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Micro-Challenges for Financial Institutions

Before going into the topic of "Micro-Challenges for Financial Institutions" I would like to briefly introduce myself as well as RZB Group where I am a Member of the Board of Managing Directors. RZB AG, the commercial and investment bank operating globally also serves as the holding company for Raiffeisen International AG, since recently a publicly traded company that owns and runs network banks in 15 countries within Central and Eastern Europe. In RZB I am heading the Corporate Customer Divisions as well as different Finance Divisions.

This short introduction is not only for the benefit of those who I have not met before, but moreover should underline that I am a banker rather than an economist. Therefore, what most of you with a background in economics would refer to as a micro-challenge, myself as a banker would very often refer to as a macro- if not a mega-challenge.

So I guess you are noticing already that I will not be talking about economic theories explaining macroeconomic measures and their effect on important issues like financial stability and the avoidance of financial crises. Besides, I suspect that I am explicitly invited today because of my reputation as an advocatus diaboli in the Basel II discussion between the regulatory authorities and the Austrian banks.

And in order to satisfy the honorable hosts of today's conference and to work on my diabolic image, I have prepared a short statement mainly dealing with micro-challenges for banks like RZB Group as a consequence of new Basel II regulations. These challenges – as well as some positive points about Basel II – shall serve as an impetus for the subsequent discussion on the panel, which I am very much looking forward to.

Basel II basically is a logical thing and most of the measures prescribed, professional banks have been applying for decades already. But Basel II demands slight changes of measuring risks, goes extremely into detail and opens a wide field of activities for banking authorities – which all have one thing in common: they cost a lot of money! Therefore my first criticism is the lack of cost-benefit analysis within the entire Basel II framework.

RZB Group is currently estimating – and this estimate is quite well informed by now – that total cost attributable to the implementation of the new regulations will EUR 100 million over the next four years – that is around EUR 25 million per year. Quite a challenge in the eyes of a banker, whose bank is No.124 in the ranking of the world's largest banks in terms of balance sheet total.

Second, I would like to address a challenge that is obvious as well, but only to those people who have had the pleasure to study and understand the Basel II Accord. Looking at Jaime Caruana, Governor of the Banco de España, I expect you would agree that the 230 pages of regulations are everything else but lean and an easy to understand paper. When I saw the formula for the new risk weight under Basel II I felt that the people, who had figured it out, should be nominated for the Nobel price in mathematics. For those who haven't seen the formula, – here it is!

$$Correlation(R) = \frac{0.12 * (1 - EXP(-50 * PD))}{(1 - EXP(-50))} + 0.24 * \frac{1 - (1 - EXP(-50 * PD))}{1 - EXP(-50))} - 0.04 * 1 - \frac{(S - 5)}{45}$$

$$Maturity_factor(b) = (0.11852 - 0.05478 * \ln(PD))^2$$

$$Risk_weight(RW) = LGD * \left\langle N\left((1-R)^{-0.5} * G(PD) + (\frac{R}{1-R})^{0.5} * G(0.999) \right) - PD * LGD \right\rangle * (1 - 1.5 * b)^{-1} * (1 + (M - 2.5) * b) * 12.5 * 1.06$$

I would like to characterize it similar to the Basel II Accord in general – extremely *complex*. A good thing that computerized systems will have to do the computations.

But that is exactly, where my major concern in connection with the new regulations and procedures comes in. I am convinced that credit business simply cannot be brought down to a single formula – no matter how long and complex it might be!

Currently, key account managers are in touch with their clients on a day-to-day basis and know their customers inside out. And they are the ones who have the final responsibility whether to lend or not to lend money to a company. Clearly, their decisions are often based on facts other than mere financial ratio analysis that leads to a mathematically derived rating. Much rather, so-called "soft facts," like the drive of top management or its net-

working skills and sociability with key clients and suppliers are the deciding factors besides pure mathematical formulas. And from my experience – and I have been in this business for a little while – this way of doing business is extremely effective. Summarizing the loss history of the loan portfolios I am responsible for, I can state that I have lost money mostly with companies, where my account managers did not follow my major principle that is "*know your customer*" and not because a certain formula showed some negative results.

My concern is that – in the future – my colleagues might rely too much on mathematical formulas, which – according to my experience – can never replace the personal judgement and assessment of a commercial banker. Or in other words: Mathematics might kill the "guts feelings."

But what else does Basel II mean to a financial institution like RZB Group? Currently, RZB Group is successfully implementing the required standards and procedures within no less than 40 financial institutions such as fully licensed banks and leasing companies in 21 countries with individual jurisdictions. Within RZB AG only, 70 highly skilled employees are dedicating 100% of their time to the project. Another 70 to 80 people do the same within our network. Not to mention the countless meetings that I as well as top and middle management within the entire Group have had and will have with regards to the subject.

And – looking into the past – the trend of extensive regulation will be continued in the future. In Switzerland, for example, the official collection of federal legislations concerning banks had 2,440 pages in the 1970s, 3,600 pages in 2001 and by 2003 the extent had grown to 5,500 pages.

Luckily, no bad comes without any good. And in order to give you a more balanced picture of what Basel II means to a lot of banks (including RZB) I would also like to mention the benefits of Basel II that come alongside its implementation:

Once Basel II is rolled out the banks concerned will have obtained uniform risk management and risk controlling. Global risk positions will be obtainable from the systems with the proverbial "push of a button." All client ratings and key data will be available to headquarters in Vienna at any time and the management and control of banking groups will be facilitated significantly. So quite a bit of good news also.

But I was asked to address another question during my short statement. How will all this affect the optimal level of capital that financial institutions are planning to hold in the future? Here, I can only speak for RZB Group and the short answer is: *Not much, really!*

First, the latest QIS (Quantitative of Impact Study) shows that the regulatory equity requirement for RZB Group will not change significantly as a consequence of Basel II.

Second, this decision will remain based on three factors outside of the Basel Accord: Return on Equity, Rating and Cost of Refinancing. The more core capital – or equity – the less return on equity can be achieved. Less equity on the other hand will result in a lower rating from the rating agencies and therefore in higher refinancing cost. In 2004 RZB Group managed to

generate a return on equity of 27.4% before tax. At the same time we maintained a core capital ratio of 9.2% and an equity ratio of 10.7% that is 34% above the legal requirements, which is particularly helpful for a fast growing bank like the RZB Group!

To make a long story short, for RZB Group the level of equity will remain a strategic decision to be periodically made and revised by RZB Group's board of management. Currently, we have set at a minimum level of 7% – a level, where we feel that we get an external credit rating that allows us to refinance our operations at competitive prices and leaves us with an equity buffer that puts the Group in a position to keep growing its operations internationally, like we have done in the past. ❧