Comments on Basel II

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The second Basel Agreement seeks to re-enforce the capital adequacy rules defined in the first Basel Agreement that have been eroded over the years via the use of off balance sheet transactions. As such, new rules, as espoused by banking regulators, will move financial institutions in two directions simultaneously:

1) Rapid adoption by financial institutions of standard methodologies for risk management and credit management in order for those institutions to qualify in the first instance for the IRB (internal ratings based) standard described in the second Basle Agreement. These institutions will also move quickly to improve their systems, procedures and controls in order to be able to maintain their current level of business for as long as possible.

2) A move toward a business model that will rely more heavily on fee based management and agency charges seeking to move high risk capital to customer organisations in which they will have little or no equity interest.

This evolution, however, could cause major tremors in financial institutions as they see their trading skills subjected to even more severe competition than currently exists for both lower fee structures and higher performance.

This pressure

The effect of these actions may result in an eventual two tier system of institutions to develop in which the most technologically advanced institutions in risk management and credit risk management and those that can best manage their transaction processing will have significant competitive advantages over those less able to meet these challenges. I believe this will also cause an evolution toward external performance audits to determine whether regulatory standards are being met.