البنك السعودي البريطاني
The Saudi British Bank

<u>*Via Facsimile # 00-41-61-2809100*</u>

Madam Daniele Nouy
Secretary General
Basel Committee on Banking Supervision
Basel
<u>SWITZERLAND</u>
Our Ref.: HOR GMC 010028

27th May 2001

Dear Madam,

Sub :- **<u>Basel New Capital Adequacy Accord (NCAF) – Second Consultative Draft</u>**

The Saudi British Bank (SABB) has completed extensive internal discussions on the above document and would like to make the following comments:-

<u>Credit Risk</u>

In liaison with the HSBC Group, of which we are a 40% owned associate, SABB is working towards implementation of the Internal Ratings Based (IRB) Foundation approach, which we would hope to be able to adopt in due course. However, based on our existing systems we will be able to adopt the Standardised approach once NCAF is introduced.

<u>Operational Risk</u>

SABB is likely to use the "Standardised Approach" (Level 2) method for computing the capital required for Operational Risk. The initial calculation will be based on 20% of the current minimum required capital. The Bank will seek to migrate to the "Internal Measurement Approach (IMA)" in a phased manner over time and the compilation of a database of historic loss data has commenced. However, this approach is unlikely to be implemented in the short term. The evolution of an appropriate methodology to be adopted for the IMA approach will be developed through our relationship with the HSBC Group.

<u>NCAF's effect on SABB</u>

Our initial estimate of regulatory capital required under NCAF, assuming that the Bank implemented NCAF as defined above as at 31st March 2001, would be nearly 25% higher than the capital requirement under the previous guidelines.

However, we would expect this estimated capital requirement to reduce, as our measurement of Credit and Operational Risks are further refined and when the Bank introduces the IRB Foundation approach for Credit Risk and the IMA (Level 3) approach for Operational Risk.

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General Commentary

- Disadvantaging Emerging Markets

  Clearly, although there is a thrust towards use of internal models, greater emphasis is likely to be placed on external rating agencies and audit / consulting firms' models for calculating credit and operational risk. This process is inevitably more advanced in OECD countries than it is elsewhere in the world. This may put Saudi banks at a competitive disadvantage as it may lead to higher funding costs for debt and a higher cost of capital for equity.

- Risk Sensitivity

  Under the Standardised approach for Credit Risk there is a need for more levels of risk weighting, as the gap between 50% and 100% is too wide. Thus, it is strongly recommended that at least one more risk weight of 75% be added.

- Retail Risk Weightings

  Banks should be allowed to apply under the Standardised approach, reduced risk weightings, for retail / personal portfolio exposure. For example, as we have a sophisticated credit scoring model then portfolio lending should be weighted at 50%.

- Disincentive to use External Rating Agencies

  Sovereign risk rated (B-) will attract 150% risk weight while unrated risk attracts 100%.

  It seems that this will be an incentive for sovereigns currently rated (B-) or worse not to be rated. We propose that the 150% risk weight is charged only upon an event of default.

- Interbank Volatility

  Under the second option regarding claims on banks, "preferential treatment" is restricted to original maturities that are <3 months.

  The definition of "short-term" for maturities of 3 months or less is inappropriate and could result in a destabilising effect in the Middle East Region. While it is generally recognised that banks in the Region should be encouraged to improve their funding profiles, it is noted that regional banks are active participants in global interbank markets. Since banks in the Region both place and take deposits outside the Region, restricting their ability to rollover short-term interbank credits may well make the interbank markets in the Middle East more volatile.

- Definition of Past Due

  The definition of "past due" should take consideration of "technical past dues" such as the delayed receipt of proceeds from trading or contracting activities – or when payment is pending from a guaranteed payment source. Technical past dues should not be treated as genuine / actual past dues.

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- Past Dues and Collateral

  The treatment of non-payment under a fully collateralised obligation should also not be regarded as "past due".

- Definition of Collateral

  There is a need for a wider recognition of collateral – particularly physical collateral. The current BIS proposals contain a market based bias towards taking collateral, where there is a sound legal framework and a liquid market. However, it is noted that the treatment of repos is particularly conservative. We suggest the extension of collateral to cover Auto and trade receivables; again subject to a sound legal framework.

  It is recommended that the national regulator should have the discretion to specify which types of collateral will receive recognition in its domestic market.

  Shares held under bank custody and covered by legal / binding agreement should be available as collateral even if the banks interest is not registered with the registrar.

  The definition of "eligible" collateral does not include bank guarantees and indemnities – they should be included.

- Enforceability of Collateral

  Banks must obtain legal opinion confirming the enforceability of their collateral arrangement in all relevant jurisdictions.

  Legal opinion should be sought on the documentation rather than on each transaction and furthermore, the legal opinion provider should be chosen at the bank's discretion – this may also include its own internal advisors.

- Insurance to reduce Operational Risks

  We suggest that banks which have insurance policies such as a standard Banker's Blanket Bond which covers certain operational risks are entitled to hold lower regulatory capital on account of Operational Risk. The level of reduction in the capital requirement could be determined through a correlation of the sum insured under the policy and the bank's net earnings.

- Operational Risk across Business Lines

  We also recommend that for the Operational Risk "Standardised" approach a common indicator, to which the beta is applied, is used across business lines. This will discourage "cherry picking" of indicators. Our preference would be to use the gross income of each business line, which could then be reconciled to the reported gross income of the bank.

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I can confirm that the Saudi British Bank does not have any objection to you discussing the contents of this letter in a public forum and I trust that our comments will prove to be of practical use as the banking community works towards adopting the Basel Committees New Capital Adequacy Framework in the coming years.

With best regards.

Yours ~~sincerely~~ly,

David Hodgkinson
Managing Director

cc : The Saudi Arabian Monetary Agency (SAMA)
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