WILL BASEL II AFFECT THE GROWTH OF THE STRUCTURED CREDIT PRODUCTS MARKET?

Kapil Chadda
Aloysius David
Cass Business School, City University, London

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ABSTRACT

This paper looks at the impact of Basel II on the Structured Credit Products Market (Securitisation and Credit Derivatives) and how the new Regulatory Capital rules will impact the growth of the market in the future.

Given the recent issuance of the guidelines and the pace of growth of the markets, this study will identify if any change will occur in the growth of the market due to regulatory changes. Having analysed the key issues, we met with a number of Banks, Investors, Regulators, Advisors and related parties to gain their input to these issues.

The main finding of the project 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 even the most important one. Most market participants will not change their business strategies fundamentally, however, smaller players will have to make considerable investments in systems in order to keep with the larger players if they want to be key participants in the market and receive advantageous regulatory capital relief for their business and thus also earn Economic Value additive returns for their shareholders.

Whilst Regulatory Capital Arbitrage may be reduced going forward the other motivations for the growth of this business remains strong and the expected future growth is expected to 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.

**Keywords:** Structured Credit Products, Regulatory Capital, Basel II, Securitisation, Credit Derivatives
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CHAPTER 1 – OBJECTIVE

This research project looks at how the impact of Basel II and the new regulatory framework being introduced, will affect the Financial Markets and its participants, with particular focus on the Structured Credit Products Market. For the purposes of this study, Structured Credit Products (“SCP”) are broadly defined as the Securitisation (including ABS, MBS, and ABCP) and Credit Derivatives (CDO, CDS) instruments traded in the structured credit markets.

Our work here is a forward looking project that is trying to solicit views from market participants (Issuers, Investors, Ratings Agencies, Regulators and Advisors to the Industry) about how they are preparing for these changes. We look at this issue from a strategic viewpoint for the industry rather than from a micro-analysis of the regulatory capital calculations and their financial impact on the balance sheet or share price of the participants.

We expect to find that whilst everyone is busy thinking about Basel II and its impact on their business, given that the more advanced elements of Basel have been pushed back from 2006 to 2007, the participants may not be well prepared for it. We further expect to find that given that one of the primary aims of SCP is to take advantage of regulatory arbitrage whilst the primary aim of Basel II being the contrary, that this business will be impacted adversely in terms of its growth and development.
CHAPTER II – CONDUCT OF OUR RESEARCH

II.1 SCOPE

This study is a fact finding document which looks at the recently finalised Basel II accords and examines its impact on the Structured Credit Products Market. The method through which we aim to better understand this is through conducting a market appraisal, interviewing various market participants who are involved in the Structured Credit Products Market. Our study is focused on the major asset classes and the European and US markets.

We aim to establish that Basel II will eliminate some of the arbitrage opportunities and that the growth of the SCP markets will continue as regulatory capital allocation remains a factor but not the most important factor influencing the growth of this market. We do however, expect to see a change in the way risk is measured and monitored. This will allow banks to allocate capital more efficiently and as a result provide better shareholder value.

During the course of our study, we have met with and interviewed a number of market participants who were represented at senior levels of their organisations and or the purposes of this written paper; we have omitted all references to names of companies and individuals to maintain confidentiality. However, we do list for reference purposes the assignment of initials (B1 for Bank No 1, Inv1, for Investor 1 and so on) in Appendix II.
II. II OVERVIEW

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. This approach allows for minimum capital requirement standards, disclosure requirements, and the evolution of such standards over time (market discipline), under the three pillars of the new proposal’s.

Capital requirements can be calculated through the “standardized approach” based on external ratings or the “internal ratings based (IRB) approach” based on ratings set by the lending bank with reference to the probability of default. With the new Basel II proposals which will become effective by 2007-08, these rules will become more simplified.

The Basel IRB proposals will enforce higher capital requirements for credit portfolios that are more concentrated than average, thus encouraging the use of Credit Derivatives that could off-lay the risk from the books to allow for optimization of the use of Capital.

Capital management at Financial Institutions focuses on optimizing the capital utilized based on the risks taken by the institution and the return sought from the capital, to sustain the minimum requirements for solvency.
whilst ensuring that the prime objective of maximizing shareholder value remains central to their activities.

This study has a very strong focus on the market and the views of the market participants. We have interviewed originators, investors, rating agencies, regulators and advisors to assess the reaction to Basel II and its impact on the structured finance market. The focus of the interviews was to obtain a multi angle perspective on the developments and how would the market react to the changes. In total over 20 interviews were conducted covering all parties mentioned above and the responses are summarised in Chapter VI of this paper.
CHAPTER III - STRUCTURED CREDIT PRODUCTS

For a full description of Structured Credit products please see the full paper and Appendix VI in the full paper (available by email to Kapil@chadda.net).
CHAPTER IV - THE BASEL ACCORDS

IV.1 BASEL ACCORDS

For a full description of the history of the Basel Accords and their evolution and impact on the SCP markets, please see the full paper and Appendix VI in the full paper (available by email to Kapil@chadda.net).
CHAPTER VI - MARKET VIEWPOINT

VI.I FEEDBACK TO OUR QUESTIONS

For each area that we wished to investigate, we posed a series of questions (listed under each topic). We present below a summary of our key findings (for detailed responses – please see full thesis by emailing: Kapil@chadda.net). Our comments are made in italics.

A) Will BASEL II achieve its objectives
   i) Are you happy with the final draft of Basel II
   ii) Are there any “loopholes” left for Arbitrage
   iii) Are you / your competitors / your clients ready for Basel II?
   iv) How many banks are moving towards IRB and how many will stay with Standardised Approach
   v) Should Regulatory Arbitrage elimination be a goal of BASEL II?
   vi) How will BASEL II affect the Capital Structure of Banks?

This question was 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.

- Broad agreement that B2 (Basel II) is a step in the right direction with its greater focus on Risk management, with particular focus on the management of correlation risk.
- According to R3 the following key changes in Basel II stand out as noteworthy:
  - Risk-sensitivity of capital charges for credit risk
• New capital charges for operational risk
• No more “one-size fits all” approach
• New incentives for good risk management practices

• Some issues remain with regards to implementation, such as:
  • Operational Risk – not clear as to what the calculations will be
  • Granularity needs clarification (6 assets making a granular pool as currently proposed in not sensible)
  • Market Risk – rules are now 8 years old (A1)
  • Trading Book Capital Measurement – needs to be defined
  • Clarity on transfer of credit risk (A4)
  • Recognition of “double default” effects
  • Trading activities, e.g. potential future exposure needs to be defined (in collaboration with the International Organisation of Securities Commissions) (R3)
  • Definition of eligible capital (reduce Tier 1 capital requirement relative to the total capital requirement) (R3, A1)
  • Future adjustments of the Basel II regulatory framework through the Capital Task Force. (R3)

Survey conducted of 300 participants in over 35 countries highlighting Obstacles to effective implementation of Basel II
According to B1 and S1 the capital retained in a firm is determined by the following major factors:

- Regulatory capital
- Shareholder demands
- Managers own view on risk
- What the market demands

Whilst regulatory capital is only setting the “minimum” standards, the other factors become the key “drivers” for overall capital management. This will lead to efficient use of capital and creation of shareholder value.

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.

Banks whilst wishing to implement new risk management systems continue to seek ways to earn money and take advantage of
regulatory arbitrage (which will not be totally eliminated by Basel II) according to the majority of the banks we spoke to.

- Arbitrage will remain and possibly grow between the regulated parts of the Financial industry and the unregulated parts of the industry.
- Capital held in the industry will be more aligned with risk but remain the same overall.
- There will be winners and losers amongst banks, depending on how the respective assets will be treated under Basel II. (A4)

Changes in Credit Capital (from QIS 3 data)

- There is a clear distinction between those institutions that are ready for Basel II and those that have a long way to go.
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 able to be on the IRB approach) (H1). This may even lead to M&A opportunities between the IRB and standardised banks (B4). If this were to materialise, this could be a great motivator for improvement in risk management techniques in those institutions that have the weakest systems.

Effective implementation influenced by culture and decision making throughout the organisation (especially senior management). (A1)

With more efficient capital alignment there may be an increase in leverage as capital is released and therefore an increase in the overall risk taken on by the banking system (B7, A1, B4 & H1).
B) Basel II and risk management
   i) Will Basel II impact the way you manage and measure risk?
   ii) Will banks become more or less risk averse as a result of becoming more remote from the client due to SCP products off-laying the risk?
   iii) Is the approach they take (IRB/Standardises) a reflection of current Risk Management systems/approach?
   iv) Is Operational Risk an issue for Securitisation /Credit Derivatives (Market and credit risk is)

Given the focus of Basel II on improving risk management and measurement, we wanted to see if market participants viewed the objectives as an opportunity to improve the overall risk management practice or compliance with the “minimum” standards required for compliance purposes.

- Basel II will encourage a move from Credit & Risk management to a Portfolio management approach (B4) and leads banks to an asset management framework of optimising their portfolio of assets (B1).
- Large banks are better positioned to deal with the risk management requirements as they have most of the systems in place to measure real time risk and also measure secondary risk (correlation) impacts on their portfolios. (B1 & A3) given better data and more up to date financial information (A2).
- The focus of the new risk management systems and processes will be to also ensure that senior management have a better grasp on what the exposures and dynamics of the risk are (A2).
• With the new framework, there will be greater impetus to break up risk and restructuring it into more investable opportunities (B7).

• The impact of accounting changes in the measurement of assets, how they are recognised and the distinction between Mark to Market assets (in the trading book) and Accrual assets (in the banking book) will lead to a significant re-think on how to classify and hold assets for Banks.

• Cultural changes have to take place to ensure that there is a move away from measuring simple “credit spreads” to using sophisticated quantitative models to measure all aspects of risk (A4).

• Banks cannot become “remote” from their risk even if they are able to use financial instruments to off lay their risk. This is for a multitude of reasons ranging from (B3):
  o Relationships still have to be managed
  o Reputation risk – especially for serial issuers (R1)
  o Banks generally hold on the first loss positions (even though this could be hedged)
  o Originators generally play the role of servicer’s and therefore if they become more remote, they will be penalised. (B7)
  o Investors (are mature) are aware of this risk and ensure it does not happen

• IRB requires data, infrastructure and a drive to implement (A1) and therefore the market would perceive Banks with the IRB approach
to be more risk sensitive than a Bank that follows a Standardised approach.

- The IRB approach needs 5 year data, which most institutions do not readily have available to them which may lead banks to use the standardised approach. (B7)

- Operational risk was perceived to be a critical risk by all participants even though measurement of the risk is currently perceived to be difficult.

- R3 stated that Operational risk was a key issue which was not focussed on by banks. R1 view was that Operational Risks as something that needs to have a minimum standard and once crossed, it is awarded a rating (irrespective of how high that standard is above the minimum).

- Basel II has however succeeded in heightening awareness of this risk by its inclusion in the regulatory framework and encouraged modelling of it, which remains a subjective art rather than a science (A4).

- INV 1 look at this with a more critical eye as they are long term investors in a transaction and therefore their perspective was markedly different to H1 who were short term momentum traders and viewed operational risk as a lesser-issue.
C) Regulatory capital and Economic Capital in the new environment

i) What has a greater influence:
   i) Regulatory Capital
   ii) Economic Capital (RAROC/EVA)

ii) Is Regulatory Capital a good way to reduce risk

The continuing debate on the different measurements of risk based capital prompted us to ask the participants on what they thought was more important of the two most commonly discussed measures of capital:

- Most banks looked at both measures but with greater focus and reliance on Economic capital for decision making. Regulatory capital is viewed more of a reporting and compliance concern (B3). However, regulatory capital is not a concern for bigger banks as they generally have excess capital and therefore management of Economic Capital is the key (A4).
- Basel II has encouraged a convergence of the two (A2) allowing elimination of regulatory arbitrage.
- The larger players tend to use economic capital whilst the less sophisticated one’s continue to focus on regulatory capital (R3).
- R2 emphasised that “economic risk” is a more refined measure.
- B1 commented that the markets understanding and calculation of economic capital remains rudimentary as evidenced in a study done by Rutter Associates which asked a number of banks to calculate economic capital on the same transaction resulting in widely different results.
• There are also situations where the regulatory capital numbers could be the same whilst the risk profile of the banks could be different because of differences in the underlying risk. (R2)

• It is perceived by A1 that no more than 5 US banks and 5 European banks currently have the ability to use Economic Capital as a standard for their internal risk measurement approach successfully. A4 suggested that the above statistics were more like 10 US banks and 10 Europeans.

• A summary of the change in regulatory capital released/required (“capital positions”) of banks after Basel II is implemented was researched and is summarised below:
D) BASEL II and its impact on the SCP market

i) Will SCP be impacted positively or negatively by BASEL II?
ii) How does B2 affect you? Will it limit/increase your interest in SCP?
iii) Are you happy with the way Pillar I treats securitisation (Is PI a sensible way to look at Securitisation)?
iv) Should Pillar II / Pillar III be more important as a standard than Pillar I (PI) for SCP products?

In order to assess the impact of Basel II on the SCP markets (which is at the core of our project) we asked participants 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 one in either Securitisation or Credit Derivatives. (B4, S1, R1).
- There will be winners and losers in terms of transactions that will gain and loose popularity (e.g. liquidity facilities of less than one year – 364 day revolvers which will loose popularity) due to their focus on regulatory capital needs. B7 thought that there would be a particular drive to restructure existing structured products to make them more capital efficient.
- The recognition of credit protection should spur the market (A2).
- The type of investors involved will change from regulated investors (banks) to a greater interest to those that are non-regulated (A2).
• 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. (H1, A2, B3). 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.

• The focus will change from regulatory arbitrage to a focus on a cheaper source of funding (A2).

• Treatment of Securitisation under Pillar I are considered to be adequate but requires greater clarity (definition of risk transfer still unclear) and some banks may be challenged in providing the data needed to be able to effectively model the risk. (B4, A3)

• In certain cases an AAA securitisation tranche will attract more capital than the bond of the same issuer (A2) and therefore anomalies exist in the new framework. Thickness will not be as much of an issue but seniority (ratings) of tranches will become key drivers of the attraction of securitisation according to INV1.

• 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) (B4).
• 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. (A2, A3, S1, R2).

• Pillar III over time will increase in importance as there is a greater drive in the market towards transparency both 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 (INV1).

• Complex structures will require even more complex risk capital calculations (compared to Statutory Formula Approach) to capture the risk involved (R2).
E) Growth potential in SCP market

i) What are the top 3 motivators to do SCP business?

ii) What are the principal constraints on the business in order of priority: if Regulatory Capital is one of them, how important is it (as a risk reduction technique or anything else)?

iii) Has the Market “matured”

iv) Costs versus benefits: Can you quantify income and costs of structuring/issuing accurately? What is the business case

We wished 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.

- According to B1 the evolution of the SCP markets started with loan concentration management where risk mitigation was the key focus, looking specifically at concentration and quality issues. Today, the focus is on smoothing out earnings. Looking ahead, the focus will be very much on yield enhancement where return optimisation along the lines of asset management will be the way forward.

- For B1 the above strategy has led to a reduction of 50% of investment grade assets on their balance sheet from a risk perspective.

- Motivation’s to be in this business were determined by
  
  o Yield enhancement and cheaper cost of funding remain key drivers (B7)
  
  o Mandate - if the bank was allowed to trade these instruments (B1)
  
  o How bankers are rewarded for doing this business (B1)
o Ability to develop flexible structures geared to investor demands (H2)

o Negative correlation and diversification to other assets in the portfolio are key drivers for Investors (H1, H2, INV2)

o Revenues (B4)

o 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 (INV1)

- Innovation to move products from banking book to the trading book is the key focus for the market (R2) and CDO\(^2\) and CDS\(^2\) are becoming increasingly popular to allow financial engineering of assets.

- New products such as Equity default swaps (of CDO’s) and the growth of the Credit Derivative Indices (CDX Indices) is proving to be the key drivers to growth in the market (R1). In addition new structures that allow blending of the equity/interest rate /fund products and credit markets are now proving to be at the cutting edge of the market (B4)

- 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 (B3) - “the heydays are over” (B4)
o Documentation being standardised - and tested by recent default events, like Marconi, WorldCom and Enron

o The time to market has shrunk from 2 months to 20 minutes for single name CDS’s over the last 10 years. (B6, B3)

o Migration from banking to trading book of the instruments (S1)

o Plain Vanilla SCP (like the indices) could move to becoming an exchange traded product (B3)

o Indices are traded as much as US$ 1bn trade in a day (B1)

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

  o Lack of liquidity (B4 & B3) 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).

  o Highly structured solutions are still required, which will continue to spur innovation (maturity would reduce innovation)

  o 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 (B3, R1).

  o Some outstanding issues re: Restructuring, Double Default (B7)

- As systems develop to better manage and measure risk, there will be a greater desire by banks to hedge these risks, this will lead to a greater use of credit derivatives and structured products.
• Certain markets will see increased activity as the existing portfolios will need restructuring, such as German Landesbank’s losing their AAA ratings (B7).

• One argument is that the largest element of cost is the people in this business and that is measurable (B6) and therefore whilst cost/benefit may be accurate, it is largely able to estimate what the equation is. 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 costs” 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.
F) SCP markets and Risk

i) Do buyers and sellers understand the risk - Can / Do they measure it properly?

ii) Do Credit Derivatives pose a systemic risk to the financial system?

iii) Has the developments in the Securitisation market led to a more efficient functioning of the financial system or do you think the innovations are motivated by other reasons than risk management - if so what are they? (Does the issue of “toxic waste” make it a risk distribution technique more than a risk reduction one - i.e. the systemic risk is not reduced?)

Given that the original focus of both Securitisation and Credit Derivatives was to better manage risk, we wanted to establish if participants were cognisant of the risk measurement and management perspective.

- Basel II will encourage banks to obtain greater protection as it will result in regulatory capital benefits
- The treatment of Guarantees in Basel II will play a great part in terms of how protection under credit derivatives is treated (INV2)
- Buyers don’t always understand the risk as there is still an overdependence on ratings and reliability sellers (INV1) whilst the larger more sophisticated players certainly do.
- 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 (A3)
- There is greater sensitivity for those investors who hold the middle tranches of transactions (Mezzanine portions) in terms of what risk they actually hold (S1).
B3 stated that a major systemic shock to the market was necessary to rationalise the market and would test the systems in place. The growth of the market in the last 3 years in Credit Derivatives has not been checked by any major systemic/market wide shock. Despite the tests of Enron, Worldcom etc, it was suggested that the market was still not as mature as it is today and what was required was a much larger systemic shock such as sudden and persistent interest rate rises or a significant bank failure.

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 (A3).

Basel II has drawn focus on risk modelling and past data has become very important, which is a good thing for the industry (A2). However, lack of default history, prevents any great depth in the analytics that can be generated by ratings agencies or banks (R1).

No major concerns about systemic risks posed by Credit derivatives as risks are now largely understood and broadly well managed, according to S2. However, there remain some concerns over counterparty exposure and concentration of risk.

There remains an issue about “toxic waste” according to S1 as banks retain the riskiest portions whilst the remaining assets circulate amongst investors.
• 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. (S1)
• 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 (INV1) whilst a Hedge fund will look at the same deal for a matter of months (H1).
G) 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) Is there an effort being made to harmonise the regulatory framework between the FSA (EU Regulator) and the Fed - what key differences are there between the regulators mentioned above
iv) Why / how are the changes proposed, important to you?
v) How do regulators view the control and oversight provisions of Basle II, in helping them to better supervise bank risk and regulatory capital?
vi) Should Insurance companies (Investors) be subject to regulatory capital management?

Regulators around the world have been entrusted with a challenging and critical role in the implementation of Basel II and 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 of fine tuning the implementation so that wider interests of the industry are met.

- The FSA is considered the leading light globally in the application of Basel II (A2) for structured credit products.
- B3 and H2 thought that US, UK and Germany were well resourced and responsive whilst Italy was mixed and Portugal, Spain and France were comparatively weak.
- There is confusion within the market place in terms of the role and involvement of regulators between their Regulatory position and their supervisory role. Whilst A1 thought that they should become
less involved on a day to day basis and more focussed on supervision of the rules, A2 thought that they could move towards the Dutch model where small teams may become embedded within institutions to more closely monitor day to day activities of banks. S1 felt that they would move away from pre notification to an exception reporting system, allowing them to dedicate resources elsewhere.

- Emerging market regulators (China, India) are considered 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.
- If global banks are operating in countries (for example, China) where local regulations are compliant with Basel I which may be more onerous than Basel II in terms of capital allocation, Banks could be disadvantaged from operating in those environments.
- There was a perception that through the Accord Implementation Group the national regulators were well co-ordinated and were sharing information in an effective manner (S1 & S2).
- Accounting Standards will force banks to giving greater disclosure which will compliment Pillar III.
- There was a common perception that Insurance companies should be better regulated with a greater focus on putting aside regulatory capital (INV2).
H) The role of the rating agencies in BASEL II

i) Will the role of rating agencies change with Basel II (Do Rating Agencies have value to add in BASEL II implementation) - should they be regulated? (considering greater dependence on ratings, i.e. is the current level of oversight as proposed good enough)

We wanted 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 controlled in terms of their output.

- Rating Agencies are well prepared for the implementation of Basle II.
- There was a unanimous view that regulating the ratings agencies is not a viable solution (R3).
- As internal ratings systems will not have enough data to determine their own historical track record, there will be continued reliance on external ratings (B4, A2, and R1).
- The pro-cyclicality of ratings remains an issue that is unresolved in the new framework of Basle II.
- S1 thought they were about 6 months behind the curve (H2 thought this was more like 2 years!) in their product knowledge of the SCP products and B7 said that they were slow to respond which made them increasingly marginal in the SCP business or Credit Derivatives (a view corroborated by H1).
- R1 felt that part of their limitations arose from the fact that they too have limited amounts of historical data to base empirical work on and the history of defaults for SCP was still limited.
• Investors still rely on them even though they do their own analysis; the restricted numbers of players means there is probably a greater reliance than there should be (INV2).

• As ratings agencies can only rate public paper, it will force companies in increase disclosure to the markets and potentially expose their activities to a point where a public bond issue could be beneficial (B1).

• B1 thought there could be a conflict of interest developing as agencies did both the ratings and credit advisory and modelling business. However, R3 thought that the Chinese walls that existed between these two activities were of an adequate standard.
VI.II IMPLICATIONS OF BASEL II ON THE SCP MARKETS

VI.II.I FOR ORIGINATING BANKS/ISSUERS

The major issues that Banks are dealing with for preparation for Basle II is the implementation of new risk management and measurement systems as they have made the strategic decision of going for the IRB (majority) or Standardised approach (at least in the UK). Another concern is the training of staff and re-evaluation of strategy on origination, distribution and portfolio management.

There may be a change in the business mix that issuers undertake. Retail assets may become more attractive to hold onto the balance sheet and Emerging Markets less so. The latter will shift focus to cost of funding and risk transfer rather than regulatory capital arbitrage.

Credit derivatives and synthetic securitisation may grow further if the issue of “double default” is resolved. The following issues still need resolution:

- The use of SPV as protection provider will no longer be possible due to the treatment of guarantees under the Basel II accord.
- Treatment of credit derivatives in the trading book remains uncertain
- Capital relief difficult to assess in specific cases

Portfolio composition in ABCP conduits is likely to change where more trade receivables will be securitised as they will become cheaper than a bank
loan or bond issuance. This may lead to a restructuring of conduits to rebalance portfolios and also restructure liquidity lines to avoid consolidation under international accounting rules.

Focus on the future in this field can be summarised as:

"Structures that do the traditional job will become a key focus. Structures that reduce balance sheet risk will get more attention. Structures that create value for investors will get more attention. Structures that are transparent will get more attention." (Quote from Janet Tavakoli, CDO & Structured Finance, Wiley 2003)

VI.II.II FOR INVESTORS

Those investors that are not regulated by the Basel II guidelines, will not suffer the same need to put aside regulatory capital and therefore may have different pricing sensitivities. The potential arbitrage opportunities between banks on the standardised approach (SA) and the Internal Ratings Based Approach (IRB) banks will create a two class system.

The other impact of 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 investor's show in the market.

Securitisation exposures rated Ba 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 who are already doing a lot of CDO\(^2\) and CDS\(^2\) business will focus on setting up CDO’s of Ba’s tranches.

**VI.II.III FOR RATING AGENCIES**

Rating agencies role will gain prominence in the future however 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 requirements (External Credit Assessment Institution).

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

There is a general desire from the market to see more competition and to ensure the Chinese walls between their ratings advisory business and the credit risk management/measurement systems business is not conflicted.

**VI.II.IV FOR REGULATORS**

Regulators have a challenging task ahead of them as they try and clarify how they are interpreting the Basel accords and how they intend to implement them whilst at the same time try and ensure that the gaps between the global regulators community is minimised.
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 adequately.

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

Regulators will also be challenged 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.
CHAPTER VII - CONCLUSIONS

VII. I SUMMARY OF 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 into 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.

Summary of Benefits of Basel II Based on a survey of over 300 participants in over 35 countries

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 other market dynamics.

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 sited as signs of maturity in
the market whilst lack of liquidity 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 and were 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.

**Benefits of achieving targeted Basel approach**

Based on a survey of over 300 participants in over 35 countries

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 they were 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.
VII.II WILL BASEL II HINDER OR HELP THE GROWTH OF THE STRUCTURED CREDIT PRODUCTS MARKETS?

Our study has allowed us to reach the following conclusions on this question:

1. The SCP markets will be influenced by Basel II at best positively and at worst neutrally. There is no anticipated negative impact on the growth rate of the market. Whilst some segments may become more unattractive, there will be compensating segments that will continue to spur growth.

2. Whist the motivations for doing SCP business remain the same the relative importance may shift from regulatory arbitrage to cost of funding in the Securitisation market.

3. Credit Derivatives market will see a greater shift to the synthetic markets and also a development of liquidity in the single name CDS’s. This will be complemented with an overall growth in the market that will be spurred on by better risk management techniques which will make banks more aware of what risk they have and therefore more able and wanting to hedge their risks better.

4. 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.

5. The market in SCP products will gain a further impetus from the parts of the financial services industry that are not regulated by regulatory capital rules. These non-regulated financial institutions (such as Hedge Funds, Mono and multi line 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 appealing counterparties.

REFERENCES

See detailed report by emailing Kapil@chadda.net