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Saudi Arabian Monetary Agency
Comments on
Basel II Capital Accord

The proposed Basel II Capital Accord when unveiled by the Basel Committee will lay the foundations for a new global capital adequacy framework. While the main objectives of these proposals will continue to be 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, the Saudi Arabian Monetary Agency supports the objectives of the new Capital Accord and believes that it will lead to strengthening risk management practices in the banking industry. 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 that require further consideration of and clarifications from the Basel Committee.

1. Definition of an "Internationally Active Bank"

The proposed Capital Accord states that the new framework will be applied to "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 that can lead to various interpretations of this term such 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 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. Comments on Standardized Approach

The 'Standardized Approach' has drawn many comments during the consultative process from developing country banks and supervisors. We have also raised some issues that we believe are shared by other supervisors. These are as follows:

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 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.
- Based on external ratings, many emerging market supervisors will be requiring domestic banks to assign a higher risk weight to their own sovereigns for its foreign currency borrowings in comparison with other sovereigns, foreign banks and foreign corporations. Not only will this prove to be politically difficult, it will provide a perverse incentive for domestic banks to favor foreign counterparties over domestic borrowers. This has potential for a negative impact on capital flows to some emerging markets.

Other concerns on the use of ECAIs include the following:

- The procedures, processes and methodology of many rating agencies are not fully transparent.
- 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.

Use of Export Credit Agencies for Sovereign Risk Ratings: Given the above 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 ECAs 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.

Lower Risk Weights for Retail and Mortgage Loans: Some new proposals such as the 75% risk bracket for retail customers and 35% bracket for residential mortgages are based on data from the G-10 countries and may not be relevant or appropriate for many emerging markets where conditions and environments are very different. The underlying reasons for low risk weights for these assets which are relevant in the G-10 countries may not be prevalent in many developing countries.

3. **Use of Internal Rating Based (IRB) Approach**

While it is still uncertain as to how many banks in G-10 countries are likely to use the Foundation and the Advanced IRB Approaches, it is likely that not many emerging market banks will be in a position to apply these approaches. The challenge for many emerging country banks is not only the development of sophisticated models and systems but also to develop the historical data on loan losses by portfolios of loans as

suggested by the Basel Committee. In this regard, 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 given default (LGD). This may require innovative techniques and methods to prove the banking system-wide data to obtain PDs and LGDs. However, national supervisory authorities and the banks will need to evaluate the cost-benefit of using IRB methodologies often on a case by case basis.

4. 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 need to meet stringent criteria. Banks in developing market countries are unlikely to benefit from these due to issues relating to lack of sophistication of payment and settlement systems, weaknesses in legal frameworks, etc.

5. Operational Risk

It is evident 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 15% Gross Income is still punitive and will mean 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 for small and medium sized banks while considering it for major banks. This is discriminatory.

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, which 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.

- The Basel II Capital Accord continues to define the short-term interbank claims as those under 90 days. This has serious 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 have 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. The disclosures required under Pillar III of the proposed Accord are likely to add significant volume of highly technical data to current bank reporting requirements, raising costs while adding little or no information of value to most readers. Such a wide range of information may be desirable for major internationally active banks, it is doubtful that it is essential or appropriate in the less demanding environment of many developing countries.

9. Conclusion

Saudi Arabia was among the first group of non G-10 countries to implement the 1988 Accord and Saudi Banks have maintained high levels of capital adequacy of around 20% during the past decade and most of it is Tier-1 capital. SAMA is encouraging Saudi banks to make a transition from the 1988 Accord to a Foundation or even an Advanced IRB approach. With some planning and dedication of appropriate resources, the transition to Basel II can be achieved within a reasonable timeframe.