

بِسْمِ اللَّهِ الرَّحْمَنِ الرَّحِيمِ

Central Bank of Oman
The President



البنك المركزي العماني
الرئيس التنفيذي

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The Secretariat
Basel Committee on Banking Supervision
Bank for International Settlements
CH - 4002 Basel
Switzerland

After Compliments,

**Sub: The New Basel Capital Accord – Comments on Third
Consultative Paper**

We appreciate the efforts of the Basel Committee in evolving a risk sensitive New Basel Capital Accord. We feel that the current approach of international consultation will go a long way in developing an Accord that has wider applications, even in emerging markets. We have carefully considered the third consultative document and are in agreement with much of the modifications made in the current format of the New Accord. Still, we feel that some amendments and modifications could greatly simplify the complexities and hasten the implementation schedule of the New Accord. Accordingly, we have some suggestions, which are attached, for the consideration of the Basel Committee.

Best regards,

Hamood Sangour Al Zadjali
The Executive President

**Comments of the Central Bank of Oman on the
Third Consultative Document on The New Basel Capital Accord**

Introduction

1. It is appreciable that the Basel Committee has taken on record of the feedbacks on previous consultative documents and has made several modifications in the Third Consultative Document to realize fully the basic philosophy of the New Basel Capital Accord to align regulatory capital with the latent risk profile of financial institutions. The modifications, more particularly, in the risk-weighting pattern, the proposal for a Simplified Standardised approach, flexibilities in the Internal Rating Based approaches, lower capital charge for operational risk, scope for wider national discretions, etc have simplified the complexities of the proposals and have also enhanced the applications of the New Accord, even in emerging markets.

2. Still, some amendments and modifications could greatly simplify the complexities and hasten the implementation schedule of the New Accord. The following suggestions are made for the consideration of the Basel Committee:

Scope of Application

3. The New Accord is proposed to be applied on a consolidated basis to **internationally active banks**. Even Basel 1 has also explicitly stated so, but supervisors across jurisdictions applied the Accord to all types of banks, notwithstanding their range, cross-border activity and complexity of operations. In view of its simplicity, the adoption of Basel I across financial institutions did not pose any significant implementation challenges. Notwithstanding the Simplified Standardised approach, the New Accord is very complex and calls for sophisticated risk management systems and techniques for estimating regulatory capital. Reckoning the complexities and costs involved, it is neither feasible nor expedient to adopt the New Accord, across all financial institutions. A clear distinction, on the basis of size, cross-border activity and complexity of operations, ought to be made, before applying the New Accord to all categories of financial institutions. Further, to ensure competitive equality and providing a reasonable degree of consistency in application, it is necessary that all supervisors, across jurisdictions, should have a common definition of **internationally active banks**.

Basel Committee may, therefore, define what constitute internationally active banks. Alternatively, the New Accord should clearly provide discretion to the national supervisors to define internationally active banks and extend the scope of application, reckoning the size, cross-border activity and complexity

of operations of institutions. This is in line with the publicly disclosed views of the Federal Reserve on adoption of Basel II. In fact, the Federal Reserve is planning to mandate the New Accord only to top 20 banks that meet certain criteria for size and foreign activity. All other banks are likely to be allowed to remain under Basel I.

4. The document further stated that the New Accord would be extended to include, on a consolidated basis, any holding company that is the parent entity within a banking group. Further, the national supervisors are given discretion in many areas and the approach adopted by them is applicable to all the banks operating in their jurisdiction. This would create problem for banks that are operating internationally. The alternative approaches and national discretions would entail the need for running parallel systems to comply with the host and home country supervisors. This could even result in multiple prescriptions on same type of claims. For instance, while a bank operating in US may be required to follow advanced IRB approach, the same bank may be required to follow Standardised or Foundation IRB approach for providing capital charge for credit risk in the Sultanate of Oman.

5. This may, also, have the potential of incurring additional costs and maintenance of excess capital in certain jurisdictions. While this conflict cannot be resolved without undermining the authority of host country supervisors, some sort of international convergence is warranted. Where maintenance of assigned capital is mandatory, permission to adopt sophisticated approaches than that mandated to other local banks would militate the basic spirit of ensuring that banks operating in the same region are subjected to same capital charge. Furthermore, the validation of such models without adequate local data and expertise may pose serious challenges to the host country supervisors. Leaving the discretion entirely to the home country supervisors is also not prudent.

Lack of clarity could be a major impediment to the effective rollout of the New Accord. Thus, host country supervisors should have the right to mandate appropriate approach/es in estimating regulatory capital on the basis of local environment, within the policy setting that no foreign banks should be discriminated in regulatory / supervisory standards. The New Accord should explicitly address the cross-border issues to avoid conflicts between host and home country supervisors. The Basel Accord Implementation Group may consider this issue.

6. The New Capital Accord has prescribed distinct approaches for assigning regulatory capital charge for banking and trading books. The accounting treatment of certain off-balance sheet items, under International Accounting Standard (IAS) 39 has been at variance with the risk management practices

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of banks. The accounting rules could potentially be in conflict with the New Accord's requirements.

It is essential that the Basel Committee and the International Accounting Standards Board (IASB) resolve the conflicts ahead of the implementation schedule of the New Capital Accord.

7. The New Accord is scheduled to be rolled out in various jurisdictions by 2006. It is true that the modifications made to the third Consultative Document have substantially simplified the implementation issues of emerging markets. While the target date may not be too ambitious in developed financial markets, emerging markets like the Sultanate of Oman may not be geared to adopt the New Accord with all the complexities and the associated implementation issues. Recognizing the fact that even the Simplified Standardized approach is likely to be more extensive and complex than Basel I, the New Accord may be applied, in phases, at the discretion of national supervisors to banks on the basis of the complexity, cross-border activity, size, etc. The supervisors in emerging markets should have flexibility in rolling out appropriate roadmaps and signposts for the implementation of the New Accord.

Thus, the Central Bank of Oman feels that supervisors in the emerging markets should have the discretion to roll out implementation schedules for smooth transition to the New Capital Accord without disturbing the local financial markets and liquidity. Each national supervisor may, however, be required to publicly announce a schedule for implementation of the New Accord and the status of implementation may be evaluated by The Basel Accord Implementation Group.

Operational Risk

8. The proposed capital charge of 15% of gross income under the Basic Indicator approach, uniformly to all banks, is overly conservative. Further, it does not reflect the risk profile of banks, operating under various levels of sophistication, markets, etc. The magnitude of operational risk depends on complexity of operations, absorption level of technology, value of transactions, legal / supervisory framework, internal control systems, etc. Thus, a uniform capital charge may not capture the underlying risk profile and also has the potential of penalizing those banks with higher gross income. Further, insurance cover has not been recognized as a risk mitigation technique under the Basic Indicator and the Standardised approaches. Most of the banks in the emerging markets have not adopted sophisticated technologies and have also not introduced complex products. Thus, banks in emerging markets will be opting for the Basic Indicator approach. In view of the uniform prescription of capital charge, banks in emerging markets would

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end up providing additional capital, although the operational risk to which they are exposed is not that significant.

We, therefore, feel that the national supervisors should have discretion to fix a country specific limit, subject to a floor of 10% of gross income on the basis of complexities of banks' operations, level of technology absorption, legal system, past loss events, insurance cover, etc.

Trading Book Issues

9. A uniform capital charge of 8% has been proposed for the category under **All others** which does not reflect and compare with the risk weight of 150% or higher being proposed for claims on sovereigns, banks and corporates that are rated below B-. Unless, the capital charge or risk weights are uniform for claims both in the trading and banking books, the New Accord may leave opportunities for regulatory arbitrage.

We, therefore, feel that the capital charge for specific risk in the banking and trading books should be consistent to avoid regulatory arbitrages.

Conclusion

10. The Central Bank of Oman appreciates the Basel Committee's efforts in refining the New Accord, which could be applied even to banks domiciled in emerging markets. The modifications now proposed addressed most of the implementation issues and concerns expressed by the emerging markets while preserving the basic philosophy of making the capital allocation more risk-sensitive. Notwithstanding the proposed Simplified Standardised approach, the complexity and sophistication of the proposals restricts its universal application and the national supervisors and financial institutions would be facing significant challenges in adopting all the proposals. The minimum standards set even for the IRB foundation approach are complex and beyond the reach of many banks. The capital charge for operational risk is overly conservative. Further, the implementation schedule is too ambitious for emerging markets like the Sultanate of Oman, which is not geared to adopt the New Accord with all the complexities and the associated implementation issues. National supervisors may, therefore, be given discretion to decide on the timeframe for implementing the New Accord and applying it to various banks in their jurisdiction depending upon the size, cross-border activities and complexity of their operations.
