

*Full Length Research Paper*

# To what extent Saudi banks committed to the decisions of the Basel II Committee

<sup>1</sup>Dr. Badi Salem Alrawashdeh and <sup>2</sup>Princess Nora Bint Abdul Rahman

Abstract

<sup>1</sup>College of Business Administration,  
Princess Nora Bint Abdul Rahman  
University.

<sup>2</sup>Deanship of Scientific Research,  
Princess Nora Bint Abdul Rahman  
University

\*Corresponding Author's E-mail:  
[badi1979raw@gmail.com](mailto:badi1979raw@gmail.com)

**This research aims to reveal the degree of commitment of Saudi banks to the decisions of the Basel Committee, which holds control of the financial and banking developments, and also working on the development of the banking performance in order to maintain the integrity and safety of the international banking system, and to prevent the occurrence of banking crisis. This research was done by reference to the annual report of two national banks and two foreign banks from banks operating in Saudi Arabia. The results showed that Saudi banks are committed to the application of Basel decision regardless the bank nationality.**

**Keywords:** The implementation of the decisions of the Basel II Committee. Conditions committed to the decisions of the commission of Basel II.

## INTRODUCTION

The Basel Committee was established in late 1974 under the auspices of the Bank for International Settlements in Basel City in Switzerland. Many reasons behind the establishment of the Basel Committee, the most important, was worsening the external debt crisis of the third world countries, and the intensification of competition among Japanese banks on one hand and the western banks on the other hand. In addition to the application by some countries meager standards for banking supervision. All these reasons prompted the ten industrial nations. Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, United Kingdom, United States and Luxemburg to the founding of the Basel committee.

Basel convention has identified in 1988 the minimum appropriate for the bank's capital under the name of the capital standard, which aims to strengthen the financial position of the bank, and protect the rights of depositors and shareholders, Where the Basel convention has committed all banks that the ratio of capital to assets hazardous 8% minimum.

This research comes to reveal how the application of the Saudi banking sector represented by four banks including two national banks and two foreign banks for the decisions of the Basel II Committee on risk management and capital adequacy and banking control.

## Problem statement and questions

The purpose of the issuance of the decisions of the Commission Basel II is to strengthen the internal control procedures in banks in order to reduce the risks to the banks, whether capital risk, credit risk or operational risk. As such, it is in the interest of the banks to commit to implement the decisions of the commission Basel II. Therefore, the problem of this study takes the following formula "Saudi banks quite eager to be bound by the decisions of Basel II committee, therefore, this problem results the following questions:

1. Are there in the banks operating in the Kingdom of Saudi Arabia internal control department associated

2. With one of the independent members of Board of Directors?
3. Are Saudi banks applying capital adequacy standard?
4. Is there in Saudi banks independent administration to manage risk?

### **The study objectives**

This study aims to the following objectives:

1. Verification of the banks operating in the Kingdom of Saudi Arabia from the application of the decisions of the commission Basel II.
2. Refer to the annual reports of the study sample and related disclosures, to see the extent to which the mechanism of banks in the implementation of the decisions of the Basel II Committee.
3. Identify the Impact of the nationality of the banks if it is national or foreigner to apply the decisions of the committee of Basel II.

### **The study Importance**

The importance of this study comes from the importance of the stability of the banking system in the country, because of this stability plays a role in the national economy, where, that the bankruptcy of one of the banks in the state has a negative impact on both microeconomic and macroeconomic, in terms of loss of equity and the erosion of the rights of depositors, causing a valuable creation of financial crisis as we are witnessing now. Therefore, Basel II Committee has created many regulations to help banks to avoid such problems, in terms of capital adequacy, risk management, and control procedures.

### **The study population and sample**

The study population consists of all banks operating in the kingdom of Saudi Arabia, while the study sample consists of two national banks and two foreign banks.

### **Data Collection methods**

Secondary data were collected from books, Periodicals and studies related to banking activity and how it was influenced by the Basel II Convention, while primary data has been collected by reference to the annual report and other disclosures issued by the Saudi banks to ascertain the extent of the application of the decisions of the Basel II Committee.

### **The methods and procedures**

The implementation of this research by reference to the annual reports of the banks operating in the Kingdom of Saudi Arabia and disclosures associated with them to verify that the bank has implemented Basel II, by calculating capital adequacy, and the presence of the department of internal audit, associated to independent member of Board of Directors, and the presence of independent department of risk management, where is that the bank that provided these three conditions committed to the decisions of the commission of Basel II. Therefore, this type of research does not require the formulation on hypotheses in order to prove or deny.

### **The theoretical framework and review of the literature**

As the banking sector of the most sensitive sectors of the economy of what is happening in the world of changes and developments, as transmitted these changes and events, whether positive or negative from any anywhere in the world to the rest of the world, due to globalization and the economic and cultural openness, and what's now the world is witnessing of unprecedented developments in information and communication technology. But, the negative events precede the positive events in the speed of the transition to the world, and the evidence of that what is happening now as a result of the global financial crisis, which began in the United States in the form of mortgages crisis, and then moved with lightning speed to rest of the countries of the world to become a global crisis has affected and continues to affect the countries themselves and economic organizations, especially banks. In such cases, usually states and international bodies established rules and procedures and policies, think it's enough to deter the risk or mitigate. And it was interesting to Basel committee on banking supervision, the subject of capital adequacy as a result of the worsening global debt crisis in the early eighties of the last century, where some researchers consider that the inability of the third world countries to repay loans granted to them from global banks were the main and only reason for the issuance of the decisions of the Basel Committee, which known as Basel I (Biskra, 2010), where may of the researchers and experts have addressed Basel Decisions in studies and articles and multiple conferences. Biskra (2010) for example has explained in his study entitled "Basel Capital Adequacy" that the period between 1974 and 1980 was a period of labor of scientific reasoning to find a formula global capital adequacy, because the collapse of some banks during that period revealed new risks where not known in the past, such as risk settlement and replacement risk, in addition to drawing attention seriously unprecedented about the credit risk. Where, it is proved that the giant U.S banks are not immune to the risk of bankruptcy and

collapse. In the month of July 1974 and the closure of Herthstat German Bank, which was of the top dealers in the foreign exchange market and inter-bank market, the U.S and European banks dealing with the bank suffered serious losses. The fallout from that, bankruptcy of Frankel National Bank, one of the major U.S banks, then followed a few years later. The bankruptcy of first Pennsylvania Bank which had total assets of and8 billion, then the authorities intervened to save it after it hit the problem of maturity mismatch between assets and liabilities, and the stability of the interest rate on loans, to the maximum extent, especially with the high interest rate on the dollar in 1980 for up to 20%. These cases and others turned the thinking of the world to find mechanisms to cope with these risks and the other by creating thought common among central banks in the countries of the world based on the coordination among central banks as authorities control to reduce the risk to the banks, and in light of this, Basel committee was formed on Banking supervision of ten industrialized nations in late 1974.

Basel1 committee has developed more specific and detailed procedures, and that was in 2001, where the commission has presented proposal to the concerned authorities, including the World Bank, hoping to be applied at the end of 2001, but the large number of responses and suggestions invited the commission to extend the deadline application until 2005, these decisions deal with the following:

A new method for calculation risk-weighted capital adequacy, which is necessary to meet the market risk and operational risk and credit risk. Where, the new agreement allowed the banks to apply internal models to determine the capital required to meet market risk due to that these risks vary from one bank to another, prompting the introduction of some kind of flexibility in application. The agreement left to the bank the freedom to choose the mechanisms simplified or more complex mechanisms in this selection, depending on the size of the bank and its ability to deal with risks. In spite of keeping the total appropriate rate as stated in the Basel I, 1988 by 8%, but the new agreement has introduced amendments to the components of the ratio. Where the total capital become consists of three segments: the first representing the paid-up capital plus reserves and retained earnings. And the second represents the supplementary capital as had been specified in the Basel 1, where the cushions or supplementary capital consists of undisclosed reserves, reevaluation reserves, general provisions, hybrid capital tools and support debt (Shaheen, 2003). As for the third segment it represents late grade and short-term debt.

Back to what has been described above and compare it with what came in the study of Biskra, 2010, the researcher concluded that Algerian legislation has been applied to the Basel I Convention, but the Algerian banking sector has not implemented yet Basel II, even though the deadline for the application in 2005.

There is no doubt that the banks are exposed to various types of risks, outlined by the Basel II, credit risk, market risk and operational risk. Tamimi (2007) has added to these risks other types of risks such as liquidity risk, international banking and the risk of other banks with common interests in addition to the legal risks. According to Al-Tamimi (2007) credit risk is the most common types of risks faced by commercial banks, and that this type of risk represents 60% of the total risk faced by these banks, and that because it produces for the borrower fails to repay the loan on time. Given the multiple and frequent borrowers, from banks, in addition to the long repayment period, this may lead to the possibility of change in the monetary and financial situation of the borrower, therefore, the risk of this type of repeated occurrence.

It is known that the borrower defaults lead to a decline in the value of financial assets, and weaken the bank's ability to meet its various obligations, in addition to the possibility of the decline in the value of collateral provided to secure loans granted. But, banks can reduce this impact of this risk through diversification in the use and investments of financial resources.

In a study entitled the Basel Convention (content-importance- dimensional-effects-challenges), Abu Rahma (2007) showed that Basel Committee was classified countries into to two groups, the first is a low-risk countries include OECD countries, in addition to both Switzerland and Saudi Arabia. The second group includes the rest of the world as a high-risk countries. Then, the researcher pointed out the most important effects of the application of Basel II on banks and other relevant parties. The effects on banks were as follows:

- The need to apply risk management framework for linking regulatory capital and economic risks.
- The need to select approaches (nodes) credit and operational risks from association with regulatory capital.
- The need to collect, analyze and store the new and comprehensive information.
- The need to adopt new institutional practices and improved.

The researcher adds, that despite the keenness of most countries in the world to apply Basel II because it is standards certified internationally, but the Basel Committee does not have the powers of legal support to impose its decisions, on the states even those who are members, so it requires the adoption of central bank governors of the recommendations issued by the commission.

The Ajami (2007) pointed out in his research entitled "Expert" Central Banks must take into account the Islamic Banks in its Instructions", that Basel did not take into account the Islamic banks, because the founding countries has no Islamic banking activity by large size, however, that the establishment of the council of Islamic financial Services in Malaysia is considered as substitute for it. Then the researcher emphasized that it is not all

that came in Basel is not suitable for Islamic banks, but it requires finding a combination of Basel and the values of the Islamic banks and ensure their safety. Therefore, the researcher recommended establishing a separate control unit in each central bank for the supervision of Islamic banking.

In a study by Qaddoumi and Nazmi (2008) entitled "Application of the Decisions of the Banks to the Basel II Committee relating to Internal Control: An Empirical Study on Banks Operating in Jordan". The study aimed to identify the extent of application to the decisions of Basel II committee by banks operating in Jordan. The study population consists all employees in internal control departments in all banks in Jordan, in addition to employees who are working in the departments of risk management, operations and lending department. The study sample was 62 employees distributed on 10 of the banks operating in Jordan. The results showed that the banks are applying the Basel II decisions in terms of managerial supervision, control culture and identifying risks, regardless the bank nationality.

A study by Cornford, 2006 entitled "The Global Implementation of Basel 2: Prospects and Outstanding Problems". The study aimed to explore the implementation of Basel 2, and the risks associated with this implementation, resulting from the changes that will get, and how international trade will be affected due to the change in banking. The researcher summarized the effects of the application of Basel 2 on international trade, where, he explained that the application of Basel 2 may result in risk in the macroeconomic especially in countries with emerging markets, as will, these changes affect the relationship between the lenders and borrowers due to the change of the mechanisms of control and supervision of this theme by banks.

In their study entitled "Regulation and Supervision of Islamic banks", Shapra and Khan (2000), they found that the three pillars of the framework of the new Basel are, capital adequacy, and the process of supervisory review and market discipline can be appropriate for Islamic banks, and that the adoption of the new system proposed by the Basel, for weighting risk assets can help to develop a culture of effective risk management in Islamic banks, through the creation of an internal assessment methods, and the appropriate control system. Then, it becomes easy for Islamic banks to adopt international standards, if the standards were separated in terms of capital adequacy for each demand deposit in order to protect them, and investment deposits, in order to convert these deposits to invest in mutual funds.

In recent study conducted on Saudi banks entitled "The extent of Saudi Commercial Banks' commitment to Basel 2 Committee Regulation" by Saffar (2012), the study was conducted on Saudi banks after exception of Islamic banks and foreign banks, to become a study sample of 10 banks. Quantitative data were collected through the distribution of a questionnaire to 100

employees in ten banks. The results of data analysis indicated the commitment of Saudi banks in the application of Basel II.

### **The position of the Saudi Arabia Agency about the decisions of the Basel Committee**

SAMA has shown great interest in the application of Basel by Saudi banks, where, the agency issued the following guidance:

#### **Over view operational risk**

All banks are subject to financial and operational risks. While most bankers are acutely aware of the potential impact of financial risks such as, interest rate shifts, exchange rate movements, etc. the area of operational risk is often less well understood. Operational risk - as distinct from financial risk - represents pure risk. A pure risk is one in which there are only two possible outcomes - loss or no loss. Whereas financial risks may lead to financial rewards, operational risks involve no opportunity for gain; as non-occurrence of an operational loss means only maintenance of the status quo. In addition, unlike financial risks, operational risks are purely human in nature and are a function of an organization being a bank. Crime, Losses, litigations, and adverse regulations are purely human in origin and may have no direct relationship with conditions in global financial markets.

The purpose of this guide is to assist directors and senior management in understanding the nature of operational risk and the management techniques which may be used to manage this risk. Since one of the most effective forms of minimizing a bank's exposure to operational risks through the implementation of a strong program of internal controls, this Guide is designed to be used in conjunction with SAMA's Internal Control Guidelines for Commercial Banks Operating in the Kingdom of Saudi Arabia (1989), Disaster Recovery Planning Guideline for the Saudi Banks (1993) and the Guidelines on Physical Security for Saudi Banks (1995). This is essential for developing an integrated program of operational risk control and management. While much of the material in this Guide is oriented towards conventional insurance, its ultimate purpose is to address the issues of identification and analysis of the full spectrum of operational risks encountered by a bank and to discuss the various methods both internal and external - which may be used to finance these risks.

In order for operational risk to be effectively managed and financed it is necessary that banks accomplish three functions.

### **Identify and analyze risks**

Only those risks which have been identified may be successfully controlled. The components of operational risks are deeply embedded in an institution's business structure. These are often difficult to isolate and identify, and constantly change as the bank's business and the policies, systems and procedures which support it change. It is ironic that banks have evolved stringent policies and standards as well as complex analytical models for the analysis of financial and market risk but often ignore the operational risk exposure inherent in their day to day operations. Therefore, it is critical that senior management ensures that a formal program of operational risk analysis is in place within the bank at least equal in management visibility and rigour with that used for analyzing and controlling financial and market risk exposure.

### **Select and implement risk management techniques**

Operational risks are most effectively controlled through integration of various risk control methods. The incidence of fraud may be controlled through rigorous training of personnel, fraud prevention and detection program, effective operational management, and internal auditing and, finally, through the Bankers Blanket Bond (BBB) and Financial Institution Bond (FIB). Litigation risks associated with professional liability may be dealt with through careful product risk analysis and training of personnel prior to implementation of sale or marketing programs, close attention to contractual indemnities with customers and, finally through a program of Professional Indemnity Insurance.

All of these strategies involve the careful analysis, selection, integration, and management of risk assumption, risk avoidance, control and transfer tools (including insurance) based on a thorough knowledge of the bank's business lines and operational risk exposures.

### **Managing and evaluating operational risk management**

The management of operational risk is one of the major functions of the Board of Directors of any bank. Therefore, it is incumbent upon the Board to ensure that operational risks are being properly identified, analyzed, controlled, and managed. This should be done by the Board through a periodic review of the performance of operational risk management within the bank in much the same manner as it reviews the effectiveness of financial and market risk management activities. On an annual basis the Board of Directors, or the Audit Committee, should receive the results of an internal review of the Risk Management Function. Furthermore at least once

every 5 years or more frequently if appropriate, an independent review of risk management activity must be conducted, and reported to the Board.

### **Retail electronic banking**

As with a bank's commercial customer base, electronic banking is also penetrating the retail market. Services such as telephone bill payments, PC based home banking, and the use of "smart" telephones combining the features of both a conventional telephone and microcomputers present significant opportunities for enhancing both the level of customer service and revenue in the highly competitive retail sector. However, at the same time, these new electronic products open new avenues of exposure to both third party and employee fraud as well as potential areas of professional liability exposure. In future this will become an increasingly important risk exposure area for the banks. The increased use of telephone services that permit computer access to banks' systems also provide an increasing opportunity to "hackers" and other criminals. These require improvements in security measures and additional risk management techniques to minimize losses.

### **Professional risk**

Exposures directly related to the provision of financial products and services currently constitute both the single largest and most rapidly growing form of operational risk globally within the financial industry.

### **Professional errors and commissions**

All banks are subject to operational losses associated with professional errors and omission by employees. These include losses through errors committed by staff such as unauthorized trading, erroneous transfer of funds to wrong accounts. Errors in booking or recording securities transaction, etc. In the event where such losses are for the account of the bank itself i.e. for trades on the bank's own account, these types of losses are completely uninsurable and must be controlled by means of traditional methods such as strong internal controls, quality assurance programs, rigorous staff training programs and strong and active management

### **Professional liability risk**

On the other hand if professional errors and omissions result in losses for the client, such events are insurable. In order to effectively assess risks in this area, it is

necessary to understand the this area, it is necessary to understand the difference between professional liability risks which may affect the Board of Directors and Officer (DandO) and those professional liability risks which affect the bank itself.

### **Directors and officer liability**

This coverage is for the directors and officer of a bank, and not for the bank itself. One of the most complex problems facing any business is the liability of its directors and officers (executive or non-executive). The personal assets of directors and senior officers may be at risk for losses arising out of the alleged negligent or imprudent acts or omissions of such individuals. The DandO coverage provides payment to the bank as it is the bank which purchases the policy to indemnify its directors and officers.

In addition, the DandO policy will reimburse directors and officers for losses for which the bank was unable to indemnify them for legal, regulatory, or financial reasons.

### **Professional indemnity**

This coverage is designed to indemnify the bank itself against litigation by customers, and other third parties alleging errors, omissions, misstatement or imprudence committed by directors, officers and employees in the performance of their service.

These two areas encompass professional liability, and there is some overlap between the insurance coverage designed to address them. However, although D and O is narrower in scope in terms of the individuals covered, it is significantly broader in terms of the wrongful acts which it covers generally covering all wrongful acts not specifically excluded. On the other hand, PI covers only specific professional services provided by the bank - trust, brokerage, investment advisory etc. D and O policies may specifically exclude such services from coverage.

Professional liability is created by the relationship between various parties including clients, regulators, shareholders, employees, vendors, joint venture partners and the banks. The relationship is based on the legal system in which the bank's activities take place. In addition, the same act may result in a liability situation for both the bank (through the actions of employees) as well as the Board of Directors. Thus acts of negligence or misconduct by employees, inappropriate or prohibited investments in a customer portfolio, errors in securities processing, failure to execute contractual obligations with a client may result in a liability for the bank. However, the legal system may also involve allegations of mismanagement by the Board of Directors, regulatory non-compliance, product fraud, insider trading, bad loans

which materially effect share price. In this case the liability may also extend to the Directors both singly and severally. Professional liability arises from a number of sources.

### **Shareholder actions**

Globally, the largest single source of professional liability exposure arises from shareholder actions against management, officers and employees for negligence and misconduct.

Lender Liability Claims - Lender liability places directors and officers at risk both as defendants in the first instance or as indemnitors when their bank has been held liable. The range of lenders' liabilities includes contractual liability, product liability, personal injury, property damage, fraud, duress, and emotional distress.

### **Within Saudi Arabia**

Under Saudi Company Law (Royal Decree M/6 of 1985) Articles 66 to 82, members of Boards of Directors are jointly responsible for compensating the company, the shareholders or others for damages resulting from their management of the company or contravention of provisions of company law. This seems to differ little from the provisions of the proposed European Community Fifth Company Law Directive and other European countries. Therefore, Saudi Company Law differs little from that of other developed countries with respect to the legal obligations of corporate directors and officers; and a substantial exposure to professional liability, obligations of corporate directors and officers; and a substantial exposure to professional liability, particularly Directors and Officers liability, currently exists for banks within the Kingdom.

### **Outside Saudi Arabia**

The third party legal liability situation outside Saudi Arabia is far graver than that found within the Kingdom. Any Saudi bank operating in another sovereign jurisdiction will be subject to the laws, business practices, political and social conditions of that area. Thus any Saudi bank operating in the United States, the United Kingdom, or Western Europe runs a significant risk of being sued for alleged illegalities and/or mismanagement in connection with the bank's activities in these areas.

Another area of exposure which Saudi banks must recognize is the exposure created by their outside directors, such as directors and officers of Saudi banks serving on the boards of joint venture companies or partnerships or other non-Saudi corporations. Outside or independent directors are now routinely threatened with

potential liability and are sued along with the rest of the board. In the past, outside directors were not expected to be involved in a bank's day to day affairs. Now, today the trend is for outside directors to be knowledgeable over experts in bank's issues and are being looked upon by courts, regulators and litigants as the "watchdogs" of board activities.

Professional liability represents a fast growing and potentially damaging area of operational risk for activities outside Saudi Arabia. Thus it is essential that Saudi banks develop policies and procedures to carefully assess product and services risks in this area and take measures to manage these risks.

### Contingent client - related liability risks

One of the fastest growing and most intractable areas of operational loss exposure is that presented by contingent client-related liability. This relates to indirect responsibility for a client's business operations and products. Since major liability losses may bankrupt a client, plaintiffs will seek anyone connected with the client possessing sufficient funds to secure a financial settlement.

Unfortunately, this is often a bank with which the client had or has a relationship. These types of contingent liabilities may arise from a number of situations including.

1. **Environmental Liability:** Banks may incur substantial environmental liability when they become responsible for environmental damage or hazardous waste cleanup (i.e. an oil spill from a tanker for which the bank was a lender). This type of liability exposure is expanding globally at a tremendous rate as countries continue to enact ever more punitive environmental laws and regulations.
2. **Product Liability:** Product liability may occur when a client in which the bank has an equity position or financing interest is sued alleging negligence (i.e., class action suits against a pharmaceutical manufacturer).
3. **Death and Bodily Injury :** This liability may arise from an event involving a bank owned asset that is leased to or operated by others (i.e. commercial aircraft) or from an event involving a repossessed asset (i.e., fire at bank owned or controlled hotel).

Therefore, as global environmental and product liability laws and regulations becomes more stringent and tort liability becomes more widespread, all Saudi banks will become increasingly more exposed to this type of operational risk both inside and outside the Kingdom.

### Other risks

#### Statutory and Regulatory Liability

Globally, banking laws and regulations are becoming more complex, compliance more costly and time

consuming, and the consequences of non-compliance (financial, legal, and reputation) more severe. In addition, some countries are increasingly applying criminal statutes to such essentially non-criminal areas as investment operations and cash management services. These liabilities may take three forms:

1. **Financial Penalties:** Within the Kingdom, violation of SAMA circulars and directives may result in substantial financial penalties being levied. Saudi banks operating outside the Kingdom are also subject to not only fines imposed by regulatory agencies, but may also find themselves responding to both civil and/or criminal charges which may carry financial penalties of such a magnitude as to cause a substantial impact on the balance sheet.
2. **Restriction or Termination of Operations:** Within Saudi Arabia, violation of SAMA rules and directives may lead to censure by the regulators and, in extreme cases, restriction of certain banking activities or total revocation of banking privileges within the Kingdom. This exposure is even more severe for Saudi banks operating outside the Kingdom. Even relatively minor technical violations of banking regulations may lead to the closure of major overseas branches.
3. **Risk to Reputation:** All banks fundamentally operate on the basis of trust. Therefore, publicity associated with statutory and regulatory infractions may act to undermine this trust with both customers and shareholders. While banks may be able to absorb both financial penalties and regulatory sanctions, they cannot absorb a major loss of customer and investor confidence.

Therefore the maintenance of aggressive and highly pro-active compliance program by banks is becoming increasingly more critical as a major component in controlling the operational risks associated with regulatory and legal non-compliance.

### Political risks

All banks operating within the Gulf Region are subject to certain distinct geo-political risks. However, if viewed in a broader perspective, these risks are certainly no more severe than those faced by banks operating in other areas. Therefore, of far more concern from an operational risk perspective is the prospect of new and more restrictive banking and securities regulations in other countries in which Saudi banks operate. Within the Kingdom, the prospect of punitive and highly restrictive regulation must be viewed as remote. However, in those overseas areas in which Saudi banks have significant business interests that some restrictive regulations may be expected.

Given the major social and political changes taking place in the industrialized countries and developing

**Table 1.** The following table shows the capital adequacy ratio for both core capital and cushions capital in Saudi banks:

<b>Bank Name</b>	<b>Proportion of Core Capital Adequacy</b>	<b>Proportion for core Capital Adequacy and Cushions</b>
Riyadh Bank	15.30%	17.70%
Bank Al Jazira	12.12%	15.67%
Saudi Hollandi Bank	12.41%	17.60%
Saudi Fransi Bank	14.65%	16.49%
Saab	11.99%	15.69%
Arab National Bank	13.75%	14.77%
Samba	19.00%	20.00%
AL Rajhi Bank	14.68%	19.38%
Al Belad Bank	13.67%	18.52%
Development Bank	33.00%	32.00%
Ahli Bank	17.50%	17.50%

**Source:** Publication of the Saudi Arabia Monetary agency (2013).

world, all markets now possess a significant degree of political instability for international banking operations. Therefore, it is imperative that all Saudi banks operating outside the Kingdom or significantly involved with international trade, develop management systems and procedures for actively monitoring operational risk associated with the political and regulatory environments in which they conduct their business operations. Such systems should include appropriate "red flag" and warning indicators, and effective alternative strategies and action plans to prevent or mitigate losses.

### **Management of operational risk through insurance schemes**

Successful management of operational risks is central to the long-term profitability and survival of a bank. All banks are exposed to a variety of such risks and must develop an integrated management approach for their effective control. Management response must include a strong organizational structure, an affective system of internal controls' segregation of duties, internal and external audits, physical security procedures, etc.

Another important method to limit operational risk includes the purchase of insurance. The various forms of insurance schemes include self insurance, regular insurance and other insurance alternatives, encompassing retention groups, group captives, risk sharing pools, etc. Insurance is a method to fund a loss exposure as opposed to managing or controlling risks. Other effective mechanisms to limit the impact of losses arising from operational risk include the finite risk insurance approach. This approach involves risk transfer through regular insurance and self insurance, and generally has an upper limit to its liability, hence finite insurance.

## **RESULTS AND RECOMMENDATIONS**

### **Results**

The study concluded the following results:

1. The Saudi National Commercial Bank is committed to the application of the Basel decisions, including Basel 2 (Annual Report).
2. Banque Saudi Fransi, is committed to the application of Basel committee decisions (Annual Report).
3. Al Rajhi Bank is committed to the application of Basel committee decisions (Annual Report).
4. Saudi Hollandi Bank is committed to the application of Basel committee decisions (Annual Report).
5. All these banks are committed to the application of the Basel II decisions in terms of capital adequacy, risk management, and internal control.

What support the validity of these results is, in what was stated in the study of Alhoawi (2013), showing the capital adequacy ratio of banks in Saudi Arabia. Where, the researcher indicates that the capital adequacy ratio is one of the most important indicators for the financial solvency of the financial sector, and represents a safety valve to protect the depositors to promote stability and efficiency in the banking system and financial institutions. The legislations of central banks in all countries of the world watching this indicator in banks operating in their economies in order to maintain the ability of the financial institution to continue to work, and maintain a strong capital to face any contingent liabilities when there is pressure in front of the financial institution or large draws from deposits.

Source: Publication of the Saudi Arabia Monetary agency (2013).

Capital adequacy is measured by the following equation:

Capital Adequacy Ratio = Owners Equity ÷ Risk-Weighted Assets.



## RECOMMENDATIONS

The researcher presents the following recommendation in order to help Islamic banks in the application of international standards especially Basel decisions.

Islamic countries must exert some kind of pressure on the Basel Committee, in order to take Islamic banking into account when issuing any new decisions, or that the committee includes members of the Islamic countries.

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