

Non-Implementation of Basel II in the U.S.A. and
Resulting Risks for Austrian Exporters

Bachelor Paper

by

Arnold Czabaun

Lector

Solen Feyissa

Minnesota State University, Mankato

Fall Semester

2008

To

Verena, my sister who travels with me

Margit, my mother who supports me in everything I do

I Abstract

Since the implementation of Basel II (BII) rules and regulations in Europe and Austria, the business landscape has changed drastically. BII instructs banks to keep minimum capital requirements if credits are granted to companies. Originally initialized by the U.S.A., BII was not implemented by the U.S.-government. This bachelor paper explains BII specifications, shows reasons for its non-implementation in the U.S.A., and explains resulting risks which can occur during the exporting process due to the discrepancy of execution and non-execution of BII on the example of small and middle sized enterprises (SME) in Austria, as 99.6% of all Austrian companies are SMEs.

Key Words: Basel II, SME, Risk, Export, Austria, U.S.A.

II Foreword

The following bachelor paper had been generated in 2008 during my exchange semester at Minnesota State University, Mankato. I wanted to work on a topic which connects Austria, my home country, with the U.S.A., my host country during the stay. As I am a part-time student who works in a small rural bank in Austria, the topic should cover both, my education and my job. Therefore I decided to write about Basel II, as I experienced the rules of BII in my job. I involved my studies, where I learn how to run SMEs and decided to examine BII from the sight of Austria's SMEs during the exporting process to the U.S.A.

The paper is part of the "Marshall Plan Scholarship Program", which supported me during my stay in the U.S.A. I want to thank the team and especially Eugen Stark, Executive Director of the Marshall Plan Program who granted the scholarship.

Thank you very much!

Arnold Czabaun

November 2008

III Index of Contents

I	Abstract	III
II	Foreword	IV
III	Index of Contents	V
IV	List of Figures	VII
V	List of Tables.....	VIII
VI	Abbreviations and Acronyms.....	IX
1	Introduction	1
1.1	Statement of the Problem	1
1.2	Objectives	2
1.3	Methodological Procedure.....	2
1.4	Paper Design.....	2
2	Definitions.....	3
2.1	SMEs (in Austria).....	3
2.2	Basel II.....	3
2.3	Basel Committee on Banking Supervision	4
2.4	Banks	4
2.5	Austrian Exporters	4
2.6	Rating.....	5
3	Explanation of Basel II.....	6
3.1	Failures of Basel I.....	6
3.2	Objectives of Basel II	6
3.3	Contents of Basel II	7
3.3.1	Pillar One – Minimum Capital Requirement	8
3.3.1.1	Credit Risks.....	8
3.3.1.1.1	Standard Approach (External)	9
3.3.1.1.2	IRB Approach (Internal)	11
3.3.1.2	Operational Risk	11
3.3.2	Pillar Two – Supervisory Review Process	13
3.3.3	Pillar Three – Market Discipline	14
4	Risks for Austrian’s SME	15
4.1	Reasons for Non-Implementation of BII in the U.S.A.	15

4.2	SME and Export Situation in Austria	17
4.3	Possible Difficulties for Austrian SMEs	19
4.3.1	Principle One – From BII to Difficulties	19
4.3.2	Principle Two – From Difficulties to BII.....	21
5	Conclusions and Cognitions.....	23
5.1	Summary.....	23
5.2	Answer of the Research-question	25
5.3	Result and Perspective.....	26
6	List of Sources.....	27

IV List of Figures

Figure 1: Comprehensive View of Major Risks..... 7

Figure 2: Overview Basel Accord..... 8

Figure 3: Overview of Basic Risks and Approaches..... 9

Figure 4: Top Four Operational Risks Influencing One Another 12

Figure 5: Number of Employees and Export Quota..... 18

V List of Tables

Table 1: Overview Company Sizes	3
Table 2: Meaning of Ratings by “Moody’s“ and Standard & Poor's	5
Table 3: Risk-Weights in SMEs	10
Table 4: Austrian Companies	17

VI Abbreviations and Acronyms

AMA	Advanced Measurement Approach
APA	American Psychological Association
BCBS	Basel Committee on Banking Supervision
BII	Basel II
EAD	Exposure At Default
Fed	Federal Reserve Board
FMA	Financial Market Authority (of Austria)
G10	Group of Ten (Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States)
ICAAP	Internal Capital Adequacy Assessment Process
IRB	Internal Rating Based
LGD	Lost Given Period
M	Maturity
PD	Probability of Default
S&P	Standard & Poor's
SME	Small and Middle Sized Enterprises
SREP	Supervisory Review and Evaluation Process
U.S. (U.S.A.)	United States (of America)

CHAPTER ONE

1 Introduction

In this bachelor-paper the implementation of Basel II regulations and rules in Austria and Europe is examined. It will also discuss the non-execution of the rules in the United States of America (U.S.A.) and the potential conflict that may arise as a result of it, especially for Austrian exporters.

The subsequent sections enlarge the statement of this problem, the objectives of this paper, methodological procedure, and paper design.

1.1 Statement of the Problem

Although BII was initialized by the U.S.A., European major banks used a lot of money to implement BII regulations on time (Lange, 2006). Europe, and therefore Austria (as well as most other G10 countries) rolled out BII on 1st January, 2007. The countries implemented the full set of BII approaches – for operational and credit risk (Holmquist, 2007). On the contrary, the U.S. still has discussions about certain facts. The U.S. financial authority wants to implement BII just in major banks and these banks shall be allowed to use advanced approaches (see section 3.3.1.1 *Credit Risks*) – BII on its highest level (Lange, 2006). Although rules and regulations for minimal capital requirements for banks were originated in the U.S.A., Europe and some other G10 countries were faster in implementing the regulations than its initiator. Therefore, the risk situation (see risks in *section 3.2 Objectives of Basel II*) for both, companies and banks is better and easier to handle in Europe. Conflicts and problems can arise if a European company transacts business with the U.S.A., because of the non-implementation of BII.

1.2 Objectives

The author's objective on this paper is to show why it was impossible for the U.S.A. to implement BII regulations, to give advice to Austrian traders, and why problems and risks may occur if they want to export to the U.S.A. Following research-question arises:

Which risks can occur to Austrian SME-exporters because of the non-implementation of Basel II in the U.S.A.?

1.3 Methodological Procedure

The paper is based on scientific literature and publications, as well as on information retrieved from the internet and approved articles from online-journals. Particular attention is given to sources which are praxis-oriented. For this paper citation rules of the American Psychological Association (APA) are followed, regarding formats of headings and graphs, spacing, citation rules, etc. According the exchange-rate of Dollar and Euro, just one rate was used, due to 26th September, 2008, retrieved from the homepage of Austria's National Bank. 1 EUR = 1,464 USD (ÖNB, 2008).

1.4 Paper Design

In the first step, the author defines particular words and explains the sense. The third chapter will be about objectives and contents of BII. Chapter four contains why it was impossible for the U.S.A. to implement BII regulations and explains risks which may occur for Austria's exporters. Finally, the last chapter summarizes the paper, answers the research-question and gives perspectives for papers with similar topics.

CHAPTER TWO

2 Definitions

The following chapter explains and defines words, which are necessary for readers to understand this paper. Some of them are expert's definitions based on literature and some are simple explanations of words or phrases used by the author to describe a general situation.

2.1 SMEs (in Austria)

SME is the acronym for small and middle sized enterprises. They are explained differently in many sources. As the research-question refers to Austrian SMEs, therefore an Austrian definition is used, based on Hundt et al. (2003). Table 1 differs smallest, small, middle, and large sized enterprises regarding the number of employees and the annual turnover of companies.

Company Size	Employees	Annual Turnover
Smallest	max. 9	≤ 2 M EUR (2.92 M USD)
Small	min. 10, max. 49	> 2 M EUR, ≤ 10 M EUR (> 2.92 M USD, ≤ 14.6 M USD)
Middle	min. 50, max. 249	> 10 M EUR, ≤ 50 M EUR (> 14.6 M USD, ≤ 73 M USD)
Large	min. 250	≥ 50 M EUR (≥ 73 M USD)

Table 1: Overview Company Sizes (generated by the author)

2.2 Basel II

Basel is the name of the city in Switzerland where the Basel Committee on Banking Supervision (BCBS) has its headquarters and holds its meetings. The committee established the Basel I and the Basel II accord, which are supervision agreements (GFS/TQS, 2006). Bachus (2005) states that the Basel Capital Accord (Basel I) established minimal capital requirements for banks. He adds, that BII is an attempt to update Basel I. Banks and

financial institutions hold their capital in a balance which enables them to handle risks and react faster on changing market conditions (Bachus, 2005).

2.3 Basel Committee on Banking Supervision

The objective of the Basel Committee on Banking Supervision (BCBS) is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide. The committee was founded in 1974 by the G10 countries. Currently, there are 13 members, including Spain, Switzerland and Luxembourg (Mishkin, 2007).

2.4 Banks

Some experts say that the regulations which BII indicates are important for all banks; either the bank is a global player or a rural small bank with less than ten employees. Every bank, irrespective of its size, has to implement BII regulations and rules. Joergen Holmquist, General Director for Internal Market and Services of the European Commission, confirms the statement above when he says, “Basel II applies to all banks in Europe, regardless of size.” (Holmquist, 2007, p. 6) The author uses in this paper just the synonym “bank” and no brands or names, because no bank shall be preferred.

2.5 Austrian Exporters

“Export is the provision of goods, services or knowledge across national and international boundaries” (Business Victoria, 2008, n.p.). Two main export types are known. Direct export is referring to exporters who get into contact directly or via an agent with the importer. In indirect export, exporters look for a trader office in their home countries and the office conducts business matters in the name of the exporters (Business Victoria, 2008). In this paper, the terms “exporters” and “Austrian exporters” are referred exclusively as Austrian SMEs.

2.6 Rating

Rating is used in many different scientific areas such as sociology, psychology, and economics, even to rate restaurants, hotels, and universities (Munsch & Weiss, 2000). Hoffmann (1991) says that in the banking and financing sector two similar but different ratings are known. On one hand, credit rating is represented by the future ability and legal liability of a debtor if the person can afford the total payment of all debts and interest within a given period (Hoffmann, 1991). On the other hand, “in corporate finance rating is a ‘grade’ to a bond, bond issuer [...] to indicate its riskiness” (Credit Rating, n.y., n.p.). “Moody’s” and “Standard & Poor’s” (S&P) are well-known rating companies who rate bonds and bond issuers who can be companies and countries. Table 2 shows the grades such as AAA on the left side and the referring meaning on the right side.

<u>Moody's</u>	<u>S&P</u>	<u>Meaning</u>
Investment Grade Bonds		
Aaa	AAA	Bonds of the highest quality that offer the lowest degree of investment risk. Issuers are considered to be extremely stable and dependable.
Aa1, Aa2, Aa3	AA+, AA, AA	Bonds are of high quality by all standards, but carry a greater degree of long-term investment risk.
A1, A2, A3	A+, A, A	Bonds with many positive investment qualities
Baa1, Baa2, Baa3	BBB+, BBB, BBB	Bonds of medium grade quality. Security currently appears sufficient, but may be unreliable over the long term
Non Investment Grade Bonds (Junk Bonds)		
Ba1, Ba2, Ba3	BB+, BB, BB	Bonds with speculative fundamentals. The security of future payments is only moderate
B1, B2, B3	B+, B, B-	Bonds that are not considered to be attractive investments. Little assurance of long term payments
Caa1, Caa2, Caa3	CCC+, CCC, CCC	Bonds of poor quality. Issuers may be in default or are at risk of being in default
Ca	CC	Bonds of highly speculative features. Often in default
C	C	Lowest rated class of bonds
-	D	In Default

Table 2: Meaning of Ratings by “Moody’s” and Standard & Poor’s (Credit Rating, n.y., n.p.)

CHAPTER THREE

3 Explanation of Basel II

3.1 Failures of Basel I

“Basel I does not reflect credit quality gradations or deterioration in asset quality. Lumping everything from a Triple-A-rated corporate bond to junk bonds in the same Basel I category helped ‘capital arbitrage’ – banks exploiting differences between regulatory and economic capital” (Holmquist, 2007, p. 3). Also Bruckner et al. (2003) criticize this problem that granting credits to economically weak countries would be considerably less risky than a credit for a more powerful country.

3.2 Objectives of Basel II

“The goal of Basel II is to develop a more flexible and forward looking capital adequacy framework that better reflects the risk banks face and encourages them to make ongoing improvements to their risk assessment capabilities” (Bachus, 2005, p. 2). Here are some important risks in the banking industry:

- Credit risk [...]
- Market risk
- Interest rate risk
- Liquidity risk
- Operational risk
- Legal risk [...] (GFS/TQS Compliance with ..., 2006, n.p.)

Chorafas (2004) confirms the risks mentioned above and goes one step further as he says that credit, market, and operational risk partly overlap (see *Figure 1*). Hence it is more important to examine operational risks from a strategic perspective.

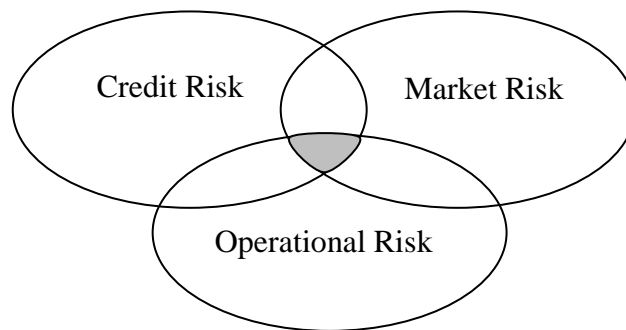


Figure 1: Comprehensive View of Major Risks (cp. Chorafas, 2004, p. 6)

Companies on the other hand have to calculate their risks, too. BII regulations and rules are therefore more sensitive to the real risks that firms face. Operational risks (e.g., systems break down) and employees' failures are considered in the calculation (Salmon & Robertson, 2006). The Basel Committee emphasizes both views mentioned above and announces four main goals of the Basel Accord:

- Continuing to promote safety and soundness in the financial system
- Continuing to enhance competitive equality
- Constitute a more comprehensive approach to addressing risks
- Focus on internationally active banks [...] (Basel Committee, 1999, n.p.)

3.3 Contents of Basel II

Principal item of the Basel Accord is the Three Pillar approach (see *Figure 2*). Hundt et al. (2003) state that controlling measures, which are based on simple reports; indications by banks; and audit reports by certified accountants shall be eliminated. In exchange a high-quality supervision of banking shall be implemented. (Hundt et al., 2003)

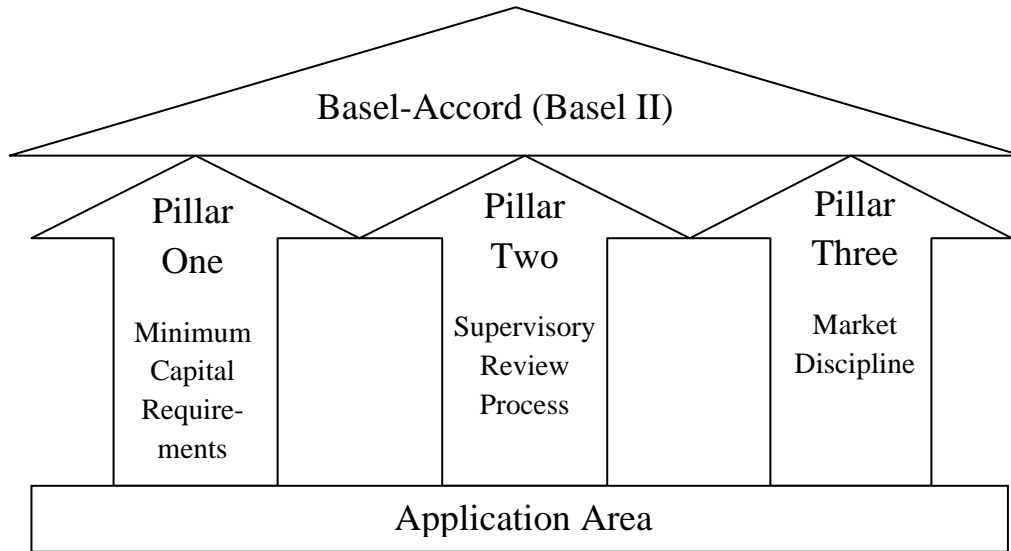


Figure 2: Overview Basel Accord (Hückmann, 2003, p. 28)

3.3.1 Pillar One – Minimum Capital Requirement

3.3.1.1 Credit Risks

The first pillar contributes minimum capital requirements for credit risks. Therefore banks have to keep equity capital in the case that a debtor cannot pay his or her debts. Rating methods evaluate risk potential and give advice about creditworthiness of different beneficiaries. A rating proposes how much equity has to be kept; the higher the risk for banks, the higher the amount of equity, at minimum 8% of the risk (Hückmann, 2003).

Figure 3 provides an overview over the three basic risks companies and banks have to face and shows explicitly that equity capital has to be 8 % at least (see section 3.2 *Objectives of BII* for basic risks).

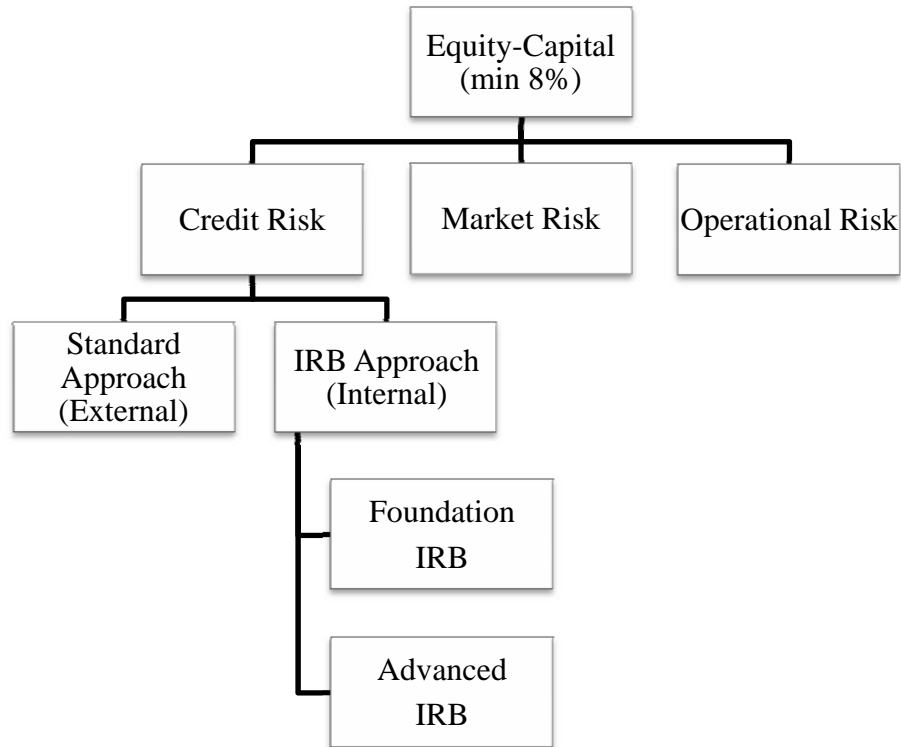


Figure 3: Overview of Basic Risks and Approaches (Cluse et al., 2005, p. 17)

In calculating the demanded equity, banks can choose between a standard approach, which is a modified approach of Basel I, and an IRB (Internal Rating Bases) approach (Bruckner et al., 2003).

3.3.1.1.1 Standard Approach (External)

Hückmann (2003) explains that the amount of equity capital or risk-weighted assets is calculated by multiplying risk-weight and credit amount. She adds, that the risk-weight has to be appraised by an external rating agency and is done for the following groups: countries, banks, large companies and SMEs. Every group has its own risk-weight (see section 2.6 *Ratings*). Since the purpose of this paper is referring to small and middle sized companies, the risk-weights for this group are shown in Table 3.

Ratings (see section 2.6 Ratings, Standard & Poor's)	Risk-Weight
AAA to AA-	20%
A+ to A-	50%
BBB+ to BBB-	100%
BB+ to BB-	100%
B+ to B-	150%
Below B- (C and D ratings)	150%
No Rating	100%

Table 3: Risk-Weights in SMEs (adapted of Cluse et al., 2005, p. 28)

To help readers understand risk-weight, following two calculated examples based on Hückmann (2003) help comprehending:

Assumption: two enterprises *A* and *B* want a credit of \$ 100,000 (€68,306.01).

- Company *A*'s rating is AAA and therefore risk-weight is 20% (see *Table 3*).
- Company *B*'s rating is B+ and therefore the risk-weight by 150% (see *Table 3*).
- Company *A*: 20% risk-weight of \$ 100,000 = \$ 20,000 there from min. 8% = \$ 1,600 (€1,092.90) minimum equity capital.
- Company *B*: 150% risk-weight of \$ 100,000 = \$ 150,000 there from min. 8% = \$ 12,000 (€8,196.72) minimum equity capital.

Rating agencies have to be approved by a national banking surveillance authority to be authorized in executing ratings. The rating itself must be published (Bruckner et al., 2003).

3.3.1.1.2 IRB Approach (Internal)

As an alternative to the standard approach banks can use the IRB approach. They can choose between a Foundation IRB or Advanced IRB and are allowed to use self estimated risk components for rating their beneficiaries:

- Probability of Default (PD)
- Loss Given Default (LGD)
- Exposure At Default (EAD)
- Maturity (M) (Ammann et al., 2001, p. 920)

Bruckner et al. (2003) explain that the difference between Foundation IRB and Advanced IRB is the amount of parameters banks have to consider. They also say, in calculating the Foundation IRB only PD has to be estimated and the other three parameters are provided by law. In the Advanced IRB also LGD and EAD must be estimated by the bank. The maturity can be changed optionally. Hundt et al. (2003) affirm this and state, credit institutions and banks are just allowed to use IRB approaches if they have adequate data-history. Accounting records of three years are necessary for calculating the Foundation IRB. (Hundt et al., 2003). Ammann et al. (2001) confirm as well, that sufficient (historical) data management in according quality has to be done, regarding data which are necessary to rate a company.

3.3.1.2 Operational Risk

Operational risks are those risks which can lead directly or indirectly to losses for the bank due to failures in internal processes, of persons or in systems. Therefore it is necessary for banks to refinance these risks in building equity capital (Cluse et al., 2005).

Figure 4, based on Chorafas (2004), shows the four main operational risks and their influence on each other.

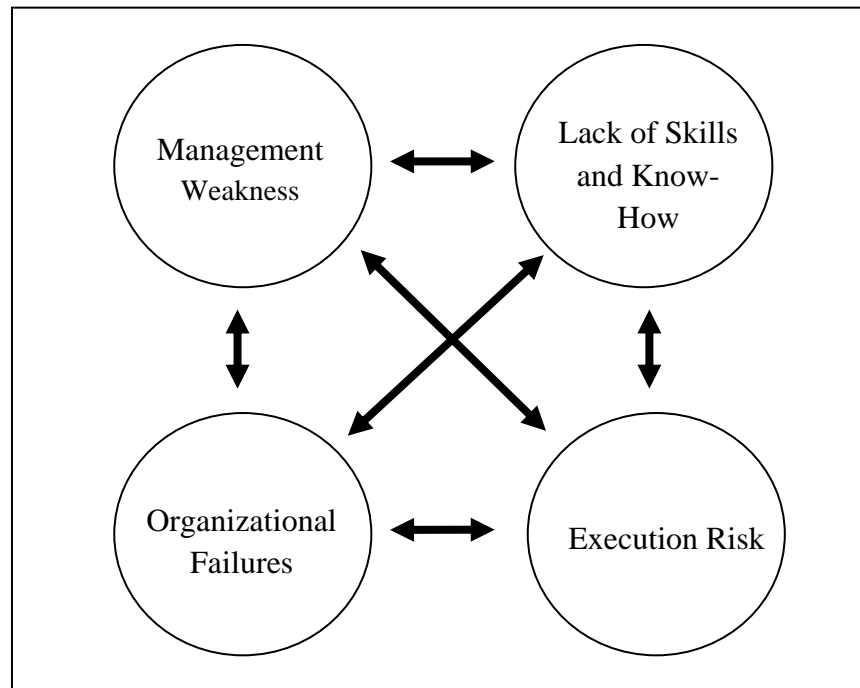


Figure 4: Top Four Operational Risks Influencing One Another (Chorafas, 2004, p. 11)

As operational risks increase steadily, BCBS implemented three different approaches to determine these risks:

- Basic Indicator Approach
- Standardized Approach
- Advanced Measurement Approach (Chorafas, 2004, p. 12)

The Basic Indicator Approach is the simplest of the three approaches, because the amount which has to be refinanced is calculated with 15% of a three year average of the operating revenues of a bank (Bruckner et al., 2003). The Standardized Approach is a bit more complex, because it investigates different business areas of banks. Natter (2006) reveals that “this method divides a bank’s activities in eight business lines (e.g., corporate, finance, retail, asset management, etc.). Gross income for each of the eight lines is then multiplied by a specified factor, ranging from 12 to 18% [...]” (p. 5). The sum of this calculation is the amount which

has to be kept as reserve in form of equity (Bruckner et al, 2003). Banks are free in configuring the Advanced Measurement Approach (AMA). Main goal of AMA is to determine the actual operational risk by using historical data (operational risk loss data). Natter (2006) adds that the data must capture all material activities and exposures in all bank systems and processes. Because of calculating with historical data, expected losses of the next year shall be refinanced by equity capital.

3.3.2 Pillar Two – Supervisory Review Process

Two main objectives are mentioned with Pillar Two. On one hand the adequacy between actual equity capital shall be in relation to actual risks for which a bank is responsible. On the other hand banks shall improve new and better risk management systems (Bruckner et al., 2003).

Four key-principles were created to guarantee an adequate supervisory review process (Cluse et al., 2005). Principle One – Internal Capital Adequacy Assessment Process (ICAAP) comprises all of a bank's procedures and measures designed to ensure "the appropriate identification and measurement of risks; an appropriate level of internal capital in relation to the bank's risk profile; and the application and further development of suitable risk management systems" (FMA, 2006, p.8). Principle Two – Supervisory Review and Evaluation Process (SREP) evaluates ICAAP and risk profiles which is done by supervisors, who can also monitor and ensure compliance with regulatory capital ratios. They should take action if the results are not satisfying (FSC, 2007). The BCBS (2001) states in Principle Three – Supervisory Measures, that supervisors should have the ability to force and require banks to operate above the minimum regulatory capital ratios. Principle Four – Supervisory Invention goes hand in hand with Principle Two. The failures which have been found in Principle Two should be highlighted in this stage. The FMA (2006) reveals that "supervisors should seek to

intervene at an early stage to prevent capital from falling below the minimum levels [...] and should require rapid remedial action if capital is not maintained or restored.” (p. 8)

3.3.3 Pillar Three – Market Discipline

The purpose of Pillar Three is to guarantee that more information about business and risk strategies of banks and companies enter markets ensured by precise publication specifications. Market discipline may be achieved through reactions of market participants, such as investors, debtors, customers and so forth. Additional equity capital requirements are not foreseen in Pillar Three (Cluse et al., 2005). Bruckner et al. (2003) define the publication specifications by the following points:

- Just material information has to be published
- If serious losses menace or obligations to maintain secrecy occur banks will not be forced to publish information
- Banks and companies can choose the publication medium
- The publication specifications have to be signed by the bank’s board of directors including controlling (p. 23)

CHAPTER FOUR

4 Risks for Austrian SMEs

This chapter generally explains the risks which can occur if Austrian's SMEs export to the U.S.A. For explaining the risks, it is necessary to understand why the U.S.A. was unable or refused to implement the regulations and rules of Basel II as well as to understand the current SME and export situation in Austria.

4.1 Reasons for Non-Implementation of BII in the U.S.A.

The Federal Reserve System (Fed) is responsible for the implementation of BII in the U.S.A. The Fed is the central bank of the U.S.A. and was founded in 1913; it consists of a central governmental agency, which is the Board of Governors, and twelve regional Federal Reserve banks. Therefore, Fed is run by both, governmental and private people (Fox et al., 2005). The Board of Governors is the head of the Fed and its headquarters is located in Washington D.C. Each governor is appointed by the president of the U.S.A. and confirmed by the Senate. (Mishkin, 2007). Other tasks of the Fed are controlling the money supply, supervising and regulating banks, maintaining and circulating currency, and protecting customers (Tucker, 2008). It depends on the Fed's choice if BII will be fully implemented. Many reasons contradict the implementation of BII. As Bachus (2005) states, "that when ultimately implemented, Basel II will apply mainly to the largest, most internationally active banks and other that voluntarily adopt it. The remaining institutions in the United States will continue to operate under the original Basel accord, Basel I" (p. 2). He continues, "once implemented, the final capital accord will have profound consequences for the banking industry, our constituents, and the economy of our country. We must take the time and the focus to get this right" (p. 4). There may be many reasons for the non-implementation or partly implementation of BII in the U.S.A. The research adverts to three different sources of

literature; the first two refer to U.S.-American sources, whereas the third one is statements from the internet site of Austria's National Bank to see why Europeans and Austrians think that the implementation in the U.S.A. has (partly) failed. Bachus (2005) said during a joint hearing of the U.S. House of Representatives in May 2005 that:

- There is a belief that the implementation is unnecessarily complex and costly.
- BII creates an unequal situation, especially because regional and small banks would be penalized unfairly.
- As the Basel committee has not yet figured out how regulators can communicate with each other to set significant capital requirements for globally active banks, international standards do not seem possible.
- Nobody knows how the new accord will affect credit markets in the U.S., especially mortgages and credit cards (pp. 3-7).

Schmiedt-Bies (2005) states on the internet site of the Federal Reserve Board that:

- The Fed has decided “to establish higher standards for internal risk management at complex banking organizations, including capital adequacy, and to improve both the supervisors' and the public's understanding of banks' risk taking and risk management”.
- Furthermore, the Fed took and still takes time in all conscience to listen to industry and other public comments to improve BII in response of these clarifications (n.p.).

Haiden (2004) demonstrates in a report of the Austria's National Bank that the U.S.A. does not speed up, because tests and studies shall be arranged to see impacts on certain banks and overall bank environment. Another comment by Haiden (2005) exposes rules will be implemented on time in Europe whereas U.S.A. banks need more time to adapt their risk control systems to BII regulations and rules.

4.2 SME and Export Situation in Austria

SMEs are the basis for Austria's corporate landscape and have therefore significant influence on the business environment. This is valid for the whole European Union and especially for Austria, where the corporate middle class has been developed outstandingly. Bornett (2005) confirms in his research about Austrian SMEs that 99.6 % of all Austrian companies are SMEs. Table 4 shows and clarifies the distribution between smallest, small, middle and large sized companies (see section 2.1 *SMEs (in Austria)* for definition of SMEs).

Company	Total	%
Smallest	218,042	86.1
Small	29,719	11.7
Middle	4,638	1.8
<i>Total SME</i>	<i>252,399</i>	<i>99.6</i>
Large	976	0.4
<i>Total all companies</i>	<i>253.375</i>	<i>100.0</i>

Table 4: Austrian Companies (Bornett, 2005, p. 3)

Several people might think that having success in exporting goods is easier for large companies than for SMEs. Some of the reasons could be that large companies have more experience, they have subsidiaries in foreign countries, they have a good developed and accepted reputation, and they have better possibilities to build relationships with foreign companies. Insofar, this theory is (partly) wrong; export success cannot be associated with the size of a company. An Austrian study done by the Vienna University of Economics and Business Administration substantiate this. The study exemplifies that there is a small significant cohesion between the number of employees and therefore the size of the company and the export quota, which can be seen in Figure 5. In a second analysis of data this

cohesion could not be approved (Kasper et al., 2005). Figure 5 illustrates the results of this study and differentiates between minimal exporters, exporters, extreme exporters, and most extreme exporters compared to the number of employees (see section 2.1 *SMEs (in Austria)* for the size of companies).

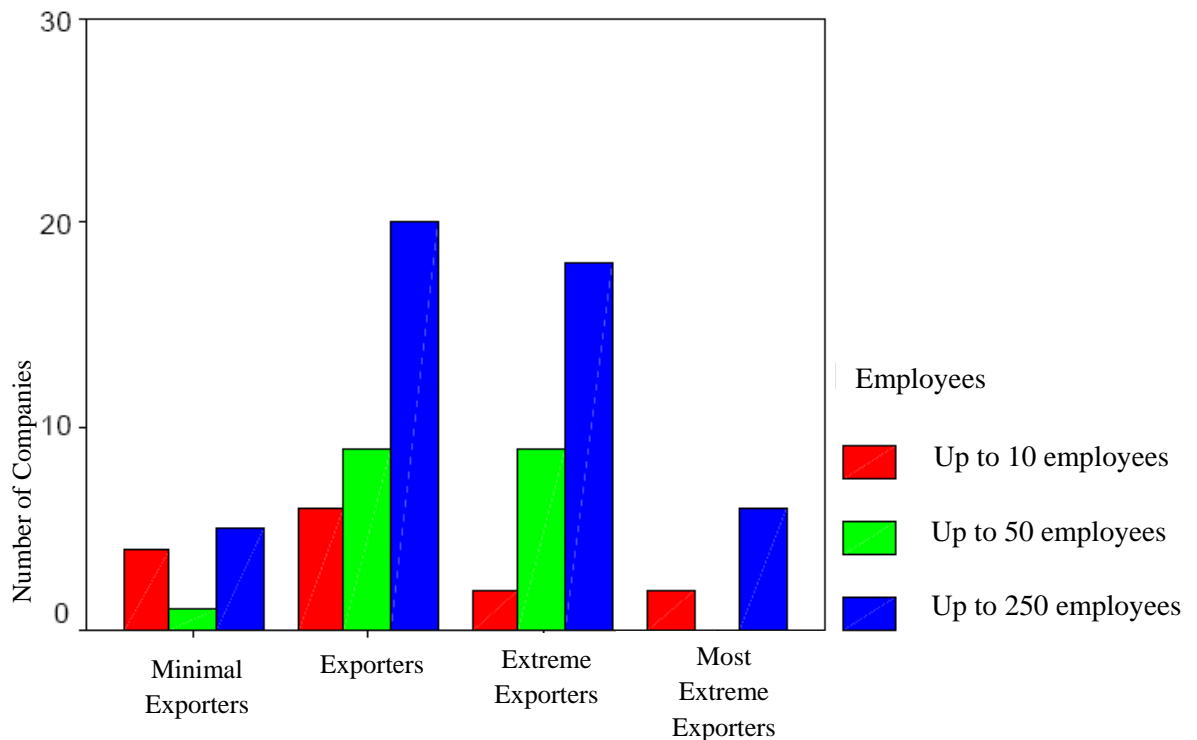


Figure 5: Number of Employees and Export Quota (Kasper et al., 2005, p. 61)

Exports to the U.S.A. from the Austrian point of view increase every year. 2006 was a record year in which Austria exported goods in value of 6.2 billion EUR (9.1 billion USD). Therefore, the U.S.A. remains Austria's third most important export partner, after Germany and Italy, and most important trading partner in overseas affairs. Main exporting industries are automobiles, chemical and pharmaceutical products, and beverages. Less than ten companies are responsible for more than 40% of all Austrian's exports to the U.S.A. Although of bad EUR – USD relations for Austrian exporters in 2006, exports to America have grown more than exports to booming Asian countries such as China or India (apa, 2007).

4.3 Possible Difficulties for Austrian SMEs

Although Austrian SMEs perform well in exporting, (see section 4.2 *SME and Export Situation in Austria*) this section gives information about the difficulties Austrian SMEs might have to face when exporting to the U.S.A. The reasons which have been found were determined in two principles. Every principle consists of two steps. Step one was to examine BII and exporting difficulties were inferred. The second principle was the other way round. First, general exporting problems were determined and connections to BII were found.

4.3.1 Principle One – From BII to Difficulties

BII implements rules which help promote safety in the financial system, and addresses risks in a proper way. As BII is an international approach which already works in Europe, it would be easier for exporters to trust the U.S. system, if BII were implemented because European exporters are already familiar with BII (see sections 2.2 *Basel II*, 2.3 *Basel Committee on Banking Supervision*, and 3.2 *Objectives of Basel II*).

In general, BII guarantees that banks themselves are liquid, because they have to keep equity capital for every credit they grant (see section 3.3.1.1 *Credit Risks*). This situation helps Austrian exporters doing business with U.S. companies because they can be sure that a bank itself will be able to help out if the U.S. trading partner is not able to pay. Even more, exporters can trust this situation because operational risks are included in the calculation of equity capital which has to be kept by banks (see section 3.3.1.3 *Operational Risk*). Even if failures arise due to difficulties in internal processes or due to mistakes of persons – who might be deluded during the extensions of credits because of wrong balance sheets or very convincing CEOs – Austrian exporters can be sure again that banks will be able to help out to fulfill outstanding payments.

Section 3.2 Objectives of Basel II shows that operational risks do not only occur in banks, they also occur in companies. If BII regulations are implemented, they will help companies to face and detect their own operational risks, which simplify the situation for exporters to trust their probable new trading partners, because failures due to persons or systems might not occur very often.

As in section 3.3.3 Pillar Three – Market Discipline described, it is necessary and obligatory for companies and banks to publish their results and figures regularly, at least every quarter of a year, once BII has been implemented. Companies are free in choosing their publishing media, which allows that oversea companies can get information very quickly. Without this BII rule, companies and banks are not forced to publish results and figures which make it more difficult for Austrian SMEs to get meaningful information about probable future trading partners. Even more difficulties arise if an Austrian SME wants to evaluate a U.S.-American company. Especially if the possible trading partner is an SME too, which does not act on the stock exchange, it will be difficult to get significant figures. Theobald (n.y.) affirms this, as he says that it is difficult to get sufficient information about trading partners who are operating in foreign countries. Exporters want to know with whom they are doing business and if the possible trading partner is trustworthy and able to pay debts. Substantiated is this problem by reasons which can be found in section 2.6 Rating, 3.3.1.1.1 Standard Approach, and 3.3.1.1.2 IRB Approach. Although companies can choose in which way they want to be rated, without BII rules companies are hardly rated, which does not make it easier for exporters to evaluate them. Rating is a method to determine the riskiness of a company and if a company can afford total payment of debts. Hückmann (2003) confirms that accomplishing a rating process is very expensive for companies; to get one significant evaluation, it is necessary to be rated by two independent rating agencies. External ratings just take place on initiative by companies (Hückmann, 2003).

Another problem which can occur is related to chapter 3.3.2 Pillar Two – Supervisory Review Process. In this chapter, it is explained that banks have to undergo a supervisory process which can be done in four principles. The process helps supervisors to act if banks want to give risky credits to companies. This situation helps so exporters can feel more confident if they want to do business with U.S.-companies. Therefore, exporters can be sure that balance sheets and thus the financial situation of U.S.-companies are not falsified because of risky credits.

4.3.2 Principle Two – From Difficulties to BII

Theobald (n.y.) defines three types of external trade risks: economical risks, political risks, and exchange-rate risks. Furthermore, he says that every main risk has several subordinate risks and just some risks are calculable. One of these subordinate risks which belong to the family of economical risks is the so called Del-Credere risk. It states that a payer is not willing to pay, cannot pay or is disable to pay. (Silverman, n.y.) Exporters can protect themselves by gaining as much information about their trading partners as possible. Theobald (n.y.) gives following examples:

- Bank inquiries: Exporters can ask their house banks to get some information about trading partners via the house bank of the importer. This is not an infringement of the bank secret, it is common usage. Special attention should be given if the importer is from a country far away. In that case credit agencies should be asked too.
- Credit agencies like “Dun & Bradstreet” and “Creditreform Suisse” do not guarantee for their information, as well as banks, but the advantage is that these agencies do not have self-interest in their customers.

- Using letters of credit for pre-payments, the risk of payment unwilling customers and their banks will be reduced for exporters. Ratings done by well-known companies, like “Moody’s” and “Standard and Poor’s” help to assess trading partners (n.p.).

Based on these general facts, BII helps to find information more easily because companies are forced to be rated (see section 3.3.1.1.1 *Standard Approach*). Connections between subordinated risks of political and exchange-rate risks and BII could not be found.

CHAPTER FIVE

5 Conclusions and Cognitions

In this bachelor paper, a summary about recently found cognitions is given and resulting conclusions about possible problems, which can occur to Austrian exporters – because of the non-implementation of BII in the U.S.A. – are inferred. These results rely significantly to the used scientific acknowledged publications as well as current cognitions.

5.1 Summary

In recent years, requirements and financial standards have changed drastically. Due to fast changing market conditions and international bankruptcies of banks and companies the Basel Committee on Banking Supervision established the Basel accords. BCBS consists of 13 members and its goal is to improve the quality of banking matters. The Basel accords are supervision agreements, whereas Basel I forces banks to keep minimal capital requirement. BII continues where Basel I failed. The BII regulations and rules help banks and companies to face risks which can occur in doing business, including credit, market, operational, and legal risk. Four main objectives can be inferred:

- Equality of competition
- Safety and solidity in the financial sector
- Adequate and comprehensive observance of risks
- Conservation of current equity capital level in banking industry (Hundt et al., 2003, p. 33)

Contents of BII

BII consists of three pillars: Minimum Capital Requirements, Supervisory Review Process, and Market Discipline. The first pillar summarizes the contents which had already been implemented in Basel I. Banks have to keep minimum equity capital, at least 8%, for every credit and loan they grant. The higher the risk for a granted credit, the higher is the amount of equity capital they have to keep. Banks to that not to end up in own financial difficulties. Two main approaches are available to calculate the risk: standard and IRB approach. During the Standard Approach an external rating will be determined. Well-known and accepted rating agencies like “Standard & Poor’s” and “Moody’s” can be conducted to appraise the risk-weight of companies. Once the risk-weight is determined, the necessary equity capital is calculated by multiplying risk-weight, credit amount and the minimum limit of 8%. The IRB Approach on the other hand refers to company’s internal data, like Probability of Default, Loss Given Default, and Exposure at Default. Important fact in this approach: banks are just allowed to use it, if they have sufficient historical data.

The goals of Pillar Two are that actual equity shall be in relation to actual risks banks have to face and improve new and better risk management systems. To achieve these objectives acknowledged supervisors give advice or can intervene if something seems to go wrong, by four key-principles.

Pillar Three guarantees that regular figures and data are published which helps investors, debtors, and customers to get information easily about companies and react quickly on market changes.

Reasons for Non-Implementation of BII in the U.S.A.

Although the BII regulations were initialized by the U.S.A., the country was not able to implement the new rules on time. Europe has been using these regulations in all

matters since the January 1st, 2007. Responsible for the non-implementation is the Federal Reserve System, which is the central bank of the U.S.A. Some reasons are:

- The implementation is unnecessarily complex and costly
- Regional and small banks would be penalized unfairly
- Studies, which are determined currently, shall show impacts on the bank environment.
- The U.S.A. needs time to adapt their risk control system

5.2 Answer of the Research-question

The problems which have been revealed are based on the rules and regulations of BII. The method of reversal has been used; first BII was examined to find facts and figures, and risks or difficulties were educed. Following four main risks can occur, while BII helps to minimize these risks.

- Risk I – Non-Payment: BII guarantees that banks will be liquid if their customers, companies (importers) which do business with exporters, cannot pay their open bills. So exporters can be sure that they will be paid, either from their business partners or from the banks of their business partners, because of the rule that banks have to keep minimum equity capital for every credit they grant.
- Risk II – Person or system failures: As the BII calculation of minimum equity capital also includes operational risk, failures which are done by people or are due to systems and processes are considered. If mistakes happen, exporters can rely that they will not suffer from these failures.
- Risk III – Wrong or insufficient information: If exporters want to get prior information about their possible future trading partners it can be difficult to get significant facts and figures, especially if the partner is a SME as well. BII forces companies to be rated by well-known and trustworthy, international companies like “Moody’s” and

“Standard and Poor’s”. On the other hand, companies have to publish their results regularly. These strategies help exporters to reduce the risk of wrong or insufficient information.

- Risk IV – No confidence in the system: Exporters often do not know much about banking and economy systems in the U.S.A. BII implements supervisors who act if something seems to go wrong either in companies or in banks. Therefore exporters are guaranteed that no highly risky credits are granted and they can feel more confident if they want to do business with U.S.-companies.

5.3 Result and Perspective

BII will be implemented in the U.S.A. with all advantages and disadvantages on the January 1st, 2009, mainly for big and international banks. Small and rural banks can decide independently, whether they want to implement the new rules and regulations. Time will show if the U.S.A. was right to implement BII in a slower way than Europe did.

In the opinion of the author, BII is a timely and adequate method to determine financial risks and equality of competition. Personal experience showed that BII helps to find out if a customer is creditworthy or not. Bank-life has become more bureaucracy but also easier since BII has been implemented.

Connecting factor to this paper could be a research about the reasons of the global financial and business crises 2008 and if it could have been averted if BII regulations would have been implemented on time in the U.S.A.

CHAPTER SIX

6 List of Sources

- Ammann, M., Jovic, D. & Schmid, C. (2001). Der "IRB-Ansatz" als strategische Herausforderung. [IRB-Approach, a strategical challenge] *Der Schweizer Treuhänder*, 10. Retrieved October 12, 2008, from http://www.manuel-ammann.com/pdf/PubsAmmann2001_Basel2SchweizerTreuhaender.pdf
- apa – Austrian Press Agency. (2007, April 3). Außenhandel: Rekord bei Exporten in die U.S.A. [Foreign trade: Export-records to the U.S.A.]. *Die Presse*. Retrieved November 7, 2008 from <http://diepresse.com/home/wirtschaft/economist/295417/index.do>
- Bachus, S. (2005, May). Basel II: Capital Changes in the U.S. Banking System and the Results of the Impact Study. Joint Hearing before the Committee on Financial Services U.S. House Of Representatives. Washington: U.S. Government Printing Office.
- Basel Committee: A New capital adequacy framework. (1999, June). Consultative paper issued by the Basel Committee on Banking Supervision.
- BCBS – Basel Committee on Banking Supervision. (2001, Jan). *Pillar 2 (Supervisory Review Process). Supporting Document to the New Basel Capital Accord*. Retrieved October 13, 2008, from <http://www.bundesbank.de/download/bankenaufsicht/pdf/basel08.pdf>
- Bornett, W. (2005, Feb.). KMU in Österreich. [SME in Austria]. *Austrian Institute for SME Research*. Retrieved November 5, 2008 from <http://www.kmuforschung.ac.at/de/Forschungsberichte/Vortr%C3%A4ge/KMU%20in%20%C3%96sterreich%2024-02-2005.pdf>
- Bruckner, B., Schmoll, A. & Stickler, R. (2003). *Basel II – Konsequenzen für das Kreditrisikomanagement*. [Basel II – Consequences for credit risk management] Vienna: Manzsche Verlags- und Universitätsbuchhandlung
- Business Victoria (2008a). *Types of Export*. Retrieved October 2, 2008, from https://www.business.vic.gov.au/BUSVIC/STANDARD//PC_50743.html
- Business Victoria. (2008b). *What is Export?*. Retrieved October 2, 2008, from https://www.business.vic.gov.au/BUSVIC/STANDARD//pc=PC_50742.html
- Chorafas, D.N. (2004). *Operational Risk Control with Basel II. Basic Principles and Capital Requirements*. Oxford: Elsevier Butterworth-Heinemann
- Cluse, M., Dernbach, A., Engels, J. & Lellmann, P. (2005) Einführung in Basel II. [Introduction in Basel II] In: Deloitte & Touche GmbH. *Basel II – Handbuch zur praktischen Umsetzung des neuen Bankenaufsichtsrechts*. Berlin: Erich Schmidt Verlag
- Credit Rating. Retrieved from October 10, 2008, from <http://www.streetauthority.com/terms/c/cred-rat.asp>

- FMA – Austrian Financial Market Authority. (2006, Feb.). *Bank Wide Risk Management. Internal Capital Adequacy Assessment Process*. Retrieved October 13, 2008, from http://www.fma.gv.at/cms/basel2//attachments/4/5/9/CH0337/CMS1143491030150/2_lf_icaa1.pdf
- Fox, L., Alvarez, S., Braunstein, S., Emerson, M., Johnson, J., Johnson, K., Malphrus, S., et al. (2005). *The Federal Reserve System – Purposes & Functions*. Washington D.C.: Board of Governors of the Federal Reserve System. Retrieved October 13, 2008, from http://www.federalreserve.gov/pf/pdf/pf_1.pdf
- FSC – Financial Services Commission. (2007, Dec.). *Guidance Note. Basel II: Pillar 2 – The ICAAP & The SREP*. Retrieved October 23, 2008, from <http://www.fsc.gi/download/adobe/banking/noteiccaapsrep.pdf>
- GFS/TQS (2006, Dec.). *Compliance with the Requirements of the New Basel Capital Accord (Basel II)*. Retrieved October 2, 2008, from <http://www.gfs.com.br/en/arquivos/GFS%20Software/Comercial/ART-TI-IN-001-1A.pdf>
- Haiden, R.A. (2004). *Basel II*. Retrieved November 5, 2008 from <http://www.notar.at/blueline/upload/langversion.pdf>
- Haiden, R.A. (2005). Basel II kommt – auch wenn die U.S.A. vorübergehend auf der Bremse stehen. [Basel II comes – even though the U.S.A. takes a break]. *Basel II-Newsletter Q4/2005*. Retrieved November 5, 2008, from http://www.oenb.at/de/img/newsletter_basel_ii_q4_2005_tcm14-35080.pdf
- Hoffmann, P. (1991). *Bonitaetsbeurteilung durch Credit-Rating*. [Credit-Rating]. Berlin: Erich Schmidt Verlag
- Holmquist, J. (2007, March). *Implementation of Basel II. Challenges & Opportunities*. Retrieved October 10, 2008, from http://ec.europa.eu/internal_market/speeches/docs/2007/jh05032007.pdf
- Hückmann, C. (2003). *Kreditrating der Mittel- und Kleinbetriebe. Eine Orientierungs- und Entscheidungshilfe zu den Verfahren der Kreditinstitute und Agenturen*. [Credit-rating for Small- und Middle-sized companies. A orientation- and decision-guidance for the methods of credit institutions and agencies]. Vienna: Erich Schmidt Verlag
- Hundt, I., Neitz, B. & Grabau, F.R. (2003). *Rating als Chance für kleine und mittlere Unternehmen*. [Rating, a chance for small und middle-sized companies]. Munich: Verlag Franz Vahlen
- Kasper, H., Loisch, U.C. & Müller, B. (2005, April). *Maßnahmen zur Steigerung der Exportquote in österreichischen Klein- und Mittelunternehmen*. [Measures to improve the export-quota of Austrian Small- and Middle-Sized Enterprises]. Retrieved November 10, 2008, from Vienna University of Economics and Business Administration, Department for Change Management and Management Development Web Site: <http://www.bmwa.gv.at/NR/rdonlyres/88D9D65E-A2BE-4437-B324-2EBB504FDE96/20856/ExportKMUWUEndbericht.pdf>

- Lange, K. (2006, Sep.) Basel II. Wenn Banken Einblick wollen. [Basel II. If banks want to have insight]. *manager-magazin.de*, Article 1. Retrieved October 13, 2008, from <http://www.manager-magazin.de/unternehmen/mittelstand/0,2828,438330,00.html>
- Mishkin, F.S. (2007). *The Economics of Money, Banking, and Financial Markets*. (8th ed.) Boston: Pearson Education, Inc.
- Munsch, M. & Weiss, B. (2000). *Rating – Finanzdienstleistung und Entscheidungshilfe*. [Rating – Financial service and decision guidance] Berlin: Deutscher Industrie/und Handelstag
- Natter, R.. (2006, Oct.). The Basel II Standardized Approach. Retrieved October 13, 2008, from <http://www.abanet.org/buslaw/committees/CL130000pub/newsletter/200609/natter.pdf>
- ÖNB – Österreichische Nationalbank. (2008, Sep). *Euro-Referenzen und Wechselkurse*. [Euro references and exchange-rates] Retrieved September 26, 2008, from <http://www.oenb.at/ebusinesszinssaetze/zinssaetzewechselkurse?mode=wechselkurse>
- Salmon, J. & Robertson, S. (2006, Feb.). *Basel II: An Introduction to the Capital Adequacy Accord and the Capital Requirements Directive*. Retrieved September 26, 2008, from. <http://www.out-law.com/page-7096>
- Schmidt-Bies, S. (Governor). The Federal Reserve Board. (2005, Sep.). *Basel II Developments in the United States*. Retrieved October 23, 2008, from <http://www.federalreserve.gov/boarddocs/speeches/2005/20050926/default.htm#pagetop>
- Silveman, H.R. (n.d.) Factoring as a Finance Device. [Electronic Version] *Harvard Business Review*, 594 – 611.
- Theobald, U. (n.d.) Export, Investition, Marketing. [Export, Investment, Marketing]. *Hilfsmittel Sinologie*, 13. Retrieved November 11, 2008, from <<http://www.uni-tuebingen.de/uni/ans/sino/personal/theobald/hm13.pdf>>
- Tucker I.B. (2008). *Survey of Economics*. (6th ed.) Mason: Nelson Education, Ltd.