RIYAD BANK
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Via Facsimile and E-Mail

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

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Dear Ms. Nouy,

Subject : Comments on The New Basel Capital Accord

We have reviewed the draft final rules in "The New Basel Capital Accord" (January 2001) document, and relevant supporting documents. We see this as a major and wide ranging revision of the 1988 Capital Accord. While we agree with the basic principles and objectives that govern and underlie the revision, we do have specific comments on various aspects, and rules cited in the New Accord.

Our comments are not confidential, and can be made public. They are referenced below to specific sections and paragraphs in the Rules Document as indicated below:-

Section II – Credit Risk

A. The Standardised Approach

1. (iii) Claims on MDB's

For some reason the IDB (Islamic Development Bank) is not considered eligible for 0% risk, in spite of the fact that the African Development Bank, and the Inter-American Development Bank are being accorded 0% risk treatment. Do they have shareholders of superior financial standing relative to IDB's? Or is their own financial standing superior to IDB's?

1. (iv) Claims on Banks

Rules governing short-term placements with investment grade country banks (that are in the OECD category under the current Accord) in the 3-12 month maturity bucket increase the capital requirement such placements attract, up to 5 times, under option (1), and 2.5 times under option (2). This is drastic, and at significant odds with loss

experience in respect to investment grade banks for this type of exposure in these maturity buckets.

Definition of Short-Term

One major contributing factor to the above is that the definition of short-term has been truncated. Under the old accord it is 12 months. In the first consultative paper 6 months was cited as a possibility, and now 3 months is what is being proposed. This will have a significant impact on Banks placing money with leading emerging market banks, in terms of relative cost of capital in the 3-12 month period (this may also impact the capital requirement for banks on the IRB Approach, if PD's cannot be validated due to the dearth of default statistics on short-term inter-bank placements and/or due to maturity adjustments for short-term exposures not being allowed under Foundation IRB). Based on historic loss experience, 3-6 month inter-bank placements with investment grade banks carry negligible risk of credit loss, and hence, capital requirement (i.e. a capital requirement that is substantially less than what is being implied through risk weights applicable to investment grade banks in A-BBB range under the standardized approach). Therefore, we would propose that the definition be extended, at a minimum, to six months to avoid overly encumbering and possibly destabilizing this important market for liquidity and balance sheet management.

3. (iv) Short-Term / Long Term Assessments

The proposed regulations stipulate that when a long-term assessment is available, the obligor's short-term assessment may not be used. This of course is detrimental to Banks that have short-term ratings that are superior to their long-term ratings. This also implicitly questions the credibility of using external credit assessment agencies. After having relied on their processes to determine capital charges under the Standardised Approach, the consultative document implies lack of confidence in their short-term ratings for short-term exposures. We believe this runs counter to the philosophy of establishing a risk sensitive regulatory capital allocation methodology. We would further add that if concerns exist that the rollover of short-term exposures results in what are effectively long-term exposures with short-term risk weights, then this potential source of abuse be addressed via pillar (2) controls.

II. A.3 (vi) Unsolicited Ratings

The proposed rules discourage unsolicited ratings. They do not disallow them. We believe unsolicited ratings are built on incomplete information, and can be motivated by commercial expediency. We therefore recommend that the Basel Committee explicitly disallow unsolicited ratings for capital adequacy purposes.

II.B.2.i (a) Eligible Collateral (paragraph 76)

It is not clear what is meant by equities in a Main Index. e.g. would this include equities forming the NCFEI index in Saudi Arabia?.

Paragraph (101) The ‘W’ Factor

If the ‘W’ factor is stipulated to cover legal and operational risks associated with perfecting collateral. Is this not covered under the operational risk charge and therefore does it not lead to double counting?

III A.2 Adoption of IRB across all Exposures (paragraph 159)

The requirement that all significant exposure classes (and business units) move to IRB within a short-period of time (according to an aggressive plan) is likely to hold back a number of leading emerging market banks from graduating to Foundation IRB. As these Banks may be in a position to generate PD’s for their corporate lending portfolio, but may not be in a position to do so – in the short run - for their sovereign, bank, or retail portfolios (due to the dearth of default data in the first two portfolios, and the latter portfolio being managed based upon Expected Loss as opposed to PD’s). Given that the risk of cherry picking in respect to the latter three portfolios is low (as they are likely to gain significant capital incentives as they move to IRB–Foundation), we would propose that as long as the IRB Foundation Approach is adopted for the corporate portfolio first, then a less than aggressive plan to adopt IRB for other portfolios is allowed. The timeframes associated with this plan should be left to national discretion of the regulator i.e. becomes a pillar two issue.

III B 1. (i) Formula for Derivation of Risk Weights

It is important to gain further insight into how the risk weight function for Foundation IRB was derived. We understand it includes a (PD) estimation error multiplier, and a Tier (2) capital absorptive capacity multiplier. If Banks in a particular market do not suffer from any of these deficiencies i.e. significant errors in estimating PD’s or lack of tier (2) capital, then Banks in such markets would be incurring capital charges to compensate for weaknesses elsewhere in the international banking system.

Paragraph (176) Representative Values of BRWs

If we compare benchmark risk weights under Foundation IRB with corresponding risk weights under the Standardised Approach (through mapping PD’s), we would observe that there are incentives to move to Foundation IRB with investment grade assets, but that these incentives reduce and then become disincentives as one goes down the credit quality spectrum into (BB-) and single (B). This seems to imply that Banks on the Standardised Approach are made to over allocate capital to their higher quality exposures (especially single (A) – (BBB) range), and under allocate capital to their lower quality portfolio. This seems counter-intuitive, and counter to the philosophy of building a risk sensitive Capital Accord. We believe there should be better parallel between risk-weights (and the respective risk weight curves) under the Standardised Approach and Foundation Approach IRB i.e. lower risk weights for middle investment grade (A-BBB), and possibly higher weights for low sub-investment grades (B and less).

Paragraph (177) Maturity Adjustment Function

One element we have issue with in the construction of the IRB Foundation risk weight function is that risk weights are set based upon a three year maturity across the board. We believe banks graduating to the IRB Foundation Approach should be in a position to risk weight their books based upon a maturity adjustment factor, albeit using a simplified version of the mechanism used for the IRB Advanced Approach. The maturity adjustment should be available for exposures both above and below one year (down to one month).

Paragraph (242) Portfolio Distribution

Banks in leading emerging markets are likely to have significant difficulties with meeting the 30% cap on gross exposures in any one rating grade. This relates to concentration in exposures to sovereigns and PSE's (which are likely to be in a similar rating grade) on the one hand, and middle market credit on the other (in spite of their being in diverse industries).

Some form of relaxation of this rule in the (AAA-BB) range of the rating scale would alleviate the encumbrance that this would pose for banks in leading emerging markets (or those in advanced markets specializing in middle market lending) looking to enter Foundation IRB.

V Operational Risk

First, we are concerned that the operational risk capital charge will be calibrated too high because the framework is being set at a level that equals a large percentage of current minimum regulatory capital.

We are also concerned that overlaps in definitions of credit risk and operational risk may result in possible double counting.

The fundamental difference between operational risk and the other major types of risk (credit risk and market risk) is that operational risk is substantially impacted by a number of highly subjective factors, such as quality of people. More importantly, we believe that time is a factor that has been underestimated. We therefore believe that the Basel Committee needs to find a way of incorporating qualitative adjustments into the regulatory capital charge.

We also feel that it is critical for the Basel Committee to assure the industry that changes based on validation will be incorporated into the final framework and that serious attention will be given to Options 1 and 2, in case the validation process creates more problems than answers.

Having said that, we believe it would be unfortunate if the Basel Committee were to overly discourage the use of Option 3 by devoting minimal resources to this option. Our main concern here is that the banks that do invest in advanced operational risk management systems will end up using a regulatory capital framework that is not very risk sensitive.

Attention should also be paid to the calibration of Option 1 since the calibration discussion begins with the stated 30% of Gross Income, which we believe is too high.

Finally, we believe that model errors and product flaws could constitute a distinct distribution for one bank and may therefore not be representative of other banks' loss distribution. Hence, care should be exercised if the calibration process focuses on distributions associated with a limited number of banks.

Part 4 Disclosures

The amount of disclosure required is extensive. While we support additional disclosure as a matter of principle, we believe there is an extent beyond which, the cost of building the infrastructure to comply outweighs the potential benefits to be achieved in terms of market discipline. In fact some of the disclosure requirements would lead to competitive information being disclosed (especially in smaller banking markets/economies).

The above concludes our comments on the consultative paper.

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We thank the Basel Committee for the substantial work and thought that has gone into designing a more risk sensitive framework in the form of The New Basel Capital Accord. We, however, do request that our concerns above be given serious consideration, as we deem they reflect concerns shared not only by banks in our region, but also with those in other leading emerging markets globally.

Best regards,

Alan R. Thompson
President/CEO