Credit Risk Mitigation – Implications Of Basel II Prescriptions In Indian Banking

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Reached in June 2004, the Basel Accord II has revolutionised the concepts of Credit Risk Management (CRM), Market Risk Management and Operational Risk Management globally. Although all these risk segments are intertwined in banking financial institution functions, the 'credit risk' occupies the center stage. Generally, the credit risk covers 90 per cent of the 'risk threat' faced by the businesses, especially in the Indian scenario. Hence, the efforts to mitigate this risk segment in banking/Financial Institutions (FIs) demand serious attention.

Credit Risk Mitigation

The credit, construed both as funded and non-funded commitments of banks/FIs, involves probability of 'loss' in the event of non-fulfilment of corresponding financial obligations by the borrower or guarantor. Therefore, traditionally the banks and FIs seek to be covered by appropriate tangible and realisable securities or by third party guarantees to avert or at least minimise the loss in the event of the default by borrower or guarantor.

A Credit Risk Mitigation tool, commonly referred to as 'security', is universally recognised as a 'protection' for the lenders although the same is often christened as 'collateral' also. The personal covenants supported by the execution of promissory notes/ agreements are then treated as 'primary' cover in the limited scope of a security cover.

In Indian context, however, there is a subtle difference between primary and collateral security. A primary security is one on which the drawing power/loan availment is allowed while a collateral security, though not considered for such purposes, provides the same degree of comfort/rights for the lenders for ultimate recovery of the dues. It is fairly common in credit market that lenders insist for collaterals (e.g. mortgage of personal landed property/other assets of the counter party) for extending large volumes of credit, i.e Rs. 5 crore and above. This is done to ensure an additional cushion on the top of primary security reckoned for drawing power/loan availment computation.

But the credit 'risk mitigation' and security cover (primary/collateral) may not be treated as the same if we go by the prescriptions of Basel Accord II, which was reached in June 2004 under the supervision of Basel Committee in Switzerland comprising Central Bank governors of Group of Ten countries. For easy reference, the distinction may be drawn as given in Table 1:

It is evident that while some asset items are treated as eligible securities like goods, fixed assets, etc, the same are

Table 1

Security in conventional sense as a cover for credit facilities	Credit risk mitigation as per Basel Accord II
● Any tangible/realisable asset is treated as appropriate security e.g. cash (time deposit/ other deposit) goods, fixed assets, tradable securities, etc. ● Third party guarantee (i.e other than personal repayment undertaking of the borrower) even by the govenment of the country, high net worth individuals, is not strictly treated as 'security' although such third party guarantee may be quite valuable for the lender. ● When a lender extends credit facilities to a counter party there is no regulatory requirement of 'subdividing' the exposure into portions covered by third party guarantees and by other securities.	● Only some specific items of assets are recognised as eligible collateral. Credit Risk mitigation covers securities such as cash, gold, debt securities issued by sovereigns rated category, etc. (Stocks in trade, book debts, fixed assets, etc. are not recognised as credit mitigation items) ● Third party guarantee is treated as a credit mitigation tool subject to fulfilling certain operational conditions such as unconditional guarantee, explicit documentation, etc. ● Credit risk mitigation guidelines under Basel II provide that the lender will be required to subdivide the exposures between third party guarantee and other recognised risk mitigation items.

not recognised as credit risk mitigation items. On the other hand, third party guarantee fulfilling certain operational conditions, is a recognised credit risk mitigation tool but third party guarantee is not strictly treated as a security. Thus, the distinction is all-pervasive.

An incidental aspect in the context of security v/s credit risk mitigation phenomenon relates to the functional role of 'margin' and 'haircut'. A tangible/realisable security considered for the computation of drawing power/loan availment is subjected to the specific percentage reduction of value (to arrive at permissible drawing power/amount of loan) depending upon the nature of security without any correlationship with the rating grade of the counterparty. In the case of application of percentage haircut (akin to per cent reduction) on eligible items of credit risk mitigation, the percentage reduction will be dependent on the nature of security correlated to rating grade of the counter party. E.g. if gold is accepted as a security in a borrowal account with say 10 per cent margin, irrespective of whether rating grade of the counter party is AAA or below 'B' the same percentage reduction will be applicable. On the other hand in case of haircut lesser percentage reduction is possible in AAA rated counterparty as opposed to lower rating graded counter-party. The concept of haircut is thus innovative in the credit administration of banks/financial institutions.

Forms of credit risk mitigation under the Basel II Accord

The accord has recognised two types of credit risk mitigation:

- By collateralisation of the exposure.

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- By obtaining third party guarantee for the exposure.

It would appear that a combination of both no (1) & (2) are also to be acceptable as a credit mitigation tool, this being a very common situation in Indian banking environment. In this respect the accord states, *inter alia*, "Partial Collateralisation is recognised."

Salient features specified in Basel II accord for treatment of CRM tool:

- CRM is applicable both for funded and non-funded exposure.
- Only banking book exposures (exposures held for regular bank business i.e. not applicable for trading, for sale, etc.).
- Where issue specific rating reflects CRM, no additional supervisory recognition of CRM will be granted to avoid double-counting effects.
- Collateral as a CRM tool may be posted by a third party besides recognising collateral of the counter party (borrower).
- Collateral must be charged to the financing bank/financial institution for the life of the exposure, it must be 'marked to market' and revalued at least once in six months.
- Appropriate haircuts as may be specified by the regulatory authorities of each country are to be considered in CRM tool.
- Financing banks/financial institution must have clear and robust procedures for the timely liquidation of collateral.
- Exposures covered by collateral would have risk weights as applicable for the respective collateral subject to a minimum of 20 per cent (for cash, however, nil per cent)
- Third party guarantees would be recognised for CRM, provided the guarantees meet the relevant laid down conditions and the regulatory authorities are satisfied in this regard.

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Eligible Collaterals for CRM purpose

Basel II has viewed collaterals eligible for CRM from two perspectives:

1. Financial Collateral
2. Non–Financial collateral

It is apparent that financial collaterals imply cash or near cash collaterals such as fixed deposit in a bank, highly rated marketable securities, etc. Any other approved collateral like gold will be treated as non-financial collateral. The list of eligible collaterals as provided by the Basel II accord is presented below:

An incidental aspect in the context of security v/s credit risk mitigation phenomenon relates to the functional role of 'margin' and 'haircut'

- Cash, Certificate of Deposit (fixed deposit, short deposit, etc.) issued by the lending bank (hence by implication such deposits held with the other banks even when lien is offered will not be treated as eligible. Incidentally, as per existing directives of RBI, Certificates of Deposits/ Fixed Deposits, etc. of the bank should not be treated as security for any loan/advance by the lending bank.)
- Debt securities rated by a recognised agency with appraised rating grades as laid down in the accord.
- Also debt securities NOT rated may be considered subject to fulfilment of conditions specified in the accord.
- Equity shares subject to certain conditions as specified in the accord.
- Mutual Funds, etc., which are publicly quoted on a daily basis
- Gold
- Third Party Guarantee (duly documented for an exposure) as may be approved by regulatory authorities of each country (e.g. RBI). By implication only guarantee by Central Government and the state government may be recognised by RBI for this purpose.

Treatment for cases covered by collateral securities and third party guarantee

Suppose Model Bank has sanctioned overdraft of Rs. 100 crore to M/s Good Company Ltd against security of approved debt securities of Rs. 90 crore and the State Government Guarantee for full amount of overdraft of Rs. 100 crore, the bank is required to subdivide the exposure for the purpose of the accord as under:

- Exposure up to Rs. 80 crore as covered by approved debt securities.
- Balance exposure of Rs 20 crore as covered by State Government Guarantee even though the guarantee provides default protection for full amount of Rs. 100 crore.

In this respect a relative portion from Basel II accord reads as under:

"In this case where a bank has multiple CRM covering a single exposure (e.g. a bank has both collateral and guarantees partially covering an exposure) the bank will be required to subdivide the exposure into portions covered by each type of CRM tool (as a portion covered as collateral, portion covered as guarantee, and risk weighted assets of each portion must be calculated separately."

Net effect of eligible financial collateral

For the purpose of computation of capital requirements under the Basel Accord II in respect of exposure of a bank covered by eligible financial collateral, the value of the collateral may be taken into account for reducing the bank's overall exposure to risks.

Implications of Residual Risks on CRM

Although the Basel II Accord recognises the fact that eligible collaterals reduce the overall risk exposure, it also states that CRM techniques may, in certain circumstances, give rise to other risks called Residual Risks, as under:

- Legal Risk (i.e. faulty documentation, change in laws, etc.)
- Operational Risk
- Liquidity risk
- Market risk

Hence, on account of the above situation, risk factors may not, in effect, reflect any reduction or transfer of credit risk, thereby nullifying the value and advantage of eligible collateral. In view of this, it has been suggested that:

- Bank using CRM benefit must employ robust procedures and processes to control residual risks.
- Appropriate strategy for dealing with residual risk to be in place.
- Risk content of the underlying credit must be considered on an ongoing basis.
- Valuation of collateral must be sound.
- Appropriate policies, procedures and systems for control of roll-off risks must be in place.
- Strong management of concentration risk must be in place.
- Interaction of concentration risk with bank's overall credit risk profile must be analysed and remedial effects must be implemented whenever necessary on an ongoing basis.

What about Dilution Risk?

The word 'dilution' with reference to any security implies reduction of intensity and strength of the relative security. While for any tradable/marketable security the fall in realisable value may be construed to be a dilution risk, Basel Accord II has attributed dilution risk with respect to receivable as security cover. (e.g. Hypothecation of book debt/bill purchased/bill discounting accounts). As per the Basel II Accord, dilution risk refers to the possibility that the receivable amount is reduced through cash or non-cash credits to the receivable's obligor (i.e. seller who has sold goods to a buyer on credit).

Such a situation may take any or all of the following forms:

- Offsets or allowances arising from returns of goods sold on credit
- Disputes regarding product quality
- Possible debts of the borrower to a receivable obligor
- Any payment or promotional discount, etc.

Since receivable as a security cover is not to be treated as eligible collateral, there will be no effect of dilution risk so far as compilation of risk weighted assets for capital computation is concerned.

Disclosure requirements

Basel II Accord has placed significant 'focus' on the need of public disclosure of all types of risks of a bank, e.g. credit risk, market risk and operational risk. As an integral part of credit risk exposure management, it is imperative that a bank using CRM technique must periodically (exact period and mode may be decided on a case to case basis) bring to public domain the credit risk mitigation procedures by way of:

- Quantitative Disclosures
- Qualitative Disclosures

The specific requirements of aforesaid two types of disclosures, keeping in view Basel II prescriptions, are shown in Table 2.

Table 2

Qualitative Disclosure of Credit Risk Mitigation	Quantitative Disclosures of Credit Risk Mitigation
General qualitative disclosures must cover: 1. Policies and processes with respect to 'on and off balance sheet netting'. 2. Collateral valuation and management together with description of main types of collateral. 3. Information on the main types of guarantor/credit derivative counterpart and their credit worthiness. 4. Information on market or credit risk concentrations within the mitigation effected.	For each separately disclosed credit risk portfolio, the total exposure after haircut that is covered by. 1. Eligible financial collateral and. 2.Other eligible collateral

For the purpose of computation of capital requirements under the Basel Accord II in respect of exposure of a bank covered by eligible financial collateral, the value of the collateral may be taken into account for reducing the bank's overall exposure to risks

Implications in Indian banking

CRM is essentially an instrument of maintenance of lower level of capital in the context of the requirement of 'Minimum Capital' under Pillar 1 of Basel II Accord. It is,

thus, unidirectional. It does not, at any rate, intend to provide comfort of security cover as is the dominant objective of any lending bank while entertaining an exposure on counter-party. This being the basic premise of CRM, only select items are recognised under CRM kit as mentioned above.

Indian Commercial Banking is substantially (around 80 per cent) under public sector – to be precise under Central Government ownership or control. Hence, Government of India stands by as a buffer of supplier of capital stock to such banks when necessary (in the recent past Government of India provided additional capital to a few banks when their capital base was substantially eroded on account of Non-Performing Loans & Advances) Furthermore, under Pillar1 prescriptions of Basel II Accord, each Bank in a country is required to maintain 8 per cent of risk-weighted assets computed after reducing the value of eligible collaterals under CRM. However, RBI has prescribed 1 per cent additional i.e. 9 per cent minimum capital of any bank. Latest available data of capital adequacy of Indian banks show that nearly all the banks maintain over 9 per cent - some even above 13 per cent-15 per cent. It is also functionally true that the approved CRM collaterals as per Basel II Accord are not basically intended to provide security cover to the lending bank. However, in a very few cases, the Government guarantees are available. Since presently any fresh Government guarantee/renewal of existing guarantee is hard to come by, for all practical purposes the CRM tool of Basel II Accord will have no major implications on Indian Banking.

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It is an acknowledged fact that India and few other Asian countries have sizable loan portfolio covered by Pledge/Hypothecation/Mortgage of Goods/Property/assets, which do not form part of CRM. Though Gold has been accepted as eligible collateral under CRM, we will hardly come across in Indian Banking that Gold is offered by a commercial borrower as security except under some agriculture finance schemes. Hence, it is suggested that CRM toolbox may be reopened by the Basel Committee to recognise following securities as eligible collateral (Non-Financial): -

- Pledge of marketable goods
- Hypothecation/ assignment of receivables when such receivables are from Government Departments/PSUs.
- Legal Mortgage of Landed Properties with power of sale by the lender without the intervention of court.

If the aforesaid suggestions are considered favourably, Indian Banking system will get more teeth and impetus since the quantum of risk-weighted assets will be correspondingly reduced.

One 'Caveat', however, may be put in place – no bank should be allowed to dilute already achieved level of capital adequacy even though regulatory minimum may be 8 per cent (9 per cent in India). Only in cases of fresh lending from a cut-off date, above modifications may be implemented.

Conclusion

The age-old proverb 'necessity is the mother of invention' holds good in credit risk management with its tool of CRM. It was in 1980s that the international authorities for the first time recognised that credit risk was a major threat to the safety and soundness of the banking system. In consequence, the concept of capital adequacy, risk weighted assets was born in 1988 by way of Basel I Accord.

No doubt the concept of CRM is innovative and a right enabler for any bank who pursues sound credit risk management policy by insisting on eligible collateral (together with appropriate disclosures) and thereby reducing volume of risk weighted Assets, and finally quantum of minimum capital requirements for such banks. It is, however, submitted that CRM techniques as prescribed, are biased in favour of the banking in advanced countries. In the context of banking system in underdeveloped/developing countries the techniques may need some refinements. Hence, eligible collaterals may be enlarged upon a review of legal/social system and practices of the countries concerned. An appropriate way may be to empower regulatory authorities of the countries to implement CRM techniques as may be best suited in the Banking System of their jurisdiction. ❐