

FINANCIES – EMPIRICAL ISSUES & RISK ANALYSIS

Bank loans pricing in the new Basel II regulatory framework

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Under the new Basel II regulatory framework, the need for an effective risk-adjusted pricing mechanism has become even more central in banking than in the past: banks are spurred to develop risk-adjusted measures that can avoid wasteful customers' cross-subsidization and, consequently, play as an essential role in the value creation process for bank shareholders.

The paper aims at detecting how the new Internal Ratings-Based approach does reflect on the loan pricing mechanism adopted by banks, by developing a pricing methodology to estimate risk-adjusted rates and spreads for credit exposures, and by further investigating the relationship between risk factors and loan price.

Following prior literature, risk-adjusted pricing for bank loans can be split into two main components: the first one is the "technical" part, which takes into account both the expected (EL) and the unexpected (UL) losses, and the opportunity cost that banks have to bear for providing committed credit lines to some borrowers, allowing them to call the committed amount at their own request. The second part is defined "commercial" and includes commissions, operational costs, and other subjectively allocated costs, depending on different factors.

We don't take care of these costs since issues arising from their allocation are solved by banks through a detailed facility accounting and this allocation doesn't have any relevance in terms of credit risk management. In this research we focus our attention on the two main components of the "technical" loan price: the remuneration for the expected losses and that for the unexpected losses.

The main inputs we need to take into account in our pricing formula can be simply drawn from an internal rating model (the probability of default, the loss in case of default, the exposure at default and the maturity) and from easy-to-find market data (risk-free interest rates and shareholders' target return).

The pricing formula we propose here is consistent with the new Basel II regulatory approach to credit risk management and provides an immediate support for bank managers in making a loan price-related decision.

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