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المنامة - البحرين
صندوق البريد ٢٧

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Date 27th May, 2001 التاريخ

Ms. Daniele Nouy
Secretary General
Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

Dear Ms. Nouy,

Re: The New Basel Capital Accord

I am pleased to set out below our banking industry comments on the consultative document on the subject matter.

Pillar 1: Minimum Capital Requirements

– Operational Risk:

The effect of operational risk on the minimum capital ratio:

While using the Basic Indicator Approach and stipulating the fixed percentage (i.e. alpha factor) of the identified indicator (e.g. gross income) for calculation of capital charge on operational risk, due consideration should be given to the approach used by the bank for calculation of credit risk and resultant reduction, if any, in capital requirement thereunder, so that the aggregate capital to be set aside by the bank for all risks, does not show sizeable increase.

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It was suggested that capital charge on operational risk may be made applicable only to banks adopting the IRB approach. Moreover, some banks are of the opinion that operational risks may be best left to national supervisors, who could assign a minimum percentage of capital to be set aside for each bank based on operational risk examinations carried out by the supervisors.

Some banks are of the opinion that the late definition of loss data requirements, may entail hefty and unrealistic operational risk capital changes for banks, particularly wholesale banks.

- The Standardised Approach:

With regard to the Committee's recommendation that lower risk weights may be applied only to those bank and sovereign <u>assets, which are funded by liabilities in the same currencies</u>, some banks believe that there is a strong case for extending this relaxation to include a mix of all Gulf-currency and US$ denominated assets and liabilities as most of the Gulf currencies are pegged to US$. Therefore, the Basel Committee should allow national supervisors to decide which currencies can qualify for lower weights. Moreover, this treatment should also be applicable to similar obligations to private sector entities.

The Standardized Approach does not distinguish between short-term and long-term exposures on sovereigns.

It was noted that the Committee is considering only original maturity, as regard banks exposure (clause 33), as opposed to the current practice of residual maturity. Further, a twelve-month residual maturity for bank exposures should be classified as short-term and, therefore, entitled to a lower risk weight.

One bank believes that a "BBB" rated counterparty has the same risk profile, whether it be a sovereign, bank or corporate. It was commented that maintaining the link between sovereign and bank risk weights could exacerbate systemic stresses during times of crises.

Some banks stated that the Accord's proposed acceptance of unsolicited ratings, on the grounds that will encourage entities to seek rating is unjustified and unacceptable.

The banks are of the opinion that it is inappropriate to use the regulatory capital framework to address perceived inadequacies in the maturity profile of the economy's debt structure. Instead, the regulatory framework should ensure that greater granularity exists in the treatment of maturity by increasing the number of maturity bands within the capital framework.

- Use of external credit ratings, and the effect upon risk weightings:

  Some banks expressed concern that since a majority of corporates and banks in the Middle East are unrated, the Accord would place Middle East banks at a disadvantage vis-à-vis Western counterparts which lend to rated entities i.e. the capital charge for banks in this region will probably be higher.

  Unrated corporates attract a lower risk weight of 100% while corporates rated below BB- relative a weight of 150%. Similarly, unrated banks attract a risk weight of 50% while banks rated below BBB – attract 100%. There will be a strong incentive that such corporates and banks rated below BB – and BBB – respectively, immediately stop rating.

- Risk weighting of equity:

  The banks believe that risk weighting of equity should also be related to the volatility of stock markets i.e. in relatively stable markets, a risk weight of 100% (instead of always 150%) may well be sufficient.

- Granularity adjustment for risk concentration in the banking book:

  Some banks believe that domestic sovereign and sovereign – like assets, as well as assets secured by cash and time deposits should be deducted from total non-retail assets prior to calculation of granularity adjustment. Furthermore, granularity adjustment considers single obligor risk concentration and it does not give due credit for sectoral diversification. It was commented that the granularity index has not yet been subject to an appropriate level of testing and it is, therefor, unclear whether it will provide any meaningful assessment of portfolio risk given its inability to measure correlations among exposures.

- Treatment of project finance and securitization:

  It was highlighted that the definition should be refined to exclude such projects, as those that would have risk characteristics similar to those of other commercial lending. Further, the definition is silent on expansion projects undertaken by existing companies.

  It was mentioned that a distinction needs to be made between cash flow finance and financing of physical movables such as planes and ships.

  It was suggested that project finance should attract high-risk weight.

  The committee has proposed risk-weighting of investment in securitisation trenches rated BB+ to BB- at 150% in the standardised approach. This is higher than corporate exposure which carries a 100% risk weight for rating of BB+ to BB-. The reason for assignment of worse risk weights to investment in securitised assets as compared to direct corporate lending is not clear.

  The definitions of commercial real estate and residential real estate of the Internal Ratings Based approach appear to be very narrow in their scope. Land value, including raw land, land applied in property under development, as well as income generating real estate should qualify as eligible security.

  Unrated corporate debt securities which are quoted on an exchange should be considered eligible collateral, in view of the liquid nature of the security.

  Some banks recommended that the extent of overcollateralisation be recognized and applied to lowering the minimum floor of 20% in the Simple Approach (clause 107) and the minimum "w" of 0.15 in the Comprehensive Approach (clause 101). Moreover, penalising collateral recognition for regulatory capital purposes through the application of the *w* factor may also provide a disincentive to this valuable credit risk management technique. From a conceptual perspective, losses due in part to enforceability problems are already incorporated into credit risk default data. Those types of losses are therefore already covered in the capital framework without requiring an additional adjustment factor. It is therefore strongly recommended that the *w* factor is eliminated.

With regard to holding periods (clause 96), banks recommended that secured lending transaction with remargining should be accorded the same treatment as capital market driven transactions.

One bank is of the opinion that the proposed segregated treatment of project finance under the IRB approach has not been outlined with sufficient clarity.

It was mentioned that since the Accord is proposing severe penalties for banks that support their securitization structures, that will affect the securitisation industry somehow and banks will be less encouraged to securities.

The banking community welcomed the wider recognition of collateral and the use of on-balance sheet netting and guarantee agreements. However, the Accord's emphasis on traded instruments rather than physical assets is of concern to some banks. It was suggested that the local regulators could be provided greater discretion to allow regionally acceptable and liquid securities or other sources of collateral.

- Commitment maturities:

  It was recommended that the credit conversion factor for commitments should be based on the <u>remaining</u> period to maturity instead of on the <u>original</u> period to maturity.

Pillar 2: The Supervisory Review Process

- The establishment of capital charges and limits for interest rate risk in the banking book:

  While determination of "outlier" has been specified in the Accord, the capital requirement norms in this regard need to be split out clearly, to avoid possible regulatory unfairness via Pillar 2.

Pillar 3: Market Discipline

- Some banks believe that the extent of disclosure prescribed in the Accord is too excessive, particularly in small markets, and recommended that the disclosure norms be applied only for submission to the national supervisor and not to market i.e. not as part of a bank's annual reports. In particular, the proposed counterparty breakdowns are clearly inappropriate and could seriously compromise client confidentiality. Moreover, non-bank competitors could use the proposed disclosures to engage in unfair market practices, relative to the bank or its clients.

General Observations:

Inclusion of expected losses in capital requirements, would result in an over-capitalization of the banking system; and accentuate cyclical trends, particularly during a downturn. This is because, in reality, provisions are intended to cover expected losses whilst capital is a cushion for unexpected losses.

Some banks proposed that a step by step approach of implementation i.e. part standardized and part IRB should be allowed.

It is questionable whether the new regulatory capital framework would be valid in the new accounting environment i.e. after the implementation of IAS 39.

Yours sincerely,

Dr. Khalid Abdulla Ateeq
Executive Director – Banking Control