondents (49%) supported the Commission’s position as consistent with market developments (Figure 20). In addition, the 51% of those characterising the Commission’s position as either “too ambitious” or “too rigid” commented that the Commission’s view has a correct and adequate orientation. Hence, one can conclude that a large majority of the respondents delivered a generally favourable assessment of the Commission’s proposals. This result, especially in light of how problematic such a thorough and extensive regulation can be, pays tribute to the intensive consultation process undertaken by the Commission in its attempt to address the needs of the industry and, at the same time, maintain rigorous standards.

20. How do you qualify the European Commission position as regards Basel II implementation?

On the other hand, the implementation guidelines for the New Capital Accord proposed by the US banking agencies received limited approval in the survey, where the answers reporting negative judgments represented 76% of the sample (Figure 21).

In particular, 41% of the respondents thought that the US implementation policy may end up disrupting the worldwide level playing field in the financial markets and, very similarly, another 35% claimed that the US position on Basel II will place European competitors operating in the US market at a disadvantage.

21. How do you consider the US position as regards Basel II implementation?

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18 For instance, the Commission has already decided to permit a ‘partial use’ approach, which will enable smaller institutions to adopt advanced risk-sensitive methods for only some of their business sectors.
7. Remaining issues and policy recommendations

According to the agenda established in Madrid in October 2003, the Basel Committee should finalise the text of the New Accord by June 2004, with implementation scheduled for the end of 2006. ⁹ To achieve this goal, the Accord Implementation Group (AIG), which was formed to promote closer practical cooperation among national regulators, has intensified its activity and, with the other working groups, presented concluding remarks on pending issues at the recent meeting in May 2004. On the basis of these remarks, the Committee elaborated some technical adjustments and subsequently announced achievement of a final consensus. After its meeting in May, the Committee seems now determined to avoid any further delay.

Indeed, a last impact study will be performed prior to implementation but, should the overall prudential requirements significantly differ ex-ante and ex-post the application date, the Committee has signalled that it would react promptly and proceed in any event to implement Basel II. In fact, the Committee has announced that, in a similar circumstance, its commitment to maintain almost unchanged the aggregate level of regulatory capital would only force a recalibration through the application of a scaling factor, but would not entail any significant modification of the framework. Therefore, there should be little doubt that the Accord will be punctually implemented in accordance with the schedule. However, despite such a tight and imminent timetable, the survey shows how coordination problems among national supervisors are still perceived by banks as particularly likely and harmful.

In fact, when asked to rank their greatest concerns associated with Basel II implementation, the respondents placed “cross-border issues” first out of a range of 11 possible answers (first column of Figure 22). Significantly, second place ²⁰ was given to the suspicion that competitive distortions may occur from assigning discretion in the interpretation and application of the new rules to the national level (second column of Figure 22).

²² What are the main concerns in Basel II implementation?

![Chart showing concerns in Basel II implementation](chart)

²⁹ Actually, according to the communication released after the meeting in May, only the standardised and foundation approaches will be implemented by the end of 2006, whereas the Committee envisages one further year of impact analysis and parallel running for the advanced approaches.

²⁰ The third and the fourth positions in the ranking asked by question 22, were somewhat more expected on grounds of the previous sections results and, therefore, did not add that much to the analysis. In fact, these must be given to the Basel II compliance infrastructural costs, and to the operational risk data shortage (largest shares respectively in the third and fourth columns of figure 22).
Such a ranking is not surprising in light of the heavy weight (43%) assigned to “opportunity costs due to regulatory compliance” in the second-choice answer to question 18 (costs of the New Accord).

Moreover, the same argument holds for the allegations directed at the US position (figure 21), with the exception that, in the present circumstance (question 23), disruption of the level playing field also figures as a potential problem in the context of the Single Market.

Therefore, the demand for further clarity\textsuperscript{21} and consistency remains high (Figure 23), in spite of the efforts of the AIG and the Commission which, in November 2003, decided to establish a Committee of European Banking Supervisors (CEBS). The CEBS is comprised of representatives from EU banking supervisory authorities and central banks, and is meant to have an essential role in the application of the Lamfalussy process’ for the banking sector. In fact, the Committee should substantially contribute to greater comparability in member states’ supervisory practices, ensuring consistency in the implementation of the EU Directives throughout the Community.

\textbf{23. What are the main recommendations to win the Basel II battle?}

In conclusion, the results of the CEPS survey show evidence that supervisory convergence is perceived as an issue that deserves maximum priority also within Europe, to prevent different interpretations of the same rules from prevailing at national levels. Perhaps the Commission’s recent proposal to adopt a ‘rulebook’\textsuperscript{22}, that is, a regulatory guide for the practical application of the Directive by the national authorities in Europe, may add to transparency and assuage some concerns.

\textbf{Conclusions}

Respondents delivered a positive overall assessment of the Basel II process and, in particular, a full understanding of the new framework’s rationale which is revealed by the importance attached to early achievement of the more risk-sensitive approaches. Nevertheless, the onerous compliance cost forecasts, largely attributable to the IT infrastructure updating required by the advanced methods, cast a shadow on the future of small banks. However, these opinions about possible large-scale consolidation due to regulatory factors remain somewhat controversial and, perhaps, a generic repositioning of all firms across the different segments is the answer which better accommodates the various positions expressed. Indeed, as long as the new Capital Adequacy Directive provides the right degree of flexibility, as seems to be Commission’s intention, the availability of a broad range of regulatory options should diversify the benchmarks and reduce the risk of misalignment for the smaller institutions. Moreover, the special treatment for SME financing, which is welcomed by the large majority of the respondents, seems to have the potential to put small banks back in game, since they typically lend money to small firms.

\textsuperscript{21} Complaints about complexity remain a significant share at every step of the ranking in figure 22.

\textsuperscript{22} This was supported by the policy recommendations of the CEPS Task Force report on Basel II and the Future of the European Financial System, April 2004.
The survey endorses the plan announced by the Commission to apply Basel II to all banks and investment firms. In fact, the respondents praised the EU’s commitment to level the playing field, whereas they largely objected to the US approach.

Finally, cross-border issues are seen as possible flaws affecting not only the global competition but also competition at the European level. In particular, respondents warned that an excessively complex Directive might paradoxically give room to national discretion in the interpretation and application of the rules and, consequently, trigger competitive distortions throughout the Single Market. Therefore, either simplification or higher precision would be desirable but, in either case, the necessity to support the whole Basel II process with further regulatory guidance appears crucial.