

All Change in the New World of Basel II

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By James Manktelow and Charles Taylor

It is easy to think of Basel II as a technical exercise only affecting banks. In fact, Basel II is likely to cause a fundamental restructuring of the asset finance and leasing industries, changing the way bank-based lessors operate and opening up new opportunities for banks, captives and independents.

By now, you'll most likely have looked into Basel II and identified what you need to do to comply. Many companies within the leasing and asset finance industry will already be providing data for corporate aggregation and analysis with the view to going live on Basel II at year-ends 2006 or 2007[J1].

The extent of work so far has probably been technical: ensuring that the correct coding and data structures are in place within your database; checking that data is accurately updated; and making sure that appropriate reports and data exports routinely produce the required information. Depending on your chosen approach to credit and operational risk measurement, you may also be reinforcing your asset management functionality, enhancing your business intelligence capabilities, or setting up risk analysis and modelling systems.

This work is complex and detailed, but it should be achievable providing that you put in the time and effort.

But is this all you need do?

We think not.

At NetSolCQ, we think that Basel II is going to drive a major restructuring of the asset finance and leasing industry. We think that the industry of 2010 will look quite different from the industry of 2005: New companies

that don't yet exist will be thriving in some areas of the markets, existing players will have shifted their focus, and late-adopters will be bloody, bruised and vulnerable.

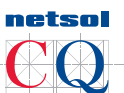
Obviously, we're being humble about this: we can only make our best assessments based on the information available, and "crystal-ball-gazing" is always vulnerable to the impact of unknown factors.

However, based on what we know now, we think that whether you win or lose will depend on the power, flexibility, efficiency and security of your systems.

As we see it, change within the market will be driven by four major factors:

1. Companies using the more sophisticated credit and operational risk management approaches permitted by Basel II (most likely to be the largest banks) will be able to source funds and write business at a significantly lower rate than others. Business will therefore migrate to the largest banks.
2. The heavy capital requirements associated with high-risk business will make this particularly unattractive to IRB banks. IRB banks will therefore move towards the lowest risk business, which they will attract with the lower rates they can offer.
3. Banks will adjust their portfolios of businesses to get rid of those that do not fit with the desired corporate risk profiles.
4. The new focus on operational risk will punish AMA banks with poor financial controls. We can expect to see an increase in control and a corresponding reduction in

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entrepreneurialism in larger banks.

We show our reasoning behind these factors below:

1. Restructuring of the Market by Size

The market will restructure by size. The players using the most sophisticated approaches (almost certainly the largest players) will be able to offer financial markets the strongest returns on equity, and will have the lowest cost of funds. General business with informed clients will therefore tend to be placed with banks, while specialist business may be placed with niche finance houses.

Factors driving this trend:

- IRB (and particularly Advanced IRB) banks are more able to quantify the risk in their business. They therefore need to hold less capital on a precautionary, formulaic basis, or can adjust their books so that this is the case [1]. If they need less (expensive) equity capital to cover their exposures, they can fund exposures with more (cheap) debt. This means that they can increase margins or lower the rates at which they write business.
- RB banks will therefore give shareholders much stronger Returns on Equity than non-IRB banks and will therefore find it easier to raise funds. Where the supply of capital is limited, this may make it more difficult and more expensive for non-IRB banks and finance houses to raise funds.
- Larger banks should enjoy economies of scale and analysis in relation to running the IRB approaches that will be unavailable to smaller finance houses. Compliance should therefore be proportionately less onerous.
- Advanced IRB banks will be able to use leased assets as collateral in a way that is not available to other banks. This further reduces regulatory capital required.

2. Restructuring of the market from Sub-Prime to Prime Business

Currently banks allocate a 100% risk weighting to substantially all business, irrespective of risk (with the exception of sovereign exposures, etc). Under Basel II,

and particularly with the IRB approaches, this changes fundamentally. Banks will be able to conduct sophisticated risk analysis and only need maintain the amount of capital that they can persuade regulators is necessary for their individual businesses.

This will make high quality, low-risk business attractive, and make sub-prime business unattractive to IRB banks in particular. This is likely to drive a significant restructuring of the market, with IRB banks divesting themselves of sub-prime subsidiaries.

Factors driving this trend:

- IRB banks will need substantially less capital to fund high quality business. This means that they can write business at a much lower rate, and/or can achieve a much higher Return on Equity on this business.
- On the other hand, IRB calculations will demand substantially increased equity to fund high-risk, sub-prime business. Rates are likely to increase substantially and/or margins will narrow. Investors are likely to see low RoEs on this business unless rates increase very significantly. This effect will be magnified if the cost of debt for sub-prime lenders is higher than the cost of debt for prime business, as might be expected.
- Even Standardised Approach lenders will suffer under Basel II, albeit to a lesser extent, as "past due" accounts take on a risk weight of 150%. This further makes sub-prime business unattractive.

3. Business Portfolio Changes

With the move from most risk-weightings being 100% to a more sophisticated situation, banks sensitivity to risk will increase radically. Seeing the strong Returns on Equity that Advanced IRB banks can achieve, shareholders generally will start to look for RoEs that simply cannot be achieved under the current Basel Accord.

Banks can therefore be expected to adjust their portfolio of businesses so that subsidiaries with ill-fitting risk profiles become early targets for divestment: these subsidiaries may have a disproportionately negative effect

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on the whole group's cost of capital.

Among the impacts of Basel II, the 100% weighting of residual values (even under Advanced IRB) makes operating leasing less attractive. This is particularly the case with long-life assets where RVs are large. This may cause a switch to HP-style contracts, however it may also reduce the overall size of the market as clients switch to other forms of finance.

4. An even greater control culture

As operational risk is brought into the calculation of capital adequacy, management of operational risk may attract even more attention than it does now.

For banks using the Basic Indicator and the Standardised Approach, operational risk is approximated by scaling it against income, and then applying appropriate factors. Here there is little pressure to change approaches to the management of operational risk.

However, for banks using the Advanced Measurement Approaches (AMA) to operational risk assessment, the approach to risk management is likely to be transformed. There will be a strong incentive to drive down operational risk. This is likely to be particularly intense, given that an operational risk loss will affect the bank's capital adequacy calculation for the next three to five years.

AMA banks are therefore likely to increase their internal controls significantly. They may also withdraw from business that exposes them to a high level of operational risk, possibly reducing early-stage, entrepreneurial activity within the bank.

So what does this mean?

These are four important forces. They will apply in some areas of the market, and not in others, just as they will apply more to some companies in a sector than they do to others. Capital structures, market conditions, internal actions and external events will either dampen or amplify these forces as the next five to ten years unfold.

However, even if some of the forces do not apply to you, you will most likely be affected

by at least one of the forces.

This is how we think it will affect different areas of the market:

Large-Bank-Owned Lessors:

Asset finance companies belonging to IRB banks are likely to benefit most from Basel II. Lessors using the most sophisticated approaches are likely to have significantly lower costs of funds than other competitors, and should therefore either be super-competitive or super-profitable or both. This is particularly the case with Advanced IRB lessors, who will be able to use leased assets as collateral.

Also, given the very low regulatory capital requirement associated with high quality business, there will also be strong pressure to write prime business at the expense of sub-prime business.

Taking both of these, IRB lessors can expect to face strong pressures from shareholders to realise these potential benefits. They can expect:

- Pressure to generate much stronger returns on equity
- Pressure to write more profitable business
- Pressure to vastly expand the size of their books using the same amount of capital, or
- Massively-intensified competition as IRB lessors fight for the same small pool of high quality business.

Lessors are already complaining about the level of competition they will face. Only the most efficient lessors with the most finely-tuned systems will meet shareholder expectations in this hyper-competitive market.

More than this, the magnified damage that will be caused by operational risk losses under the AMA approach will intensify control demands. The potential fraud exposures caused by legacy non-integrated systems, off-system workarounds and loose financial control risk raising lessors' cost of funds by an unacceptable amount for an unacceptably long period of time. Only with strong systems controls and constant vigilance will the cost of operational risk be driven down.

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Medium-Sized-Bank-Owned Lessors:

Asset finance companies belonging to medium-sized banks (which we assume will find it difficult to move to Advanced IRB) will have to be fleet of foot to survive in the new Basel II market.

They will find it increasingly hard to compete on rate for commodity business, which will migrate to the largest banks. Problems with risk weightings on residual values will get in the way of using operating leasing as a differentiating factor.

Medium-sized lessors will have to “go niche” to survive.

To do this, they will have to compete with existing niche specialists. And to win, they will have to offer the high levels of specialised customer service that customers demand if they are not to source finance through their own (mainly big, IRB) banks.

Medium-sized lessors with old, inflexible, legacy systems will find it very hard to survive in this new market. But by investing in new systems now, they can position themselves to “blow away” existing niche incumbents where these have not adjusted to the new reality.

Niche Lessors:

Niche lessors will lose some business to the majors as the difference in rates offered increases. However, with their knowledge of the specialised needs of their clients' needs, they should be able to mount a robust defence of their markets.

However, they need to keep a sharp eye on other finance companies seeking to enter their markets – it will become a matter of urgency for medium sized players to do so if they are to survive.

Now is the time for niche players to build the defences that will protect them. These defences are investments in efficiency and in the specialised customer and business partner service that will mark their niche out as “too tough a nut to crack” for medium-sized players.

Bank-Based Operating Lessors:

Operating lessors face many of the same

pressures as other finance companies, but have some protection from the bundling of other services with their product, which will help to camouflage rate differences.

On the other hand, they face the 100% risk weighting for operating leases under the IRB approaches. This may be particularly punishing for bank-based operating lessors with long-life assets and high residual values.

This is likely to put a lot of pressure on these lessors to achieve substantial cost-reduction if they are to achieve reasonable returns on equity. These can only be achieved through extensive automation.

Captives, Independents and Non-Bank Finance Companies:

For much of the world, Basel II only applies to internationally active banks. Within the EU, it is likely [2] to apply to the majority of credit institutions and investment firms that hold client funds (there are likely to be some specialist waivers).

Many existing lenders will therefore be outside the scope of Basel II. Other non-Basel II lenders may enter the market, either as spin-outs from banks or as new entrants. Prime among these may be captives able to use the strong credit rating of their parent to secure lower cost funding than is now possible.

As well as these, banks with primarily non-prime business may opt to use the Standardised Approach to credit risk assessment rather than IRB-based approaches: While this will damage their ability to compete for high quality business with majors, it will make them more competitive for sub-prime business.

As the largest, IRB-based banks focus on high quality business and withdraw from sub-prime lending, this will create plenty of opportunity for companies that can compete effectively in this new market space.

However, we emphasise “compete effectively” – there will be something of a feeding frenzy in these areas. The companies that succeed will be those that can flexibly adapt to the opportunities that arise in the market, offer exceptional levels of service and operate

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efficient systems that help them keep costs down. In sub-prime areas, they will also be those that are particularly good at managing arrears.

Companies with inefficient, sclerotic legacy systems and poor arrears management can expect to lose out. In particular, spin-outs that have traditionally relied on bank systems and bank-introduced business will have to work hard to reshape themselves to compete effectively.

Adapting to “Interesting Times”

Summarising this, we believe that four important forces will affect asset finance and leasing companies over the next five years:

1. A significant reduction in cost of funds for IRB and AMA banks
2. A movement away from sub-prime and towards high quality business for IRB-based banks, forcing non-IRB banks to move in the opposite direction.
3. An adjustment of banks’ portfolios of businesses to get rid of those that do not fit with the desired corporate risk profiles, with corresponding spin-out, divestment or run-off of non-matching portfolios.
4. A new focus on operational risk (particularly for AMA banks), and a corresponding reduction in loosely-controlled, entrepreneurial activity.

This radical increase in the risk-sensitivity of banking business will force tremendous change in our industry. Very many companies, perhaps the majority, will have to defend or substantially change their market position - or be forced out of business. And this will affect non-Basel II finance companies just as it does to Basel II banks.

When the Basel II storm breaks, it will be the companies that have prepared for it that win out – those that only start worrying when they’re in trouble will be way, way too late. A major part of this preparation is making sure that you have systems that will support your adaptation to your new position in this new market:

- Flexible systems that can quickly and cost-effectively adapt to exploit new market opportunities as they arise
- Robust systems that are always to yourself and your business partners, making you a

totally dependable supplier and partner

- Powerful systems that drive costs down through intensive automation, at the same time that they provide exceptional service

- Scalable systems that grow with you as you grow, however big you grow.

- Safe, integrated systems that minimize operational risk with tightly-controlled business processes, supporting your business effectively while minimizing human error

As ever, good strategy, good systems, good execution and a measure of raw opportunism will be needed to win through in this new world.

James Manktelow & Charles Taylor are both Directors of NetSolCQ. NetSolCQ provides robust, powerful, scalable, safe and flexible systems to the international asset and loan finance industries.

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