United States banking regulators introduced three sets of proposed regulatory capital rules in 2012 that are intended to buttress the long-term financial stability of the banking industry. When finalized, these proposed rules will implement the latest international standards issued by the inter-governmental Basel Committee on Banking Supervision, known as Basel III.

Implementation of Basel III will require banks to increase capital, which many have warned will raise the cost of borrowing and delay the revival of an economy that dragged for three years. The complexity associated with the eventual implementation of Basel III makes it difficult to predict its impact with certainty. As one of many factors that will impact decisions about the allocations of bank capital, higher Basel III regulatory capital minimums are unlikely to move the needle up by more than 30 basis points on borrowing costs charged by the well-run lending operations of larger financial institutions to creditworthy customers.

The Basel Committee is comprised of bank supervisory authorities and was established by the central bank governors of the G-10 countries in 1975. Since that time, the Basel Committee has continued to expand its membership and now includes representatives of more than 20 countries. The Basel Committee actions do not have the immediate force of law within the member countries, but as a condition of continued membership. Each member state has agreed to apply the Basel Accords to their internationally active banks. This commitment is intended to create a level regulatory playing field for banks located in different countries. The Basel Accords accomplish this objective by imposing minimum bank solvency standards across different countries. Though the new standards are still only proposed rules, U.S. bank regulators are highly committed to following through on their adoption, so it is only a matter of time before they take hold in the United States.

Basel III is designed to shore up weaknesses in the bank regulatory framework that became apparent in the aftermath of the 2008 financial crisis. The Basel Committee generally has concluded that many large banks had inadequate capital and liquidity to maintain public confidence in the face of the challenges encountered during the 2008 crisis. To address these perceived weaknesses, the three sets of Basel III rules put forth by U.S. banking agencies propose to increase minimum capital requirements, impose new "capital buffers" and tighten certain gaps in ways in which banks account for certain market risks.

Although a detailed explanation of the wickedly complex provisions of Basel III is beyond the scope of this article, one of the principle impacts of Basel III will be to increase the quantity and quality of minimum bank regulatory capital. These increases are to be implemented in phases over a six-year transition period beginning in 2013. The following table provides a simplified overview of some of the changes that are currently proposed:

1. The Federal Reserve and other banking agencies issued a press release on November 9, 2012, stating that: "In light of the volume of comments received and the wide range of views expressed during the comment period, the agencies do not expect that any of the proposed rules would become effective on January 1, 2013. As members of the Basel Committee on Banking Supervision, the U.S. agencies are working as expeditiously as possible to complete the rule-making process. As with any rule, the agencies will take operational and other considerations into account when determining appropriate implementation dates and associated transition periods.”


**Basel III: Impact on Asset-Based Lending**

**Complexity With Eventual Implementation Makes it Difficult to Predict With Certainty**

**BY MARK V. NUCCIO AND RICHARD R. LOEWY**

As one of many factors that will impact decisions about the allocations of bank capital, higher Basel III regulatory capital minimums are unlikely to move the needle up by more than 30 basis points on borrowing costs charged by the well-run lending operations of larger financial institutions to creditworthy customers.

In pricing loans secured by inventory and receivables, lenders with internal risk-weighting systems ought to already enjoy a significant advantage over those that follow a standardized model.

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Minimum Capital Requirements  
(After Phase-in Period)

<table>
<thead>
<tr>
<th>Capital Ratios</th>
<th>Current</th>
<th>Basel III</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common Equity Tier 1 Capital</td>
<td>4%</td>
<td>4.5%</td>
</tr>
<tr>
<td>Tier 1 Capital (includes obligations that are subordinated to depositors and other creditors, with no maturity date)</td>
<td>4%</td>
<td>6%</td>
</tr>
<tr>
<td>Total Tier 1 &amp; Tier 2 (Tier 2 includes obligations that are subordinated to depositors and other creditors, with a minimum maturity of at least five years)</td>
<td>8%</td>
<td>8%</td>
</tr>
<tr>
<td>Capital Conservation Buffer</td>
<td></td>
<td>2.5%</td>
</tr>
<tr>
<td>Countercyclical Buffer (to be deployed as instructed by regulator in periods of “excess credit growth”)*</td>
<td>0 – 2.5%</td>
<td>0 – 2.5%</td>
</tr>
<tr>
<td>Minimum Total Capital Plus Conservation Buffer</td>
<td>8%</td>
<td>10.5%-13%</td>
</tr>
</tbody>
</table>

*For banks using Advanced Approach

At the heart of bank minimum capital requirements are ratios determined by dividing different categories of capital by the amount of a bank’s risk-weighted assets (RWAs). RWAs are calculated by multiplying the amount of a particular type of asset on the bank’s books by a reserve percentage (approved by bank regulators) that is intended to reflect the relative risk of loss associated with that type of asset. A bank’s capital ratios will therefore be dependent on these two variables and the ratio can be increased either by increasing the numerator (increasing capital) or by decreasing the denominator (decreasing RWAs subject to higher reserve percentages). While Basel III portends the need to raise more capital, it does not change the risk-weighting of the asset class into which asset-based loans fall from the risk-weighting assigned to the class under Basel II.

For the largest banks, one strategy to mitigate the impacts of increased capital requirements continues to be sharpening the sophisticated internal risk-weighting systems implemented as a result of Basel II. In pricing loans secured by inventory and receivables, lenders with internal risk-weighting systems ought to already enjoy a significant advantage over those that follow a standardized model. To ameliorate their competitive disadvantage now magnified by increased capital requirements, bank lenders currently using a standard method may seek to adopt the advanced approach which allows for use of internal risk models.

The extent to which borrowing costs will increase as a result of Basel III, of course, difficult to predict. The Basel Committee conducted an assessment of the impact of Basel III on lending rates, by analyzing income and balance sheet data of numerous banks in 13 countries covering the 15-year period from 1993 to 2007. The objective of this study was to create a model that would project how much returns on equity from changing.

Based on various assumptions, the model created by the Basel Committee indicated that median lending spreads across countries would increase by 13 basis points for each percentage point increase in the ratio of tangible common equity to risk-weighted assets.² The study acknowledged there are also numerous factors that it decided not to include in its model, and those factors could potentially reduce the amount that lending spreads were projected to increase.

The primary effect of the implementation of Basel III’s increased capital and liquidity requirements is to increase the cost of complying with regulatory capital requirements for banks that are currently operating with capital below the new standards. Basel III’s fine print does not disfavor loans secured by inventory and receivables. Whatever the minor cost increases, banks will respond to these increased costs by pricing the increases into their lending products, including loans secured by inventory and receivables.


In addition, as the costs of maintaining sufficient capital for a particular type of RWA increases, banks may reexamine the returns they are achieving through their various business lines and decide to reallocate their resources towards business sectors that are achieving better rates of return and away from sectors perceived as having lower returns or greater credit risks. Decision making by bankers will reflect their idiosyncratic circumstances and will thus vary accordingly.

The impacts of Basel III on the asset-based lending industry will be indirect. The new regulatory standards may increase the costs of obtaining funding from bank-regulated entities and may reduce the level of assets deployed by banks to this sector.

The impacts of Basel III on the asset-based lending industry will be indirect. The new regulatory standards may increase the costs of obtaining funding from bank-regulated entities and may reduce the level of assets deployed by banks to this sector. Banks are not the only sources of capital for the industry and non-bank lenders or lending vehicles may seek to exploit the fact that they are not subject to such costly capital requirements.

Therefore, it would not be surprising if alternative sources of capital expand to fill any void left by the banks that are seeking to increase rates or reduce their exposure to loans secured by inventory and receivables collateral. It may also be the case that such non-bank lenders will need the services of experienced asset-based lending professionals as they pursue such opportunities and the economy begins to expand at a faster rate in 2013. The adverse impact of the implementation of Basel III on the asset-based lending industry should not be a cause for alarm.

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