4. The Implementation of Basel II: Effects, Challenges, and Risks (Source: KPMG, 2003)

Constituent	Current Situation	Effects of Basel II	Challenges	Risks
Banks	• Use "one-size-fits-all" regulatory capital approach	• Need to implement risk management framework tying regulatory capital to economic risks • Need to choose credit and operational risk approaches (Pillar I) • Need to gather, store, and analyze wide array of new data • Need to embed new/enhanced practices across the organization	• Interpret new regulations and understand effects on business • Manage change to risk culture • Secure and maintain board and senior management sponsorship • Face new expectations from regulators, rating agencies, and customers • Need to consider whether to target certain customers/producs or eliminate others • Determine what to do with surplus capital	• Fail to diversify loan portfolio to mitigate risks • Fail to determine the extent of change required, associated costs, benefits, and relevant options • Fail to implement change consistently across the organization • Need to avoid 'gaps'/overlaps in operational and credit risk approaches • Receive a reduced credit rating • Become a target of consolidation

Customers	• Often unable to generate sufficient internal cash flow to realize all necessary investments • Depend on external resources, which could be debt or equity	• Need external/internal rating to obtain credit • Face increased transparency of account profitability • Need to collect and disclose new information • Face possibility of reduced service, standardized products, higher interest rates	• Face new costs resulting from need to provide lenders with new, timely information • Improve lending terms • Improve connections with lenders/investors through enhanced disclosures and structured debt holder's relationship management • Use key performance indicators to monitor performance • Face request for better collateralization • Manage rating process	• Receive a marginal rating, which could result in: - Reduced credit lines - Increased collateral requirements - Fewer refinancing opportunities - Higher interest and general costs Increased information requirements - Comparative disadvantages with suppliers and customers if rating is part of a prequalification process
Regulators	• Operate in a fragmented environment • Need enhanced information to be able to anticipate bank problems (vs. respond in crisis/default)	• Gain access to more and timely information through the new disclosures Basel requires of banks • Gain power to set incentives, penalize wrong-doers, and act (not react) thus contributing to increased financial stability and transparency	• Need well-trained, educated professionals to fill roles that are traditionally not as well paid as comparable positions within financial institutions • Create regulation that reflects the linkages among risks • Provide incentives for banks to evaluate risks through stress-testing and scenario analysis	• May create new costs for banks and ultimately for customers • Impose numerous locally specific choices that diminish the effects of the levelled playing field that Basel II seeks to create

Rating Agencies	• Operate in an oligopolistic environment dominated by Standard & Poor's, Moody's, and Fitch (Europe); others face high barriers to entry	• Grow based on new need for ratings by banks and capital market participants Compete with new, smaller players allied in new associations designed to improve their competitiveness and reputation • Respond to requirements for greater transparency in rating components	• Seek to improve reputation (national agencies) • Obtain approval (supervisory criteria) for banks to use Standard Approach • Maintain high quality of ratings Benefit from intermediation process	• Face reduced market share because most banks will likely use IRB approaches • Fail to benefit from increased competition if smaller agencies cannot surmount barriers to entry
Capital Markets	• Face trend toward securitization, including credit derivatives	• Deal with accelerating trends toward: - Securitization, and growth in derivatives markets - "Risks" (e.g., corporate bonds) offered in smaller parcels - New growth of debt market	• Face reduced customer base as low-quality corporations avoid debt capital markets in favor of stable relationships with banks • Create investor trust and reduce volatility by encouraging the development of a regulatory framework, by market	• Deal with potential for: - Volatility in the debt market - Reduced liquidity - Corporations facing difficulties in offering bonds - Companies running out of capital

Financial Institutions out of Basel II's scope (non-banks, near banks, credit card companies, consumer financing companies)	• Not covered by financial regulation comparable to the Basel regime	• Operate in same markets but in different regulatory environment then Basel-compliant institutions • Do not need to gather or disclose the same information as Basel-compliant institutions • Need to consider the extent to which "complying" with Basel II is strategically important to help the institution remain competitive and to signal quality • Can potentially offer similar financial products at a lower price than competitors	• Interpret new regulations and understand effects on business and risk management • Demonstrate quality as Basel II emerges as a best practice standard	• Fail to respond effectively as Basel II becomes an industry benchmark • Face potential downgrades when assessed by external rating agencies and not applying Basel II