Saudi Arabian Monetary Agency

RIYADH 11169 - SAUDI ARABIA

Deputy Governor

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30th May 2001

Mme. Daniele Nouy
Secretary General
Basel Committee on Banking Supervision
Basel, Switzerland

Dear Mme. Nouy,

Subject: **Comments on the Second Consultative Draft of the Proposed New Capital Accord**

We are pleased to forward to you comments of the Saudi Arabian Monetary Agency on the New Basel Capital Accord issued in January 2001. In the next few days, we will also forward to you a summary of the comments and suggestions of Saudi Banks on these proposals. Some of the main concerns that have been elaborated in the attachment include the following:

1. The New Accord fails to provide a definition of an "internationally active bank".

2. The proposals have not clearly defined the role and responsibilities of the home and host supervisory authorities for implementation of the Capital Accord for cross-border operations.

3. The proposed use of external credit assessment institutions (ECAIs) in countries that lack rating institutions and a rating culture will be difficult to implement.

4. In small markets, the lack of sufficient customer population for various portfolios (corporate, sovereign, project finance, banks) will make it difficult to develop statistically valid Probability of Default (PD) and Loss Given Default (LGD) data.

5. The estimated 20% capital requirement for operational risk under the Basic Indicator Approach appears to be too high for many emerging market banks.

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6. Banks can acquire insurance coverage for a variety of operational risks. The risk mitigation impact of insurance coverage on capital requirements should be recognized.

7. The definition of short-term claims as those under 90 days will have a significant negative impact on the interbank market in many emerging markets.

8. The Islamic Development Bank, based in Jeddah, Saudi Arabia and owned by 53 Islamic countries should be included in the list of Multinational Development Banks that qualify for a 0% risk weight.

9. The Arab Monetary Fund located in Abu Dhabi, UAE and which is owned by 21 Arab countries should also be included in the list of MDBs qualifying for a 0% risk weight.

10. Under Pillar 3, the proposals suggest extensive qualitative and quantitative information disclosure requirements. We are concerned with the cost benefit of these requirements for many small banks in emerging markets.

We are aware that work is still ongoing in important areas related to Operational Risk and the IRB Approach. We will review these proposals as they are made available and provide our comments thereupon.

We will be pleased to discuss our comments with you and your colleagues at the next meeting of the Core Principles Liaison Group. Also we have no objections for our comments to be made public.

Best regards.

Jammaz Al-Suhaimi

cc: GCC Secretariat (Banking Supervision Committee)
Arab Monetary Fund (Bank Supervision Committee)

30th May 2001

Saudi Arabian Monetary Agency Comments on The New Basel Capital Accord

The New Capital Accord unveiled by the Basel Committee in January 2001 lays the foundations for a new global capital adequacy framework for the next decade. While the main objectives of these proposals are to continue to promote safety and soundness of global financial system and enhance competitive equality, its novelty lies in a more comprehensive approach to addressing risk and in greater risk sensitivity in allocation of regulatory capital.

In general we in the Saudi Arabian Monetary Agency support the objectives of the New Capital Accord and believe that it will lead to strengthening risk management practices in the banking industry. Under Pillar 1, banks will be encouraged to develop systems and procedures to better measure, monitor and report credit, market and operational risks. Furthermore, significant incentives are provided for banks to enhance risk management by the promise of regulatory reliance on their internal systems and models. For many sophisticated banks this could translate into lower regulatory capital and will present opportunities for better alignment of their regulatory and economic capital. Under Pillar 2, the Accord emphasizes management's responsibility for managing risks while recommending more proactive banking supervision. It envisages that banking supervisors should have powers to establish capital adequacy levels above the Basel minimum for their banking systems and for individual banks that match their risk profile. The framework is completed by Pillar 3 which favors greater transparency and disclosure by banks commensurate with the complexity and sophistication of their operations. While the core disclosure requirements applicable to all banks are significant, additional requirements are imposed on banks using advanced and sophisticated risk management and capital allocation techniques.

From an emerging market country perspective, there are many positives in the New Accord. Most importantly, the Accord does away with the OECD Club vs. Non-Club distinction in the 1988 Accord and in principle restores fairness and equality. Also, the proposal permits national discretion to banking supervisors for determining risk weights for claims on national government, public sector entities and banks in the domestic market as long as such claims are funded in the local currency. Banking supervisors will also have substantial discretion in applying criteria in areas such as choice of rating agencies and export credit agencies. These proposals further support the major theme of the Basel Core Principles of greater empowerment of national banking supervisory authorities for strengthening the global financial systems. Nevertheless, there are several important areas of concern to the emerging market and developing countries. These require further consideration of and clarifications from the Basel Committee. This article intends to highlight some of these concerns.

1. Definition of an "Internationally Active Bank"

As was the case with the 1988 Basel Accord, the New Accord states that the new framework will focus primarily on "internationally active banks" while its underlying principles are intended to be suitable for banks of varying complexity and sophistication. This is continuation of an ambiguous position and can lead to an interpretation that the New Accord applies mainly to "internationally active banks" and not to all "banks". Many observers believe that given the flexibility and variety of options under the new proposals, it would be simpler to state that the Accord applies to all "banks". Furthermore, the term "internationally active bank" is also unclear and can be interpreted as:

- a bank that is not only a domestic bank;
- a bank that conducts its activities mainly on a cross border basis;
- a bank that is active in international markets for its principal activities;
- a bank that is of systemic importance to international markets.

The absence of a clear definition can lead to inconsistent interpretations among banking supervisors and market participants. This could be detrimental for ensuring competitive equality and a level playing field. Furthermore, as Capital Adequacy is

an important Core Principle, differing interpretations could be a serious point of discord in independent assessments of a country's compliance to the Basel Core Principles.

2. Cross Border Supervisory Responsibilities - Issues Arising from the New Capital Accord

The implementation of the proposed Capital Adequacy Accord would require a clear delineation of responsibility and authority of the host and home banking supervisors in relation to regulatory capital for a cross-border banking establishment. The proposed Accord is largely silent on this subject and the issues have not been addressed in the 1983 Concordat and other guidance from the Basel Committee. Examples include the following:

1. Can a banking supervisor that only permits its domestic banks to apply the standardized approach in the local market require a foreign bank's subsidiary to apply the same approach even where its parent bank has chosen the IRB Approach? Can the banking supervisor apply similar requirements to branch operations of a foreign bank?

2. Can a banking supervisor require a foreign bank's subsidiary to apply an IRB approach while the parent bank follows the standardized approach or a different IRB approach?

3. Where there is a difference in the exercise of national discretion between the home and host supervisory authorities, would a foreign bank's subsidiary be required to comply with both? These discretionary areas include:

   - Preferential treatment of claims in home/host national government and central banks.
   - Acceptable ECAIs and ECAs.
   - Treatment of claims on home/host PSEs at preferential risk weights.
   - Choice of different options by home/host for claims on banks.
   - Choice of risk weights assigned to claims on commercial real estate.

- Choice on use of 150% risk category.
- Potential differences in views on credit mitigation techniques and instruments.

We suggest that the Basel Committee should carry out a thorough review of the cross-border implementation issues and provide relevant guidance for facilitating the implementation.

3. **Inclusion of Islamic Development Bank on the List of Multilateral Development Banks**

Islamic Development Bank (IDB) is a major multilateral development bank that was established in 1975. IDB is based in Jeddah, Saudi Arabia and is owned by the governments of 53 Islamic countries. As at 16 April 1999, the Bank had assets of Islamic Dinar 3.5 billion and equity capital of Islamic Dinar 3.3 billion (one Islamic Dinar is equal to one SDR). IDB participates in equity investments and extends finance for projects in member countries consistent with Islamic Shariah Laws. The purpose of IDB is to foster economic development and social progress of member countries and Muslim communities around the world. Given the multilateral nature of this development bank, its strong financial position and the firm support of its shareholders, we suggest that claims on IDB should be accorded the same treatment as other MDBs.

4. **Inclusion of Arab Monetary Fund on the List of Multilateral Development Banks**

The Arab Monetary Fund (AMF) was established in 1976 as a multilateral financial institution with objectives of promoting economic development, economic integration and financial stability in member countries. The Fund is authorized to provide short-term and medium-term credit facilities, issue guarantees and act as intermediary in issuance of loans, etc. to member states. The AMF is owned by 21 Arab countries and is located in Abu Dhabi, UAE. We suggest that given the objectives and the purposes of the AMF, its strong financial position and the firm support of its member countries,

AMF should be included on the list of MDBs that qualify for a preferential risk weight.

5. Implications for Domestic Banking Systems in Emerging Markets

While the consultative process has involved both the G-10 and non-G-10 countries, many key aspects have only been unveiled in January 2001, after agreements were reached among the G-10 countries. Therefore they are now still to be reviewed by the non-G-10 countries. The quantitative impact study of the New Accord on banks is now underway in many G-10 and non-G-10 countries and should provide important data and information.

All countries need to carefully assess the implications of the New Capital Accord for its impact on their domestic markets. While some of the concerns raised by developing countries following the June 1999 Draft Proposal have been addressed, others still remain, including the following.

(i) **Use of External Credit Assessment Institutions (ECAIs) for Risk Weights.** The Basel Committee sees the Standardized Approach in the New Accord as a revision of the 1988 Accord and to be likely followed by many banks around the globe. To improve risk sensitivity the Committee is proposing to base risk weights on ratings by ECAIs that meet specific criteria. These proposals are particularly problematic for many emerging markets for the following reasons:

- Many countries lack a rating culture in their domestic markets as there are no domestic or regional rating agencies. Where such rating agencies exist they may have difficulty to meet the strict criteria laid out in the proposal. Also, it is unlikely that the major global rating agencies can fill the gap in many countries given that rating coverage in the G-10 countries is still minimal. Therefore most private sector credit in emerging market countries will remain unrated.

- Many strong and sound corporations in emerging market countries are likely to be constrained in obtaining high ratings due to the practice of many ECAIs to apply a sovereign ceiling. Emerging market countries will be reluctant to adopt

rules that will promote allocation of credit by their banks to foreign firms with a high rating while equally sound domestic firms lacking an external rating will be penalized.

- Also, national supervisors will be reluctant to issue rules that would discriminate against domestic banks whose access to higher ratings from global rating agencies may also be hampered by factors beyond their control, i.e. sovereign ceilings. Foreign banks and their branches from countries with high sovereign ratings will have an advantage over domestic banks, distorting competition.

- Some rating agencies, motivated by commercial reasons, carry out unsolicited ratings of sovereigns and banks. Such unsolicited ratings, based on public information are generally low and are intended to open the door for a solicited rating.

Other concerns on the use of ECAIs include the following:

- The procedures, processes and methodology of many rating agencies are not fully transparent. It is ironic that an industry that thrives on transparency of others itself wishes to remain opaque.
- The use of unsolicited ratings in general and the fact that some rating agencies are unwilling to disclose that an assigned rating is "unsolicited".
- The failure of rating agencies to disclose the sovereign ceiling established for a country which acts as a ceiling for all other ratings in that country.
- The proposals could also provide incentives for ECAIs to engage in more unsolicited ratings, for higher risk counterparties to stay unrated and for rating arbitrage.

(ii) **Use of Export Credit Agencies for Sovereign Risk Ratings.** In June 1999 the Basel Committee proposed that the risk weight of sovereigns should be based on ratings assigned by external credit assessment institutions (ECAIs). These proposals met significant resistance because of the poor track record of external rating agencies in predicting sovereign default in the 1990's and particularly during the Southeast Asian Crisis. Furthermore, some countries objected that their low sovereign ratings

were unsolicited and were based on limited public information, and without proper consultation with the relevant authorities. There was also evidence that some ECAIs were using these as a coercive tool to force solicited ratings. Given these objections the Basel Committee has proposed another option whereby national supervisors may permit the use of sovereign ratings assigned by export credit insurance agencies (ECAs) that meet certain criteria. While this may be an acceptable solution for countries which have ECAs, for many emerging market countries without such agencies there are several problems as follows:

- Given that ECAs are often government-owned institutions, their objectivity and independence cannot be assured.
- The purpose, objectives, funding sources and methodologies of these agencies differ widely.
- They are even less transparent than ECAIs as far as their procedures, processes and methodologies are concerned.
- There is little information on their track record in assessing sovereign risk.

Given these concerns, many emerging market countries are unlikely to permit the use of foreign ECAs in risk weighting of sovereign risk including their own sovereign.

(iii) **Use of Internal Rating Based (IRB) Approach**. While the Basel Committee believes that many more banks in G-10 countries than was initially envisaged are likely to use the Foundation and the Advanced IRB Approaches, it is still unclear whether many emerging market banks will be in a position to apply these. The challenge for many banks is not only the development of sophisticated models and systems but also many lack the historical data on loan losses by portfolios of loans as suggested by the Basel Committee. Further, many emerging markets with limited number of participants in the corporate, government, banking and project finance sectors are unlikely to have sufficiently large loan populations for applying statistical techniques for computation of probability of default (PD) and loss give default (LGD).

Another concern for many developing country banking supervisors will be that subsidiaries and branches of large multinational foreign banks are likely to use the IRB Approaches developed by their parent banks. This not only will test the technical

capability of supervisors but also has the potential for distorting competitive equality in these markets. A solution would be that a developing country banking supervisor may decide to permit the use of only the more simple standardized method by all banks in its home market. However, this could lead to strong objections and pressures from the foreign banks.

(iv) **Credit Mitigation Techniques**. The Basel proposals permitting the use of credit mitigation techniques for reducing bank exposures are based on the best practices in the most advanced markets. These credit mitigation techniques will need to meet stringent criteria. Banks in developing market countries are unlikely to benefit from these due to issues relating to payment and settlement systems, weaknesses in legal frameworks, etc.

(v) **Operational Risk**. In the absence of Beta and Gamma factors which are still being prepared by the Basel Committee it can be assumed that the Basic Indicator Approach will be the most punitive followed by the Standardized Approach and the Internal Measurement Approach for calculating capital for operational risk. While this provides a strong incentive for banks to move toward a more sophisticated approach, it appears that many banks are unlikely to have the data on business lines proposed under the Standardized Approach. Even fewer banks will have the historical data on their losses arising from operational risk for computing Probability of Loss Event (PE) and Loss Given Event (LGE).

Many emerging market supervisors believe that the operational risk for banks in their countries is lower than in the more developed markets due to lesser dependence on technology, simpler payment and settlement systems, and lower legal risks. Consequently the regulatory capital requirements for their banks should be much lower than for banks in the advanced markets. However, many emerging market banks are likely to use the Basic Indicator Approach for allocating capital for Operational Risk. The proposed rate of 30% Gross Income is punitive and will mean very high level of capital requirements for such risks.

Many banks in Saudi Arabia and elsewhere carry insurance coverage against certain operational risks such as employee fraud, director's liability, fire, theft, system failure,

etc. Such insurance coverage mitigates the operational risks for the banks and replaces it with the credit risk of the insurance company. The Accord has not recognized the influence of insurance coverage on operational risk.

6. Concerns Arising from the Application of the Accord by International Banks

Banking supervisory authorities in emerging market countries will also need to assess the implications for their financial market and the banking systems of the application of the Accord by major international financial institutions. The implications for the emerging market countries could be as follows:

- A few highly rated countries could benefit from a lower sovereign risk weight, but there could be access and pricing implications for sovereigns with low ratings issued by ECAs and ECAIs. Many countries will see their risk weight rise from 100% to the 150% risk bracket. This will be particularly contentious if their risk weight is based on unsolicited ratings.

- The risk weight for most developing country banks will increase from the current 20% for all short-term interbank claims to a much higher level under option 1. While under Option 2, the Basel Committee has delinked bank rating from sovereign ratings making it theoretically possible for a bank to have a higher rating than its sovereign. However, this ignores that bank ratings are constrained by the use of sovereign ceilings by rating agencies. Furthermore, many banks receive unsolicited ratings based on public information. These are often low as they are intended for banks to seek solicited ratings. Consequently, many emerging market banks are likely to see their access and pricing suffer adversely as a result of these proposals.

- In the aftermath of the Southeast Asian Crisis, it is understandable that the short-term interbank claims have been redefined as those under 90 days. This has implications for many developing country banks' access to liquidity from global markets.

- The corporates and institutional customers in many emerging markets that borrow from international financial markets will also be adversely affected due to sovereign ceilings, lack of domestic rating industry, etc.

In summary, the proposals have the potential to have an adverse impact on international capital flows to emerging market countries and on access of weaker countries to international financial markets. Specifically the use of external ratings to determine risk weights for sovereigns, banks and corporates would increase cost of borrowing for poorly rated countries. Furthermore, tying risk weights to debt ratings could be pro-cyclical. This could aggravate capital outflows from a country or a region, in case of a sharp downgrade of debt, particularly during an economic downturn or crisis.

7. Pillar 2 – Supervisory Review Process

While most emerging market countries fully support the principles in Supervisory Review Pillar 2, their main challenge will be to prepare for more proactive supervision of their banks proposed in the Accord. Not only the supervisors will be required to exercise national discretion in many areas, but they are also required to assess, validate and approve the banks' internal models, risk management practices and information systems. Furthermore the supervisors will far more information for supervisory purposes and for public disclosure from their banks. These requirements will put significant demands on supervisory resources. Many emerging market supervisors will be challenged to obtain, train and retain adequate levels of qualified human resources to meet these responsibilities.

8. Pillar 3 – Market Discipline

These proposals considerably raise the disclosure threshold requiring extensive quantitative and qualitative information. Such a wide range of information may be desirable for foreign investors but it is doubtful that it is essential or appropriate in the less demanding environment of many developing countries.

9. Timetable for Consultations

There are still several important areas where details are incomplete or missing in the New Accord. These include Operational Risk (including refining the definition), Project Finance and Equity in the IRB Approach, Retail Portfolio, Maturity Treatment, Securitization, better calibration of capital, etc. A Quantitative Impact Survey (QIS) of banks in many countries that will provide useful data is still ongoing and the results will be available only in the next few months. The results of the survey may have an impact on the finalization of the New Accord. Currently, it is unclear whether the Basel Committee intends to carry out further consultations in these areas. Given that neither the banking industry nor the broader banking supervisory community would have had a chance to study and assess the impact of the proposals in these areas, a prudent course of action might be to extend the consultative process by a few months.

The 1988 Basel Accord was an agreement between the G-10 countries that was voluntarily adopted by banking supervisors from over 100 countries. The 1988 Accord, despite many weaknesses, provided a simple method of allocating regulatory capital to risks, permitted global comparability and unified definition of regulatory capital. By year 2001, it has arguably outlived its utility due to more sophistication and complexity in banking institutions and financial markets. While everyone supports greater flexibility and refinement in allocation of regulatory capital, the result should not be two completely different systems; one for sophisticated markets and another one for emerging markets. The New Accord should meet the needs of all banks and all markets so that it can be universally applied on a voluntary basis.