BASEL II AND ITS IMPACT ON THE STRUCTURED FINANCE MARKET

By
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1. Introduction

During the past few years, structured finance products have become very popular in the western world and growth will be global soon. Whilst Basel II attempts to better, regulate global financial markets, the challenge posed by complex product structures in the structured finance world is huge.

This paper attempts to capture the viewpoint of market participants on the impact of Basel II on the Structured Credit Products Market. It is based on interview centred research conducted in 2004 at the Cass Business School City University London by the author and Mr. Kapil Chadda and is a forward looking, market orientated study. It does not explain in detail the treatment of structured finance products under Basel II nor explore the different product structures available in the structured finance market.

One may wonder if it would be premature at this point of time to discuss a topic related to Basel II and structured finance in Sri Lanka as the domestic structured finance market is still in its infancy and Basel II has only caught the attention of the local banking community during the past two years or so.

The objective of the article is to focus on the current thinking of selected financial professionals, mainly based in London, on Basel II and its impact on the structured finance market. Such investigation will benefit the local banking community in two ways.

1. Firstly it gives a fair view of the concerns and thoughts of 23 financial professionals from London , New York and Paris who directly deal with structured finance and Basel II on a day to day basis.

2. Secondly it will draw attention to issues of implementation, opportunities, and drawbacks of Basel II in the structured finance world.

For the purposes of this study, Structured Credit Products ("SCP") broadly cover Asset Backed Securities (ABS), Mortgaged Backed Securities (MBS), Collaterised Debt Obligations (CDO), and Credit Default Swaps (CDS).

The aim is to give the reader an insight into how the dynamics of this market may be impacted by the new regulatory capital framework and how Issuers, Investors, Regulators and Ratings Agencies will adapt to the way business is done under the new guidelines. Recognising that some uncertainty remains over the decisions and implementation processes that Basel II will to require. This execise is a forwardlooking project on the anticipated changes.

The 23 participants who were interviewed, represented the following cross section of the financial industry:-

1. Buyers of Structured Credit Products (Investors)-
Asset Managers, Insurance Companies, Pension Funds, Hedge Funds (6 participants)

2. Sellers of Structured Credit Products (Issuers)-
Banks and Securities Houses (8 participants)

3. Regulators (2 participants)

4. Credit Ratings Agencies (3 participants)

5. Advisors/ Consultants to the above parties (4 participants) The market participants interviewed, represented senior levels of their organisations and for the purpose of this paper, all references to names of institutions and individuals have been omitted to maintain confidentiality.

The key areas researched were,
1. Will Basel II achieve its objectives?
2. How will Basel II impact the SCP market
3. The role of Regulators and Rating Agencies in making Basel II work for the Structured Credit Market.

The main finding of the study was that whilst Regulatory Capital is an important factor in determining the rationale for conducting this business, it is not the only one; and in fact is not believed to be the most important one. Most market participants will not change their business strategies fundamentally, though smaller players will have to make considerable investments in systems in order to keep up with the larger players and enjoy advantageous regulatory capital relief for their business.

Whilst Regulatory Capital Arbitrage opportunities may be reduced, other motivations for the growth of this business remain strong and the expected future growth will continue undiminished. What will be evident is that the nature of structures will change and the allocation of capital will become more risk sensitive and efficient as financial institutions become Basel II compliant. Financial institutions that anticipate the changes will emerge winners.

2. Overview

Efficient capital management is a foundation for maximization of Shareholder Value for Financial Institutions. The key objective of capital regulation is to ensure that Financial Institutions have a sufficient equity buffer to absorb unexpected credit events and other risks to ensure that unnecessary systemic risk is not created in the financial markets.

The more advanced calculations of the new Basel accord will allow greater emphasis on the risk sensitivity of products based on the internal ratings systems of banks, external ratings or the ‘Statutory Formula’ in the case of Securitization exposures. This approach compared to the Standardised Approach allows for less stringent capital requirement standards, disclosure requirements, and market discipline, under the three pillars of the new proposals.

With the publication of the accord recently, the main focus of banks is currently on implementation and IT installation through 2005-06. Banks will be running Basel I and Basel II rules in parallel through 2007 and Basel II will come into formal effect by the end of that year for most significant players in the market (with US banks having an extra year).

Regulatory capital has been accepted as a useful tool to reduce systemic risk and manage the financial industry effectively. First Basel I and thereafter the proposed Basel II framework were two giant steps in establishing a global framework in setting regulatory capital standards. A common issue that is of interest to academics and practitioners, is how Regulatory Capital is treated when trying to optimize Economic Capital. In the majority of cases in Europe there is an excess of Regulatory capital and therefore regulatory capital is looked upon as a minimum requirement, which most firms more than adequately meet, and
therefore the focus is largely on the optimisation of Economic capital.

Basel Accord has influenced the change that has taken place in the financial industry over the past decade and expectations are that Basel II will have a more pronounced impact. As financial markets have become increasingly efficient, spreads have narrowed and financial institutions are becoming extremely effective in managing their capital resources. On the other hand, markets have become complex in response to demanding client requirements and regulators have been challenged to ensure that the systems are in place to prevent complex financial instruments creating undue systemic risk.

One of the significant developments that changed the landscape of the financial industry during the past decade was the development of the structured finance market. This market has grown rapidly during the past 10 years and it is anticipated that it will grow at an even faster rate during the next 5 years. Products such as ABS, MBS, CDO and synthetic securitization products have become important tools in the financial industry and this has led to the development of a sophisticated credit derivatives market.

The growth of the SCP market is by now well documented. Its usefulness, growth and prevalence in today's market are no longer an issue of debate. As the market continues its growth, there is now a greater focus on the secondary market trading in the products, rather than the origination and structuring of products to restructure balance sheets on a "cash" basis.

As risk becomes a better understood commodity and better managed by banks, there will be a significant shift to a portfolio management approach from a pure credit management approach of balance sheet assets. In addition, most risk is now marked to market, which is also encouraging the need to originate and distribute assets rather than hold them to ensure an optimised portfolio.

Credit risk constitutes a significant portion of the risk in a bank portfolio of assets. This can be packaged into Cash or Synthetic securitization or an "Insurance" product (such as CDS, CDO's, CLN's etc) to off lay the risk into the market. The implication of this is that the risk is therefore reduced and so is the need for Regulatory Capital. The release of this need to hold regulatory capital is a big motivator for the expansion of this market apart from the prime reasons such as

reduction/redistribution of credit risk concentration, insurance from the event of default and freeing up the balance sheet to be able to undertake further risk and develop new business.

The Basel Committee has published its final proposals and now financial institutions are required to put in place the required systems and procedures. The Basel Committee has been careful to assign a critical role for the national supervisors in the implementation of the proposals. Whilst this would encourage countries to implement the most appropriate models, it also opens doors for differences in treatment of financial products in different markets resulting in regulatory arbitrage opportunities.

3. Market Viewpoint - "Interviewee Feedback"

For each area that was investigated, a series of questions (listed under each topic) was posed. Presented below are the key findings from the interviews, in summary bullet form. This will allow the reader an insight to a range of comments the questions elicited and this is followed by brief comments on significant issues that concern the various participants. The interviewers' comments are made in italics.

A) Will Basel II achieve its objectives

i) Does Basel II meet the expectations of the market?
ii) Should Regulatory Arbitrage elimination be a goal of BASEL II?
iii) How will BASEL II affect the Capital Structure of Banks?

These questions were posed to the participants to assess their views if the accord met their expectations and what its potential impact will be on the banking industry. The interviewers believe that the success of Basel II will greatly depend on confidence of the market participants in the broader objectives of Basel II.

- Broad agreement that the accord as published is a step in the right direction with its greater focus on Risk management, with particular focus on the management of correlation risk. Better than what is in place currently.

- Some issues that remain with regards to implementation, are:

- Operational Risk – not clear as to what the calculations will be
- Granularity needs clarification (6 assets making a granular pool, currently proposed is not sensible)
- Trading Book Capital Measurement – needs to be defined
- Clarity on transfer of credit risk Recognition of "double default" effects
- Definition of eligible capital (reduce Tier 1 capital requirement relative to the total capital requirement)

Geographically Europe will be putting in place a regulatory framework under the EU directive that will be a stricter interpretation of Basel II whilst the US will enforce it to its largest 10-20 banks. Asia and other markets are far behind in that some have opted out (China) whilst others are either

undecided or are far behind.

- Business decisions will not be made solely on the basis of regulatory capital charges as it may be capital intensive and yet profitable. It is a consideration but not a key driver.

- Arbitrage will remain and possibly grow between the regulated parts of the Financial industry (Banks, Securities Houses) and the unregulated parts of the industry (Insurance companies and Hedge Funds) which was a consensus reached by most Issuers and Investors that were interviewed.

- Overall capital held in the industry is not going to increase or decrease significantly. It will however, be more aligned with risk.

- The process of implementation and enforcement will evolve to eliminate loopholes that may exist. Different speeds and forces of implementation by National Regulators, will lead to a non-homogeneous regulatory environment across the globe.

- There is however a question of whether the cost of implementation of Basel II will provide an adequate benefit for the smaller financial institutions, given the investment needed to update risk and operational management systems

- The main issue regarding effective implementation is change management with regard to culture and decision making throughout the organisation (especially senior management).

B) Basel II and its impact on the SCP market

i) How does Basel II affect you? Will it limit/increase your interest in SCP?
ii) Should Pillar II / Pillar III be more important as a standard than P I for SCP products?

In order to assess the impact of Basel II on the SCP markets (which was the core of this project) the participants, were asked, if they thought that there would be any significant change to the markets as a result of Basel II.

- The overall impact of Basel II on the SCP market is considered to be “neutral” – Regulatory Capital is only one amongst many factors that motivate participants to be in this business whilst market sentiment will remain a key driver. Regulatory Capital is by far not the most important driver in either Securitisation or Credit Derivatives.

- There will be fewer arbitrage opportunities as there will be uniformity in the application of regulations; but there will be opportunities to securitize bad credits

- The recognition of credit protection should spur the derivatives market.

- The type of investors involved will change from regulated investors (banks) to a greater interest to those that are non-regulated (and don’t suffer from the same capital charges).

- There is currently a trend to provide a hedge against impact from Basel II, by inserting options within the structures that allow participants to mitigate their positions from an adverse

interpretation Basel II when it comes into effect. An example of such a structure could be a synthetic CDO with an embedded “regulatory call option” that would allow the transaction to be called in case of a significant change in the regulatory capital requirement for the structure.

- There will be differentiation in pricing for two similar ratings in different asset classes reflecting more closely the underlying risk (e.g. sub-prime loans vs. mortgages).

- Those banks on the standardised approach may be penalised both from a risk rating point of view and also from a cost of funds point of view for not applying the IRB approach (especially if their competitors are adopting the IRB approach). This may even lead to M&A opportunities between the IRB and standardised banks.

- Pillar II and III will be complimentary to Pillar I but will have little value on a stand alone basis. Pillar I will lay the foundation for risk measurement and reporting.

- Pillar III, over time, will increase in importance as there is a greater drive in the market towards transparency from a compliance, corporate governance and financial disclosure point of view. This may be tempered by banks not wanting to disclose too much to allow their competitors insight into their methods.

C) Growth potential in the SCP market

i) What are the top 3 motivators to do SCP business?
ii) Has the Market “matured”?
iii) Costs versus benefits: Can income and costs of structuring/ issuing be quantified accurately? What is the business case

The objective was to see if the changes in Basel II would impact the growth of the SCP markets given one of their key drivers having been regulatory arbitrage.

- Motivation to be in this business was determined by

- Yield enhancement and cheaper cost of funding remain key drivers
- How bankers are rewarded for doing this business
- Ability to develop flexible structures geared to investor demands
- Negative correlation and diversification to other assets in the portfolio are key drivers for Investors
- None of the respondents said that regulatory capital was today THE KEY motivator to do this business.

- Recognition of double default probability would increase the use of credit wraps on SCP structures and therefore reduce the regulatory capital required and promote further growth of the market

- Innovation to move products from banking book to the trading book is the key focus for the market and CDO2 and CDS2 are becoming increasingly popular to allow financial engineering of

assets.

- Regulatory capital for retaining senior tranches of CDO's will be reduced under Basel II and will be an incentive to hold on to these, whilst focusing more on sale of the mezzanine levels which attract very unfavourable treatment under the new rules.

- There was a common consensus that the SCP markets have now reached a level of maturity, as evidenced by:

- Smaller spreads – gone from 50bps to 5 bps –
- Documentation being standardised – and tested by recent default events, like Marconi, WorldCom and Enron
- The time to market has shrunk from 2 months to 20 minutes for single name CDS's over the last 10 years.
- Migration from banking to trading book of the instruments
- Plain Vanilla SCP could move to becoming an exchange traded product
- Indices are traded as much as US$ 1bn trade in a day

- However, maturity may still not be at its peak due to:

- Lack of liquidity in certain Credit Derivative instruments, such as CDS's where the top 10 names still constitute 50% of the market (with GM, Ford and Daimler-Chrysler constituting a disproportionate majority).
- Highly structured solutions are still required, which will continue to spur innovation (maturity would reduce innovation)
- Number of names in CDS market grown from 125 to 600 in the last year
- but that is still far short of the total market of corporate credit that is traded in the bond market
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- With introduction of more sophisticated systems being introduced for risk management, institutions will have better ways of calculating the true cost of dealing in SCP and therefore will be able to arrive at a more realistic cost/ benefit analysis of their business.

A general feature of this market does seem to be that income was measured far more accurately than costs and in many cases the analysis of costs was mainly focused on headcount. There seemed to be little appreciation of the "hidden cots" of being in a business (such as capital usage, technology etc) as it was considered a function for back office/accounts departments to figure out.

D) SCP markets and Risk Management

iv) Do buyers and sellers understand the risk - Can / Do they measure risk properly?
v) Do Credit Derivatives pose a systemic risk to the financial system?
vi) Have the developments in the Securitisation market led to a more efficient functioning of the financial system or are the innovations motivated by reasons other than risk management – if so what are they?

Given that one of the key objectives of both Securitisation and Credit Derivatives was to better manage risk, interviewers wanted to establish whether participants were cognisant of the risk measurement and management perspective.

- Today sophisticated portfolio management systems that allocate capital efficiently and allow for internal transfer pricing of risk are becoming popular and help the relationship managers to better focus on profitable client relationships.

- Buyers don't always understand the risk as there is still an overdependence on ratings and reliance on sellers whilst the larger more sophisticated players better understand risk.

- There could be a tendency for the front office to take on risk that they may not understand well, as their motivations could be different from the control departments

- With the envisaged growth in the cross industry (eg. Insurance Industry) trades, there is a greater need for non-banking financial institutions to better understand the risks associated with the products that they deal in, as it would lead to a healthier financial environment .

- Very few sellers have the ability to measure the risk on a continuous fair value basis and very few buyers take in to account the correlation risk (second order risks) of the products they buy.

- Basel II has drawn focus on risk modelling and past data has become very important, which is welcomed by the industry. However, lack of default history, prevents any great depth in the analytics that can be generated by ratings agencies or banks.

- When continuously repackaging risk, the cash can leak out leaving the final holder of the risk with an inadequate asset base to absorb the risk.

- Depending on the participant, the time horizon for the risk assessment is very different: A mono-line insurer will look at a structured deal from cradle to grave whilst a Hedge fund will look at the same deal for a matter of months.

- Documentation has a great impact on the ultimate risk of these products.

E) Role of regulators and Basel II

i) What role should national supervisors play in the future?
ii) Do they have the resources to deal with BASEL II/SCP market developments, given the rate of growth and volume/complexity of regulation?
iii) How do regulators view the provisions of Basle II, in helping them to better supervise bank risk and regulatory capital?
iv) Should Insurance companies (Investors) be subject to regulatory capital management

Regulators around the world have been entrusted with a challenging and critical role in implementing Basel II. The success and final shape of the Accord will depend on how well the regulators rise to the challenge. It's equally important for the different market participants to

have confidence that their national regulators are capable to fine tune the implementation so that wider interests of the industry are met.

- Many participants considered the Financial Services Authority (FSA) as the leading light globally in the application of Basel II for structured credit products.

- There is confusion within the market place in terms of the role and involvement of regulators between their Regulatory position and their supervisory role.

- Emerging market regulators (China, India) are thought to be well behind the curve and have not yet even got to the basic standards of Basel I (B4) with great reluctance to contemplate the implications of Basel II. (It is believed that this position has changed during the past year.)

- There was a common perception that Insurance companies should be better regulated with a greater focus on putting aside regulatory capital. Regulators should not get involved in the micro-management of banks.

- Regulators need to help educate the market in terms of how to get to the IRB standards.

- There was a common perception that Insurance companies should be better regulated with a greater focus on putting aside regulatory capital. Regulators should not get involved in the micro-management of banks.

- There was doubt expressed on the resources available to the regulators specially to deal with complex financial instruments.

F) The role of the rating agencies in Basel II

i) Will the role of rating agencies change with Basel II ?
ii) Should they be regulated? (considering greater dependence on ratings)

The objective was to establish the view of the market as to the future relevance of ratings agencies and if given their prominence in the SCP markets, they should be better regulated in terms of their output.

- Rating Agencies are confident that they are well prepared for the implementation of Basle II.

- There was a unanimous view that regulating the ratings agencies is not a viable solution, especially if the independent opinions of the agencies would be affected.

- Most participants agreed that the role of rating agencies was going to continue to be important and critical for the effective implementation of Basel II.

- As internal ratings systems will not have enough data to determine their own historical track record, there will be continued reliance on external ratings. However one of the rating agencies interviewed felt that they too would face similar constraints.

- There was also the feeling that instead of external regulation, self-regulation was more appropriate. As rating agencies are significantly exposed to reputation risk, reputation risk would be a key driver for rating agencies to implement systems for self-regulation. It was felt that more competition in the industry would be healthy and lead to greater concern for reputation risk.

- The pro-cyclicality of ratings remains an issue that is unresolved in the new framework of Basel II.

- Investors still rely on ratings even though they do their own analysis; the restricted numbers of rating agencies means there is probably a greater reliance than there should be.

- There could be a conflict of interest developing, as agencies did both the ratings and credit advisory and modelling business. However, a rating agency explained that the Chinese walls that existed between these two activities were of an adequate standard.

- The agencies need to prove their worth through the analytics that they apply and that can be tested in a downturn.

4. Implications of Basel II on the SCP Markets

Based on the analysis arising from the interviews, research done on the Internet and review of publications, some of the key issues that were of consequence to the participants appeared to be as follows:

Originating Banks / Issuers

The major issues that Banks are dealing with regard to the preparation for Basel II, is the implementation of new risk management and measurement systems as most of them have made the strategic decision of selecting either the IRB or Standardised approach. Another concern is the training of staff and re-evaluation of strategy on origination, distribution, portfolio management and whether they wish to focus on the cash or the synthetic markets. Banks may face change management issues. The top 5 to10 players in Europe and the US appear to be ahead of the pack currently but with the investment in infrastructure and resources being put in place this gap will be narrowed.

There may be a change in the business mix that issuers undertake as residential mortgages, credit cards, retail assets and high-grade corporate bonds become more attractive. Conversely, deals in low grade assets such as high yield corporate bonds, commercial mortgages, project finance, sub-sovereign & emerging countries will attract high levels of regulatory capital and the focus will shift to cost of funding and risk transfer rather than regulatory capital arbitrage. The impact of revised accounting standards, Sarbanes-Oxley and Basel II may however influence the business in multiple ways and will make the future incentive of these transactions difficult to predict.

Investors

From an investors' point of view the impact on the treatment of these instruments for issuers will

create interest for investors to take a more active role in the market. Investors that are not regulated by the Basel II guidelines, will not require to put aside regulatory capital and therefore may have different motivations influencing the demand of such products. The potential arbitrage opportunities amongst banks on the standardised approach (SA) as opposed to those amongst banks on the Internal Ratings Based Approach (IRB) will create a two class system.

Other factors affecting the growth in the Credit Derivatives market such as transparency, standardisation of documentation and liquidity will also be major influences on the level of interest, investors show in the market.

Securitisation exposures rated BBB and below will be sold outside the Basel II sphere to either insurance companies, hedge funds or specialised private equity funds or even to Basel I banks / Basel II banks on the simplified standardised approach, where there will be more attractive treatment of the tranche. Hedge funds that are already doing a lot of CDO2 and CDS2 business will focus on setting up CDO's of BBB tranches .

Rating Agencies

Rating agencies' role will gain prominence in the future whilst the onus will be on them to be self-regulated and to provide an independent and timely analysis for investors. They will have to nevertheless comply with ECAI (External Credit Assessment Institution) requirements.

Whilst the dependence on ratings will increase, especially from those that rely on the Standardised Approach, those that rely on the IRB approach will use ratings under the supervisory formula more as a reference tool rather than a benchmark.

Similarly, investors that are sophisticated will also only use them as a reference tool; however, financial institutions that have a binary view of the risk profile of a client will depend on ratings as guide.

There is a general desire from the market to see more competition and to ensure the Chinese walls between rating agencies' advisory business and the credit risk management/measurement systems business are not conflicting.

Securitisation deals will be encouraged to have a public rating, as without this, they will be disadvantaged and may suffer from a pricing and marketability penalty. Whereas seeking a public rating for an unrated (risky) corporate appears to have even less incentive than today, based on how they will be treated by banks from a regulatory capital perspective.

Regulators

Regulators have a challenging task ahead of them with regard to interpretation and implementation of Basel II while ensuring that the gaps between the global regulators environment are minimised. In most less developed financial markets the regulator also has a critical role as a catalyst. The effective use and active participation of Global forums for the co-ordination of their activities is very important going forward.

Most regulators are challenged by the quality, quantity and reward structure for their personnel

and therefore their biggest challenge remains their ability to implement these new rules effectively and trying to keep up with the innovation in this market segment in a timely manner. Regulation of the structured finance market will be a major strain on the resources available to the regulators.

The distinction between regulating and supervision will be an important split in the role of a regulator and there is currently a wide divergence between the countries with advanced financial markets and the less developed countries, in terms of where the emphasis should be for regulators, going forward.

Regulators are burdened with the volume of work and the level of detail that has to be dealt with and specifically at the evolutionary nature of their work. The dialogue between industry and regulators has to move from a consultative process to one where the less well equipped market participants receive guidance from the regulators as to how to implement their reporting and management systems.

5. Summary of the Market Research

There is broad agreement that Basel II will lead to a more risk sensitive capital provision and also encourage improvement in the risk management techniques applied by banks. However, while regulators are trying to eliminate arbitrage opportunities, banks are hard at work looking for future arbitrage opportunities within the new framework. Though regulatory capital is taken in to consideration in decision making, it is not the driving force. Economic capital is of more significance and market participants believe that eventually regulatory capital will converge with economic capital measurements.

Most market participants disagreed on the argument that 'usage of credit derivatives and securitisation will lead banks to creating higher levels of risk as they hardly retain any risk', pointing out the importance of reputation and long term objectives of the market players. There was consensus that the focus on operational risk in Basel II was positive, even though operational risk measurement was impaired by weak models and lack of understanding of the nature of risk.

The new regulatory framework will have an impact on the securitization and credit derivatives markets in areas such as counterparty concentration and ratings as well as the types of assets being securitised. It is not expected to affect the overall growth rate of the market which will be driven by other market dynamics.

The market has already begun to factor some of the expected implications of Basel II in to structured finance products by way of regulatory call up options and pricing decisions. Whilst Pillar I will remain the building block of the new regulatory framework, market participants strongly believe that Pillar II and Pillar III would become more important in the future.

The majority of the interviewees were of the view that there was growth potential for highly structured products and there was a tendency for the basic products in the market to move towards a more standardised format. Developments in documentation, indices and a sharp drop in spreads and time taken to complete a transaction were all cited as signs of maturity in the market whilst lack of liquidity and counter-parties was considered as one of the main concerns.

It was believed that though most of the large and sophisticated players in the market were well positioned to understand and measure the risks in the industry, many players did not have the required systems nor were fully aware of the risks.

They were also highly dependent on recommendations made by the rating agencies and pitch documents prepared by the sellers. This points towards the significance of more accountability, transparency and better business practices in the industry.

Banks that remain on the standardised approaches will pay a penalty for not having sophisticated risk management systems and this penalty will result in a cost of funding disadvantage. As these banks look at efficient capital usage, they will need to raise additional capital and may use structured products to both raise funding and restructure their capital base. This remains a key opportunity for those banks on the IRB approach and could lead to regulatory arbitrage opportunities between the IRB approach based banks and the banks that follow the Standardised Approach. “Regulatory Swaps” similar to total return swaps could be a new product to surface in the market.

The market in SCP products will gain a further impetus from those sections of the financial services industry that are not regulated by regulatory capital rules. These non regulated financial institutions (such as Hedge Funds, Insurance companies, private equity funds) will have greater interest in these products and banks that are both on Basel II and especially on the IRB approach will find them to be appealing counter-parties.

Part of the success of Basel II will depend on the crucial role that the regulators have been called upon to play and there is a clear distinction between the regulators who are better prepared than the others and most market participants expressed their confidence in the UK and US regulators to be ahead of the league.

Regulators are aware of their changing role and are trying to find the right balance between being a regulator (setting and enforcing rules for all institutions) and a supervisor (involved in detailed review of individual institutions). Rating agencies would have increased responsibility in providing an important component (ratings) that Basel II framework requires and were believed to be generally geared to meet the challenge. Regulation of rating agencies was not considered to be the way forward and any regulatory action that would undermine the independence of the rating agencies was believed to negatively impact the industry.

Undoubtedly Basel II would change the length, breath & colour of the structured finance market and has opened the doors for financial institutions to identify new opportunities. Proactive financial institutions that identify the opportunities will emerge as winners in the new landscape.

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