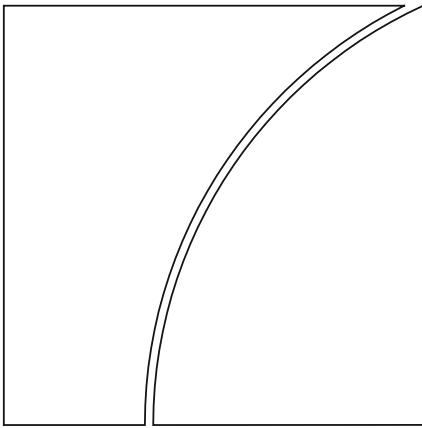


# Basel Committee on Banking Supervision



## Regulatory Consistency Assessment Programme (RCAP)

### Assessment of Basel III risk-based capital regulations – Saudi Arabia

September 2015



BANK FOR INTERNATIONAL SETTLEMENTS

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## Glossary

AMA	Advanced Measurement Approach
A-IRB	Advanced Internal Ratings-Based Approach
ASA	Alternative Standardised Approach
BCBS	Basel Committee on Banking Supervision
BCL	Banking Control Law 1966
BIA	Basic Indicator Approach
CAR	Capital adequacy ratio
CCP	Central counterparty
CCR	Counterparty credit risk
CET1	Common Equity Tier 1
CEM	Current exposure method
CVA	Credit valuation adjustment
D-SIBs	Domestic systemically important banks
EL	Expected loss
FAQs	Frequently asked questions
FSAP	Financial Sector Assessment Program
FX	Foreign exchange
G-SIB	Global systemically important bank
GCC	Gulf Cooperation Council
HVCRE	High-volatility commercial real estate
ICAAP	Internal Capital Adequacy Assessment Process
IMA	Internal Models Approach
IMM	Internal Models Method
IPRE	Income-producing real estate
IRB	Internal Ratings-Based Approach
KSA	Kingdom of Saudi Arabia
LGD	Loss-given-default
MR	Market risk
OTC	Over-the-counter
PD	Probability of default
PON	Point of non-viability
RCAP	Regulatory Consistency Assessment Programme
RWA	Risk-weighted assets
SAMA	Saudi Arabian Monetary Agency
SAR	Saudi Arabian riyal
TSA	The Standardised Approach
UK PRA	United Kingdom Prudential Regulation Authority

## Preface

The Basel Committee on Banking Supervision sets a high priority on the implementation of regulatory standards underpinning the Basel III framework. The prudential benefits from adopting Basel standards can only fully accrue if these are implemented appropriately and consistently by all member jurisdictions. The Committee established the Regulatory Consistency Assessment Programme (RCAP) to monitor, assess, and evaluate its members' implementation of the Basel framework.

This report presents the findings of the RCAP Assessment Team on the domestic adoption of the Basel risk-based capital standards in the Kingdom of Saudi Arabia (KSA) and its consistency with the minimum requirements of the Basel III framework.<sup>1</sup> The assessment focuses on the adoption of Basel standards applied to the KSA banks that are internationally or regionally active and of significance to the Kingdom's domestic financial stability.

Over recent years, Saudi Arabian Monetary Agency (SAMA) has undertaken several noteworthy initiatives designed to strengthen the prudential framework relating to bank capital. SAMA issued the final rule on Basel III risk-based capital in December 2012 to implement the first phase of Basel III (taking effect on 1 January 2013). A number of new rules and policies were also put in place in October and December 2012, particularly on capital requirements for bank exposures to central counterparties (CCPs) and Pillar 3, respectively.

The RCAP Assessment Team was led by Mr Stephen Bland, Director, and Strategic Policy Adviser of the United Kingdom Prudential Regulation Authority (UK PRA). The Assessment Team comprised seven technical experts drawn from China, the Financial Stability Institute, Germany, New Zealand, South Africa, Sweden and Turkey (Annex 1).

The assessment relied upon the data, information and materiality computations provided by SAMA up to 31 July 2015. The assessment findings are based primarily on an understanding of the current processes in the KSA as explained by the counterpart staff and the expert view of the Assessment Team on the documents and data reviewed. The overall work was coordinated by the Basel Committee Secretariat.

The assessment began in February 2015 and consisted of three phases: (i) completion of an RCAP questionnaire (a self-assessment) by SAMA; (ii) an off- and on-site assessment phase (February to May 2015); and (iii) a post-assessment review phase (June to August 2015). The off- and on-site phases included an on-site visit for discussions with SAMA and representatives of the KSA banks (which were used as the RCAP sample banks for the purpose of impact assessment) and external audit firms. These exchanges provided the Assessment Team with a deeper understanding of the implementation of the Basel risk-based capital standards in the KSA. The third phase consisted of a two-stage technical review of the assessment findings: first by a separate RCAP Review Team and feedback from the Basel Committee's Supervision and Implementation Group; and secondly, by the RCAP Peer Review Board and the Basel Committee. This two-step review process is a key instrument of the RCAP process to provide quality control and ensure integrity of the assessment findings. The focus of the assessment was on the

<sup>1</sup> See also the separate RCAP assessment report on Saudi Arabia's compliance with the Basel III Liquidity Coverage Ratio. Other Basel III standards, namely the Net Stable Funding Ratio, the leverage ratio, and the framework for systemically important banks will be assessed as those standards become effective as per the internationally agreed phase-in arrangements.

consistency and completeness of the domestic regulations in the KSA with the Basel minimum requirements. Issues relating to adequacy of prudential outcomes, capital levels of individual banks, the adequacy of loan classification practices, or SAMA's supervisory effectiveness were not in the scope of this RCAP assessment exercise.<sup>2</sup>

Where domestic regulations and provisions were identified to be not in conformity with the Basel framework, these deviations were evaluated for their current and potential impact (or, non-impact) on the reported capital ratios for a sample of internationally active KSA banks. Some findings were evaluated on a qualitative basis. The assessment outcome was based on the materiality of findings and use of expert judgment.

The report has three sections and a set of annexes: (i) an executive summary with a statement from SAMA on the material findings; (ii) the context, scope and methodology, and the main set of assessment findings; and (iii) details of the deviations and their materiality along with other assessment-related observations.

The RCAP Assessment Team acknowledges the professional cooperation received from SAMA counterparts throughout the assessment process. In particular, the team sincerely thanks the staff of SAMA for playing an instrumental role in coordinating the assessment exercise. The series of comprehensive briefings and clarifications provided by SAMA enabled the RCAP assessors to arrive at their expert assessment. The Assessment Team would also like to thank the representatives of the KSA banks that provided data and information to the Assessment Team. The Assessment Team is hopeful that the RCAP assessment exercise will contribute towards strengthening prudential effectiveness and full implementation of the recent reform measures in the KSA.

<sup>2</sup> The most recent assessment of Saudi Arabia's financial system under the IMF-World Bank Financial Sector Assessment Program (FSAP) was published in 2012. A detailed assessment of Saudi Arabia's compliance with *Basel Core Principles* on supervisory issues was also carried out as part of the FSAP assessment and published in 2013.

## Executive summary

SAMA has implemented the Basel III risk-based capital regulations consistently with the internationally agreed timeline and has also applied the transitional arrangements in line with Basel III. SAMA's risk-based capital rules apply to all 12 locally incorporated banking institutions.

Overall, the Assessment Team finds SAMA's prudential regulations to be compliant with the standards prescribed under the Basel framework. All 14 components of this review are assessed as compliant with the Basel standards. SAMA made a number of rectifications in response to the findings of its self-assessment and of the Assessment Team. In all, SAMA's capital framework benefited during the course of the RCAP assessment work from 93 rectifications. These findings were mostly not material and largely related to incomplete or inaccurate incorporation of Basel text.

There was only one finding which has not been rectified. SAMA applies a zero (0%) risk weight for banks' sovereign exposures to Gulf Cooperation Council (GCC) countries and this requirement has been applied since the local implementation of the Basel I accord in 1992. Under the Basel framework's standardised approach for credit risk, a zero risk weight is only available for banks' exposures to sovereigns of at least AA- credit rating and for banks' exposures to sovereigns to which a zero risk weight is applied by the relevant supervisory authority in the issuing country. The Assessment Team noted that there are some GCC exposures which do not comply with this test, notably Oman and Bahrain. While paragraph 54 of Basel II<sup>3</sup> allows for national discretion to apply a lower risk weight to the sovereign exposures of these two countries, the exposures must be denominated in the domestic currency and funded in that currency. With respect to KSA banks with exposures to Oman and Bahrain, SAMA should only apply a zero risk weight if the supervisory authorities in these countries allow their banks to apply a zero risk weight to sovereign exposures in their respective countries. Based on the discussion during the on-site visit, SAMA stated that this preferential treatment was agreed and implemented due to the collective agreement made by all GCC members. At present, these exposures are not material in amount. Nevertheless, this could possibly change in the future due to an increase in banks' exposures or a downgrade in the sovereign rating of other GCC countries and might thus potentially become a material deviation from Basel standards.

Several elements of the Basel capital framework, notably the Internal Ratings-Based (IRB) Approach for credit risk, the Internal Models Approach (IMA) for market risk, and the Advanced Measurement Approach (AMA) for operational risk have not at this point been adopted by KSA banks (one bank is in parallel run for the IRB approach, but SAMA has not yet granted it approval to migrate to an advanced approach).

SAMA regulates Sharia-compliant banks in the same way as it does non-Sharia banks in the KSA. This does not currently lead to any deviation from Basel standards. Nevertheless, if there were a greater variety of Sharia-compliant activities and/or if the International Financial Reporting Standards were differently applied to Sharia-compliant activities in the KSA, this could change. More generally, the

<sup>3</sup> Paragraph 54 of Basel II: At national discretion, a lower risk weight may be applied to banks' exposures to their sovereign (or central bank) of incorporation denominated in domestic currency and funded in that currency. Where this discretion is exercised, other national supervisory authorities may also permit their banks to apply the same risk weight.



Basel Committee may wish to consider whether the application of its standards take full account of Islamic financial activities.

Several aspects of SAMA's framework are more conservative than the Basel framework and these are summarised in Annex 10. They are listed in the report but have not been taken into account for the final assessment of compliance as per the agreed assessment methodology.

The Assessment Team recognises the amendments made by SAMA to strengthen alignment of its capital rules to the Basel III framework throughout the course of the assessment process. These amendments became effective on 31 July 2015 (see Annex 6 for a complete list of the amendments).

## Response from SAMA

SAMA welcomes this opportunity to respond to the findings and comments of the RCAP Assessment Team on the implementation of Basel III Capital Adequacy Regulations in Saudi Arabia. SAMA also wishes to acknowledge and appreciate the commitment, professionalism and expertise of the RCAP Assessment Team, under the leadership of Mr Stephen Bland, and would like to thank the Assessment Team for the proficiency with which the entire RCAP exercise for Saudi Arabia was completed.

This assessment has provided a comprehensive and thorough review of the level II implementation of the Basel regulatory capital framework in Saudi Arabia and we are pleased that Saudi Arabia has received an overall compliant rating.

SAMA has always considered a strong capital adequacy framework to be the cornerstone of a sound banking system. This important principle was embedded in the Banking Control Law which provided for a capital adequacy ratio and a capital leverage ratio for Saudi banks as far back as 1966. In the following years, SAMA led the way in this region, introducing the Basel I Capital Adequacy Accord in 1992, and the Basel II Framework in 2008. Since becoming a member of the Basel Committee, SAMA has introduced Basel III Capital Adequacy rules with effect from 2013, in accordance with the Basel-agreed timelines.

SAMA has always encouraged Saudi banks to maintain high levels of capital adequacy; consequently, since the 1990's, Saudi banks have maintained a Basel capital ratio of on average around 18% to 20%. It is worth noting that about 85% of banks' regulatory capital is composed of Common Equity Tier 1 (CET1).

Based on SAMA's self-assessment and as identified by the RCAP Assessment Team, SAMA has carried out a number of modifications to the existing regulations and guidelines before the cut-off date of 31 July 2015. We believe that these modifications will further strengthen the implementation of the Basel capital adequacy framework in Saudi Arabia.

Overall, SAMA considers the RCAP process to be a useful exercise, and is supportive of the Basel goals to promote consistency of implementation of rules among member countries. SAMA also concurs that the RCAP process promotes a level playing field among Basel member jurisdictions, which reduces regulatory arbitrage and promotes safety, soundness and stability in the global financial system.

# 1 Assessment context and main findings

## 1.1 Context

### Status of implementation

SAMA, the central bank of the KSA is responsible for the regulation and supervision of the banking sector. SAMA is empowered by the Banking Control Law (BCL) (1966) and SAMA Charter (1957) to issue banking regulations, rules and guidance to licensed banks in the KSA. The Basel II standards have been in effect from 1 January 2008 and, subsequently, Basel 2.5 and Basel III were implemented with effect from 1 January 2013 via the issuance of regulations and circulars (see Annex 2 for a complete timeline). These are all in effect as on the date of the assessment.

### Status of approval of Basel advanced approaches

Number of banks, end-December 2014

Table 1

	Standardised Approach	Thereof: Intent to move to advanced approach	Advanced approach approved by SAMA
Credit risk	RCAP banks: 5 Other banks:7	RCAP banks: 1 (FIRB) Other banks: Nil	RCAP banks: Nil Other banks: Nil
Counterparty credit risk	RCAP banks: 5 (CEM) Other banks:7 (CEM)	RCAP banks: Nil Other banks: Nil	RCAP banks: Nil Other banks: Nil
Market risk	RCAP banks: 5 Other banks: 7	RCAP banks: Nil Other banks: Nil	RCAP banks: Nil Other banks: Nil
Operational risk	RCAP banks: 5 Other banks: 7 <sup>4</sup>	RCAP banks: Nil Other banks: Nil	RCAP banks: Nil Other banks: Nil

Source: SAMA

### *Regulatory system and model of supervision, and binding nature of prudential regulations*

The following chart provides an overview of the legal hierarchy of banking regulations in the KSA.

### Hierarchy of banking regulations in the KSA

Table 2

Laws and regulations	SAMA Charter (1957) – legislation
	Banking Control Law (1966) – legislation
	Ministerial Decree of Minister of Finance (1986) – legislation
	SAMA Regulations (various) – regulation
	SAMA Prudential Returns and Guidance Notes (various) – regulation
Internal regulation derived from the above laws and regulations	SAMA Circulars and Guidance Documents eg (Loan-to-deposit ratio, role of audit committee etc)

<sup>4</sup> Four banks have adopted the Basic Indicators Approach for operational risk.

## 1.2 Structure of banking sector

As at December 2014, 24 banks were licensed in the KSA (12 banks are locally incorporated), with total bank assets (including off-balance sheet equivalents) amounting to SAR 4.2 trillion (approximately USD 1.1 trillion – see Annex 8 for an overview of selected key indicators of the KSA banking sector). The financial system is dominated by the five largest internationally active commercial banks, which hold about 63% of total banking assets. There are no global systemically important banks (G-SIBs) in the KSA, but three of the 24 banks in the KSA are branches of foreign G-SIBs. SAMA has finalised the framework for identification of domestic systemically important banks (D-SIBs) and has identified six banks as D-SIBs.

Under the new Basel III standards, the weighted average total capital ratio of the five largest banks stood at 18.3% (31 December 2014). The Tier 1 ratio and the CET1 ratio were 16.8%. Credit risk is the predominant risk type for KSA banks, and accounts for approximately 90% of total risk-weighted assets, followed by market risk (3%) and operational risk (7%). SAMA has been cautious in allowing banks to engage in complex financial activities.

## 1.3 Scope of the assessment

### Scope

The RCAP Assessment Team has considered all documents that effectively implement the risk-based Basel capital framework in the KSA as of end-July 2015, the cut-off date for the assessment (Annex 4).

The assessment focused on two dimensions:

- A comparison of domestic regulations with the capital standards under the Basel framework to ascertain that all the required provisions have been adopted (*completeness* of SAMA domestic regulation); and
- Whether there are any differences in substance between the domestic regulations and the capital standards under the Basel framework and their significance (*consistency* of SAMA regulations).

In carrying out the above, the RCAP Assessment Team considered all binding documents that effectively implement the Basel framework in the KSA as discussed above. Importantly, the assessment did not evaluate the adequacy of capital or resilience of the banking system in the KSA or the supervisory effectiveness of the KSA regulatory authorities.

Any identified deviation was assessed for its materiality (current and potential, or having an insignificant impact) by using both quantitative and qualitative information. For potential materiality, in addition to the available data, the assessment used expert judgment on whether the domestic regulations met the Basel framework in letter and spirit (see also Section 1.4).

### Bank coverage

For the purposes of assessing the materiality of deviations, data were collected from the following five banks: National Commercial Bank, Al Rajhi Bank, Riyadh Bank, Samba Financial Group and Saudi British Bank. These banks are internationally active and are the largest banks in the KSA. They represent more than 63% of total assets of the banking system in the KSA (31 December 2014).

### Assessment grading and methodology

As per the RCAP methodology approved by the Basel Committee, the outcome of the assessment was summarised using a four-grade scale, both at the level of each of the 14 key components of the Basel

framework and overall assessment of compliance: compliant, largely compliant, materially non-compliant and non-compliant.<sup>5</sup>

The materiality of the deviations was assessed in terms of their current or, where applicable, potential future impact (or non-impact) on the capital ratios of the banks. The quantification was, however, limited to the agreed population of internationally active banks. Wherever relevant and feasible, the Assessment Team, together with SAMA, attempted to quantify the impact based on data collected from the KSA banks in the agreed sample (see Annex 8). The non-quantifiable aspects of identified deviations were discussed and reviewed in the context of the prevailing regulatory practices and processes with SAMA.

Ultimately, the assignment of the assessment grades was guided by the collective expert judgment of the Assessment Team. In assigning grades, the Assessment Team relied on the general principle that the burden of proof rests with the assessed jurisdiction to show that a finding is not material or not potentially material. A summary of the materiality analysis is given in Section 2 and Annex 9.

In a number of areas, the KSA rules go beyond the minimum Basel standards. Although these elements provide for a more rigorous implementation of the Basel framework in some aspects, they have not been taken into account for the assessment of compliance under the RCAP methodology as per the agreed assessment methodology (see Annex 10 for a listing of areas of super-equivalence).

## 1.4 Main findings

A summary of the main findings is given below.

Summary assessment grading		Table 3
Key components of the Basel capital framework	Grade	
Overall grade:	C	
Scope of application	C	
Transitional arrangements	C	
Pillar 1: Minimum capital requirements		
Definition of capital	C	
Credit risk: Standardised Approach	C	
Credit risk: Internal Ratings-Based Approach	C	
Securitisation framework	C	
Counterparty credit risk framework	C	
Market risk: Standardised Measurement Method	C	

<sup>5</sup> This four-grade scale is consistent with the approach used for assessing countries' compliance with the Basel Committee's *Core principles for effective banking supervision*. The actual definition of the four grades has been adjusted to take into account the different nature of the two exercises. In addition, components of the Basel framework that are not relevant to an individual jurisdiction may be assessed as not applicable (N/A). For further details, see [www.bis.org/publ/bcbs264.htm](http://www.bis.org/publ/bcbs264.htm).

Market risk: Internal models approach	C
Operational risk: Basic Indicator Approach and Standardised Approach	C
Operational risk: Advanced Measurement Approaches	C
Capital buffers (conservation and countercyclical)	C
Pillar 2: Supervisory review process	
Legal and regulatory framework for the Supervisory Review Process and for taking supervisory actions	C
Pillar 3: Market discipline	
Disclosure requirements	C

Definition of the grades: **Compliant (C)**: all minimum Basel provisions have been satisfied and no material differences have been found that would give rise to prudential concerns or provide a competitive advantage to internationally active banks; **Largely compliant (LC)**: only minor provisions have not been satisfied and differences that have a limited impact on financial stability or the international level playing field have been identified; **Materially non-compliant (MNC)**: key provisions of the framework have not been satisfied or differences that could materially impact capital ratios have been identified; **Non-compliant (NC)**: the regulation has not been adopted or differences that could severely impact capital ratios and financial stability or international level playing field have been identified.

Colour code:

Compliant	C
Largely compliant	LC
Materially non-compliant	MNC
Non-compliant	NC

## Main findings by component

### *Scope of application*

SAMA's implementation of the scope of application is compliant with the Basel Framework. The Basel framework applies to internationally active banks on a fully consolidated basis as well as at every tier within a banking group, including the holding company that is the parent entity within a banking group. This is to ensure that the Basel requirements capture the risk of the banking group holistically. SAMA applies the Basel framework to all licensed banks including foreign banks' branch operations, on a solo and a consolidated basis.

There were several areas where SAMA adopts a stricter approach. For example, it applies a materiality level of 10% of the bank's capital (instead of 15% under the Basel II) to determine significant investments in commercial entities, which will be 1250% risk-weighted. The list of areas where SAMA rules are stricter than the Basel standards can be found in Annex 10.

### *Transitional arrangements*

Under the Basel framework, banks using the Basel II advanced approaches are subject to a capital floor based on the application of the 1988 Accord (ie Basel I). SAMA states that the capital floor continues to apply beyond 2009 (as envisaged by paragraph 48 of the Basel II standard).

SAMA has modified the transitional arrangements – which were previously slightly different – to be fully consistent with Basel III arrangements. Based on the rectified regulations, the Assessment Team considers SAMA's rules on the transitional arrangements to be compliant.

### *Definition of capital*

Basel III's overarching objective is to ensure that banks' risk exposures are sufficiently backed by high-quality capital, ie maintain a sufficient level of capital comprising CET1, additional Tier 1 and Tier 2 capital instruments. This is to ensure adequate loss absorbency capacity in the capital instruments, as well as to harmonise capital deductions and prudential filters applied at the common equity level.

SAMA requirements on definition of capital are generally a reproduction of the Basel III requirements. As such, SAMA's implementation of the definition of capital is assessed as compliant with the Basel standards.

### Point of non-viability (PON)

Basel III requires that all Additional Tier 1 and all Tier 2 capital instruments include a contractual principal loss absorption mechanism that is activated by the "trigger event" (broadly speaking, non-viability of the bank) unless the governing jurisdiction of the bank has in place laws that (i) require such Tier 1 and Tier 2 instruments to be written off upon such event, or (ii) otherwise require such instruments to fully absorb losses before taxpayers are exposed to loss.

SAMA has issued a circular (#BCS 5611) which requires banks to comply with these requirements when planning to issue any additional Tier 1 or Tier 2 capital instruments. The Assessment Team considers SAMA's rules for PON to be compliant with the Basel III.

### Capital conservation buffer

In addition to the minimum capital requirements, Basel III includes a capital conservation buffer, to be phased in by 1 January 2019, that will ultimately require banks to maintain an additional 2.5% of CET1 capital or face constraints on capital distributions and discretionary bonus payments.

SAMA rules reproduce the Basel III capital conservation buffer requirements, and are therefore assessed as compliant.

### Countercyclical buffer

Basel III has established a countercyclical buffer between zero and 2.5% through an extension of the capital conservation buffer, based on the local authority's judgment as to the extent of the build-up of system-wide risk. The countercyclical buffer is to be phased in in parallel with the capital conservation buffer and becomes fully effective on 1 January 2019.

SAMA rules reproduce the Basel III capital countercyclical buffer requirements, and are assessed as compliant with the Basel III.

### Credit risk: Standardised Approach

In general, SAMA's regulatory requirements for the credit risk Standardised Approach are assessed to be compliant with the Basel standards. There was one issue identified by the Assessment Team which is assessed to have a potentially material impact.

The Assessment Team notes that SAMA has provided a concession for banks' to apply a zero (0%) risk weight for banks' GCC sovereign exposures for the purpose of computing the credit risk capital charge. The preferential treatment was granted since the publication of the Basel I standard, based on the mutual agreement that all GCC members (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates) would apply a similar treatment to GCC sovereign exposures. SAMA did not use the discretion allowed in Basel II's paragraph 54 to allow for such treatment and this provision was implemented without ensuring whether or not other GCC members would apply the requirements set out in paragraph 54. This paragraph provides for a preferential risk weight for exposures to a jurisdiction's own sovereign provided the exposures are denominated and funded in the local currency.

Based on the risk weight table in paragraph 53 of Basel II, all of the GCC countries fulfil the preferential risk weight criteria (ie AA- and above rating), except for Bahrain (BBB-, which corresponds to a risk weight of 50%) and Oman (A-, a risk weight of 20%). At present, KSA banks have no exposure to Oman and only minimal exposure to Bahrain. However, KSA banks may increase their exposures to these countries or there may be a downgrade in the sovereign rating of other GCC countries. SAMA believes that these exposures are likely to decrease rather than increase, but the risk of a further country downgrade cannot be ruled out. The impact of this deviation is thus assessed to be potentially material.

Additionally, the team also notes that SAMA regulates Sharia-compliant banks in the same way as it regulates non-Sharia banks and hence, no special treatment is applied to Islamic products. However, the Assessment Team is aware that, in some markets with Sharia-compliant banks, different treatments are applied to certain Islamic banking products. For example, deposits collected by Islamic banking institutions in some markets are subject to certain Sharia-compliant features which do not guarantee the return/profit paid to the deposit holders and are linked to the performance of a particular asset, eg financing/loans. In this case, the deposit holders will additionally be exposed to the default risk of the loan. Further, conversion factors (ie an alpha factor which effectively reduces the exposure amount) are applied to the financing extended utilising these participation accounts.<sup>6</sup> These exposures would then be subjected to relevant risk weights, since such credit risk exposure is shared with the deposit holders. In the event that such products become available in the KSA and the local accounting rules subject these products to an alpha factor which reduces the exposure amount, this could result in a deviation from the Basel standards.

#### *Credit risk: Internal Ratings-Based Approach*

SAMA's standards are compliant with the Basel Framework for the Internal Ratings-Based Approach.

SAMA rules are more conservative than required by the Basel standard in several areas. For instance, SAMA does not recognise certain types of collateral (referred to in the Basel standard as eligible IRB collateral) and for purchased corporate receivables the top-down approach is not permitted. Also under the foundation approach, senior claims on corporates, sovereigns and banks not secured by recognised collateral must be assigned a loss-given-default (LGD) estimate of 60%, which is higher than the LGD estimate of 45% in the Basel standard. At present, no bank in the KSA uses the IRB approach for regulatory capital purposes.

#### *Credit risk: Securitisation framework*

The minimum capital requirements for the Securitisation framework set forth in the KSA regulation and guidance notes are consistent and compliant with Basel III.

The Assessment Team notes that securitisation comprises a relatively minor proportion of the overall risk-weighted assets of the KSA banking sector and no bank currently adopts the advanced modelling approaches for regulatory capital purposes.

<sup>6</sup> Please see the guidance note in connection with the IFSB capital adequacy standard: The determination of alpha in the capital adequacy ratio for institutions offering only Islamic financial services, [www.ifsb.org/standard/eng-GN-4%20Guidance%20Note.pdf](http://www.ifsb.org/standard/eng-GN-4%20Guidance%20Note.pdf).



### *Counterparty credit risk framework*

In the KSA, all three approaches specified by the Basel framework to measure counterparty credit risk (CCR) exposures can be adopted by banks in the KSA. Currently, banks only apply the Current Exposure Method (CEM). The rules for these three approaches and both approaches for credit valuation adjustment (CVA) risk have been specified by SAMA in their local regulations. Also, rules on capital requirements for bank exposures to CCPs have been captured by a circular which makes direct reference to the applicable Basel framework.

Overall, the CCR framework in the KSA is deemed to be compliant with the Basel framework. As an observation, the Assessment Team notes some ambiguity as to whether banks in Saudi Arabia can recognise bilateral netting of derivatives for capital adequacy purposes given the uncertainty surrounding the enforceability of netting agreements locally. However, the Assessment Team acknowledges that this issue goes beyond the scope of the RCAP assessment. The Assessment Team also notes that derivatives activity in the KSA and its corresponding CCR is relatively small. CCR risk-weighted assets (RWA) currently represent on average around 1% of total RWA for banks captured within the RCAP sample for assessment, with the largest contribution being 2.4% of total RWA.

### *Market risk: Standardised Approach*

SAMA's requirements on the Standardised Measurement Method for market risk are considered compliant with the Basel framework. No deviation has been identified.

### *Market risk: Internal Models Approach*

The minimum capital requirements for the IMA for market risk set forth in the KSA regulations and guidance notes are consistent and compliant with Basel III. Currently, no bank in the KSA adopts the IMA for market risk regulatory capital purposes. SAMA has, in addition to the regulations/guidelines, issued a circular stating that the original Basel texts for market risk are binding, thus preventing deviations.

### *Operational risk: Basic Indicator Approach, Standardised Approach, and Advanced Measurement Approaches*

The Basel Framework allows three approaches in order to calculate the capital requirements for operational risk, namely: the Basic Indicator Approach (BIA), the Standardised Approach (TSA) or its variant the Alternative Standardised Approach (ASA) and the Advanced Measurement Approach (AMA). SAMA permits all the above-mentioned approaches but no bank uses the advanced approach for regulatory capital purposes.

SAMA's rules for operational risk are compliant with the Basel Framework. The rules are more conservative than required by the Basel standard in a few areas (see Annex 10 for more details). For instance, the criteria under the Basel standard intended for internationally active banks to qualify for the standardised approach have been imposed by SAMA on all banks.

### *Supervisory review process*

The RCAP assessment of the supervisory review process covers the adoption of prescribed standards under Pillar 2 of the Basel II framework and the Supplementary Pillar II Guideline.

SAMA's Pillar 2 framework is considered compliant with the Basel framework as the domestic rules are broadly aligned with the Basel expectations on Pillar 2.

The implementation of Pillar 2 in the KSA has been integrated by SAMA into their risk-based supervisory framework. Banks are required to submit an internal capital adequacy assessment process (ICAAP) document to their supervisor on an annual basis for review. This ICAAP is used by SAMA as one of the inputs to determine the individual capital adequacy ratio (CAR) targets that each bank must meet.

These CAR targets – which cover both Pillar 1 and Pillar 2 risks – are set on an annual basis. SAMA uses its broad powers available under Article 7 of SAMA Charter 1957 and Article 22 of the Banking Control Law 1966 to impose the minimum requirements under Pillar 1 and the annual CAR targets and to take supervisory action where these requirements are not met. Further details of the supervisory review process in the KSA have been provided by SAMA in Annex 14.

### *Disclosure requirements*

SAMA has implemented Pillar 3 by providing banks in the KSA with a set of prescribed templates supplemented by guidance notes, both of which are largely based on requirements of the Basel standards. Its Pillar 3 framework was first introduced in 2007 with Basel II, and has since been updated to reflect more recent expectations under Basel II.5 and Basel III on the composition of capital and on remuneration.

Overall, SAMA's regulations on Pillar 3 are assessed to be compliant with the Basel standards.

## 2 Detailed assessment findings

The component-by-component details of the assessment of compliance with the risk-based capital standards of the Basel framework are detailed below. The focus of Sections 2.1 to 2.5 is on findings that were assessed to be deviating from the Basel minimum standards and their materiality. Section 2.6 lists some observations and other findings specific to the implementation practices in the KSA. This section is based on the assessment of the rules as at 31 July 2015 including the published amendments.

### 2.1 Scope of application

Section grade	Compliant
Summary	The implementation of the scope of application was found to be compliant with the Basel standard. The Assessment Team identified a few deviations from the Basel standards, which have subsequently been rectified by SAMA (refer to Annex 6).

### 2.2 Transitional arrangements

Section grade	Compliant
Summary	The implementation of the transitional arrangement was found to be compliant with the Basel standard. SAMA has implemented the transitional arrangements in line with the Basel standards. The Assessment Team identified a number of deviations, all of which have subsequently been rectified by SAMA (refer to Annex 6).

### 2.3 Pillar 1: Minimum capital requirements

#### 2.3.1 Definition of capital

Section grade	Compliant
Summary	The implementation of the definition of capital was found to be compliant with the Basel standard.

#### 2.3.2 Capital buffers (conservation and countercyclical)

Section grade	Compliant
Summary	The implementation of the capital buffers was found to be compliant with the Basel standard.

#### 2.3.3 Credit risk: Standardised Approach

Section grade	Compliant
Summary	SAMA's regulatory requirements for credit risk is generally consistent with the Basel standards with the exception of the 0% risk weight allowed for the GCC exposures, which is not fully in line with the paragraph 54 of the Basel II standard.
Basel paragraph no	Basel II paragraph 54: Claims on sovereigns
Reference in the domestic regulation	Section 4.1.1 "Claims on sovereigns", Page 17 of SAMA Detailed Guidance Document Relating to Pillar 1, June 2006
Findings	Paragraph 54 of the Basel II framework allows a lower risk weight to be applied to banks' exposures to their sovereign that are denominated and funded in domestic currency. Where this discretion is exercised, other national supervisory authorities may also permit their banks to apply the same risk weight to domestic currency

	<p>exposures to this sovereign (or central bank) funded in that currency. The Assessment Team notes that SAMA has given a concession for exposures of banks at 0% for GCC sovereign risk for the purpose of computing the credit risk capital charge. Based on the discussion during the on-site visit, SAMA stated that this preferential treatment was agreed and implemented due to the collective agreement made by all GCC members (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the UAE) since the publication of the Basel I standard. SAMA did not utilise the discretion allowed in paragraph 54 to allow for such treatment and this provision was implemented without ensuring whether or not other GCC members collectively apply the requirements set out in the paragraph 54 of the Basel II standard, ie 0% risk weight to their own sovereign's exposures and the sovereign exposures must also be denominated and funded in the relevant country's currency. Based on the risk-weight table in paragraph 53 of the Basel II, all these countries fulfil the 0% criteria (rating of AA- and above), except for Bahrain (BBB- = 50%) and Oman (A- = 20%). At present, banks in the KSA have no exposure to Oman and minimal exposure to Bahrain. However, this could change in the future potentially due to an increase in banks' exposures or a downgrade in the sovereign rating of other GCC countries. SAMA foresees that these exposures are likely to decrease rather than increase, but the risk of a further country downgrade cannot be ruled out. The impact of this deviation is thus assessed to be potentially material.</p>
Materiality	<p>Potentially material</p> <p>Based on the data provided by SAMA on the current exposures to the GCC countries (specifically, Bahrain), the weighted average impact across the RCAP sample of banks is 1.8 bps and the impact for the most affected bank is 4.5 bps. Although these amounts are not material at this point, the potential increase in the exposures to these countries due to a direct increase of exposure or due to a possible sovereign rating downgrade cannot be reliably ruled out. Hence, the overall impact of this deviation has been assessed as potentially material.</p>

### 2.3.4 Credit risk: Internal Ratings-Based Approach

Section grade	Compliant
Summary	<p>The implementation of the IRB approach to credit risk was found to be compliant with the Basel standard. SAMA revised various standards in response to findings of the Assessment Team during the review period. These revisions are outlined in Annex 6. In some areas SAMA's rules are more conservative than required by the Basel standard (see Annex 10 for more details).</p>

### 2.3.5 Securitisation framework

Section grade	Compliant
Summary	<p>The implementation of the securitisation framework for credit risk was found to be compliant with the Basel standard. All of the findings identified by the Assessment Team were rectified by SAMA before the cut-off date.</p>

### 2.3.6 Counterparty credit risk framework

Section grade	Compliant
Summary	<p>The implementation of the treatment of counterparty credit risk was found to be compliant with the Basel standard. In the KSA, all Basel approaches available to measure CCR exposures and to measure CVA risk can be adopted by banks. The rules for all of these approaches have been specified by SAMA in their local regulations and are consistent with the BCBS standards. Meanwhile, rules on capital requirements for bank exposures to CCPs have been captured by a circular which makes direct reference to the applicable Basel standard.</p>

### 2.3.7 Market risk: The Standardised Measurement Method

Section grade	Compliant
Summary	The implementation of the standardised measurement method for market risk was found to be compliant with the Basel standard. All of the banks in the KSA which have market risk exposure currently utilise the Standardised Approach for regulatory capital purposes.

### 2.3.8 Market risk: Internal Models Approach

Section grade	Compliant
Summary	The implementation of the IMA for market risk was found to be compliant with the Basel standard. Currently, no bank in the KSA adopts the IMA for market risk regulatory capital purposes.

### 2.3.9 Operational risk: Basic Indicator Approach and the Standardised Approach

Section grade	Compliant
Summary	The implementation of the BIA and the standardised approach for operational risk was found to be compliant with the Basel standard. SAMA has revised several minor findings which have been raised by the Assessment Team during the review period. These revisions are outlined in Annex 6. In some areas SAMA's rules are more conservative than required by the Basel standard (see Annex 10 for more details).

### 2.3.10 Operational risk: Advanced Measurement Approaches

Section grade	Compliant
Summary	The implementation of the AMA for operational risk was found to be compliant with the Basel standard. SAMA has revised several minor findings which have been raised by the Assessment Team during the review period. These revisions are outlined in Annex 6. At present, no bank in the KSA is using AMA to calculate regulatory capital.

## 2.4 Pillar 2: Supervisory review process

Section grade	Compliant
Summary	The implementation of the principles of Pillar 2 was found to be compliant with the Basel standard.

## 2.5 Pillar 3: Market discipline

Section grade	Compliant
Summary	The implementation of the Pillar 3 for market discipline was found to be compliant with the Basel standard. SAMA has implemented Pillar 3 by providing banks in the KSA with a set of prescribed templates supplemented by guidance notes, both of which are largely based on requirements of the BCBS. Its Pillar 3 framework – which was first introduced in 2007 with Basel II – has since been updated to reflect more recent expectations under Basel 2.5 and Basel III on the composition of capital and on remuneration.

## 2.6 Observations and other findings specific to the implementation practices in the KSA

### 2.6.1 Credit risk: Internal Ratings-Based Approach

Basel paragraph no	Basel II paragraphs 218–228: Definition of corporate exposure
Reference in the domestic regulation	Basel II – SAMA Detailed Guidance Document Relating to Pillar 1, June 2006: Section 5.0, paragraphs 2.2.2.2 and 2.2.11.
Observation	<p>SAMA standard identifies an asset class called VIP and High Net Worth Private Accounts (VIP asset class), in section 5.0, paragraph 2.2.2.2. The VIP asset class is a sub-category of the corporate SME asset class. This VIP asset class is identified separately by SAMA because it exhibits distinct risk characteristics. However, the formula for calculating capital is the same as for other corporate SME exposures. The Assessment Team do not consider the existence of this asset class to be inconsistent with the Basel II framework.</p> <p>Basel II paragraph 227 contains the definition of high-volatility commercial real estate (HVCRE) (which is one of the five sub-classes of specialised lending). This paragraph states that HVCRE includes commercial real estate exposures secured by properties categorised by the national supervisor as sharing high volatilities in portfolio default rates. While the Detailed Guidance Document incorporates the Basel II definition of HVCRE (section 5.0, paragraph 2.2.11) it does not specify what properties SAMA classify as sharing high volatilities in portfolio default rates. SAMA maintains that the KSA banks are not exposed to commercial real estate exposures of this nature, although if this changes SAMA may issue guidance on what constitutes high volatilities in portfolio defaults rates.</p>
Basel paragraph no	Basel II paragraphs 256–262: Adoption of IRB approaches across asset classes
Reference in the domestic regulation	N/A
Observation	Paragraph 262 of the Basel II framework states that a bank should not move to the advanced approach for the HVCRE sub-class without also doing so for material IPRE exposures. SAMA does not impose this requirement because SAMA does not permit the advanced approach for HVCRE.
Basel paragraph no	Basel II paragraphs 295–296: Recognition of eligible IRB capital
Reference in the domestic regulation	Section C, Prudential Returns, General Guidance note on Internal Ratings Based Approaches, January 2012, paragraph 31.
Observation	Basel II paragraphs 295–296 set out the methodology for recognition of eligible IRB collateral and recognition where both eligible financial collateral and eligible IRB collateral have been taken by a bank. As SAMA does not recognise eligible IRB collateral, these paragraphs are not incorporated into SAMA's standards.
Basel paragraph no	Basel II paragraphs 523–524: Requirements for the recognition of leasing
Reference in the domestic regulation	Section C Prudential Returns General Guidance on IRB approach, January 2012, paragraphs 79–80.
Observation	Basel II paragraph 523 states that leases other than those that expose the bank to residual risk (the risk of loss due to the fair value of the equipment declining below its residual estimate at lease inception) will be accorded the same treatment as exposures collateralised by the same type of collateral. This paragraph also sets out various additional standards that apply to leases. SAMA's standards (paragraphs 79–80 of the General Guidance) do not contain the various standards set out in Basel II paragraph 523. The Assessment Team has assumed this is because SAMA does not recognise physical collateral.

## 2.6.2 Counterparty credit risk

Basel paragraph no	Basel II Annex 4 Paragraph 96 (ii): CEM – Recognition of Bilateral Netting Agreements
Reference in the domestic regulation	<p>SAMA Finalised Guidance Concerning the Implementation of Basel III, December 2012: Annex 5, Paragraph 96(ii)</p> <p>SAMA Circular 361000021954, 3 December 2014: Frequently Asked Questions concerning SAMA's various Guidance Documents regarding Basel III (See Item 4)</p>
Observation	<p>Paragraph 96(ii) of the Basel II framework requires that the national supervisor, after consultation (when necessary) with other relevant supervisors, must be satisfied that the netting is enforceable under the laws of each of the relevant jurisdictions. Further, footnote 250 explains that, if any of these supervisors is dissatisfied about enforceability under its laws, the netting contract or agreement will not meet this condition and neither counterparty could obtain supervisory benefit.</p> <p>In the case of the KSA, SAMA has recently allowed banks to recognise bilateral netting for purposes of capital adequacy requirements under the local regime. Based on its interactions with SAMA and the industry, the Assessment Team is of the view that there is some ambiguity as to whether netting agreements for derivatives transactions are legally enforceable locally. As such, this could have implications on the ability of banks to recognise netting benefits. Currently, there is no netting law in Saudi Arabia and the Assessment Team is unaware of any publicly available legal opinions on the status of bilateral netting agreements in the country. Nonetheless, the team acknowledges that SAMA is undertaking efforts to enhance the legal certainty of netting contracts as part of broader measures to strengthen the local resolution framework.</p> <p>The Assessment Team acknowledges that this issue goes beyond the scope of the RCAP assessment as it relates to the operationalisation of the Basel standards. It is also considered to be an issue which currently has limited impact due to the relatively small total derivatives exposures in the KSA, with those subject to bilateral netting agreements even smaller.</p>

## Annexes

### Annex 1: RCAP Assessment Team and Review Team<sup>7</sup>

#### Assessment Team

Mr Stephen Bland, UK Prudential Regulation Authority (Team Leader)

Name	Affiliation
Mr Qaiser Anwarudin	Financial Stability Institute, Bank for International Settlements
Mr Erhan Çetinkaya	Banking Regulation and Supervision Agency, Turkey
Mr Stuart Irvine	Reserve Bank of New Zealand
Ms Katherine Munsamy	South African Reserve Bank
Ms Jin Wang	China Banking Regulatory Commission
Ms Johanna Eklund	Riksbank, Sweden
Mr Markus Herfort	Federal Financial Supervisory Authority (BaFIN), Germany

#### Supporting members

Name	Affiliation
Mr Nik Faris Sallahuddin	Basel Committee Secretariat
Mr Christian Schmieder	Basel Committee Secretariat

#### Review Team

Name	Affiliation
Mr Brad Shinn	The Office of the Superintendent of Financial Institutions, Canada
Mr Sudarshan Sen	Reserve Bank of India
Mr Vance Price	Office of the Comptroller of the Currency, United States
Mr Karl Cordewener	Basel Committee Secretariat

<sup>7</sup> The RCAP Assessment Team worked closely with Mr Olivier Prato, Head of Basel III Implementation at the Basel Committee Secretariat. It has also benefited from the feedback of the RCAP Review Team and the Peer Review Board. The Review Team is separate from the Assessment Team, and provides an additional level of quality assurance for the report's findings and conclusions.



## Annex 2: Implementation of the Basel framework as of cut-off date

### Overview of adoption of capital standards

Table A.1

Basel III Regulation	Date of issuance by BCBS	Transposed in the KSA rule	Date of implementation in the KSA	Status
Basel II				
Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework – Comprehensive Version	June 2006	<ol style="list-style-type: none"> <li>1. <i>Capital Adequacy Requirement for Market Risk, December 2004</i></li> <li>2. <i>Basel II – SAMA's Detailed Guidance Document Relating to Pillar 1, June 2006</i></li> <li>3. <i>Basel II Guidance Document Pillar 2 Supervisory Review Process, February 2007</i></li> <li>4. <i>SAMA Basel II Prudential Returns, March 2007</i></li> <li>5. <i>Basel II – Pillar 3 Disclosure Requirements and Guidance Notes, May 2007</i></li> <li>6. <i>Guidelines on Application Procedures for the Adoption of IRB Approaches, April 2008</i></li> <li>7. <i>Pillar 2 – SAMA's Guideline Document on the Internal Capital Adequacy Assessment Plan (ICAAP), September 2008</i></li> <li>8. <i>SAMA's Amended IRB Prudential Returns and Guidance Notes Package and Frequently Asked Questions (FAQs), January 2012</i></li> </ol>	January 2008	4
Basel 2.5				
Enhancements to the Basel Framework Guidelines for computing capital for incremental risk in the trading book Revisions to the Basel II market risk framework	July 2009	<p>On 29 July 2009, SAMA issued circular No BCS 769 entitled - <i>Enhancements and Revisions to the Basel II Framework, Market Risk and Trading Book</i> requiring banks to establish necessary policies, systems and processes to enable them to meet the Basel requirements pertaining to:</p> <ul style="list-style-type: none"> <li>• Enhancements to the Basel II Framework</li> <li>• Revisions to the Market Risk Framework</li> <li>• Guidelines for Computing Capital for Incremental Risk in the Trading Book</li> </ul> <p>Interpretive issues with respect to the revisions to the market risk framework, November 2011 issued via circular BCS8724 of 22 Feb 2012.</p>	January 2013	4
Basel III				

Basel III: A global regulatory framework for more resilient banks and banking systems –revised version	June 2011 (Consolidated version)	SAMA's Final Guidance Document Concerning Implementation of Capital Reforms Under Basel III Framework, December 2012 SAMA's Final Document concerning Basel III IRB Approaches for credit risk, July 2014	January 2013	4
Pillar 3 disclosure requirements for remuneration	July 2011	SAMA Circular # 19120 dated 16 July 2011	January 2013	4
Treatment of trade finance under the Basel capital framework	October 2011	SAMA has issued a circular No. BCS 28548, entitled "Treatment of Trade Finance under Basel Capital Framework" dated 21 November 2011.	November 2011	4
Composition of capital disclosure requirements	June 2012	SAMA's Final Guidance Documents Concerning Implementation of Basel III Pillar 3 component, December 2012	January 2013	4
Basel III IRB approaches	July 2014	SAMA's Final Document concerning Basel III IRB Approaches for credit risk	July 2014	4
Basel III counterparty credit risk – FAQs	Nov 2011 July 2012 Nov 2012	Frequently asked questions, November 2011, July 2012, November 2012	Dec 2011 Jan 2013	4
Capital requirements for bank exposures to CCPs	July 2012	SAMA Circular # 25092 dated 6 October 2012	January 2017	2

Number and colour code: 1 = draft regulation not published; 2 = draft regulation published; 3 = final rule published; 4 = final rule in force. For rules which were due for implementation on 30 June 2012, the following colour code is used: **green** = implementation completed; **yellow** = implementation in process; **red** = not implemented.

## Annex 3: List of capital standards under the Basel framework used for the assessment

- (i) International Convergence of Capital Measurement and Capital Standards: A Revised Framework (Basel II), June 2006
- (ii) Enhancements to the Basel II framework, July 2009
- (iii) Guidelines for computing capital for incremental risk in the trading book, July 2009
- (iv) "Basel Committee issues final elements of the reforms to raise the quality of regulatory capital", Basel Committee press release, 13 January 2011
- (v) Revisions to the Basel II market risk framework: Updated as of 31 December 2010, February 2011
- (vi) Basel III: A global regulatory framework for more resilient banks and banking systems, December 2010 (revised June 2011)
- (vii) Pillar 3 disclosure requirements for remuneration, July 2011
- (viii) Treatment of trade finance under the Basel capital framework, October 2011
- (ix) Interpretive issues with respect to the revisions to the market risk framework, November 2011
- (x) Basel III definition of capital – Frequently asked questions, December 2011
- (xi) Composition of capital disclosure requirements: Rules text, June 2012
- (xii) Capital requirements for bank exposures to central counterparties, July 2012
- (xiii) Regulatory treatment of valuation adjustments to derivative liabilities: final rule issued by the Basel Committee, July 2012
- (xiv) Basel III counterparty credit risk – Frequently asked questions, November 2011, July 2012, November 2012

## Annex 4: Local regulations issued by SAMA for implementing Basel capital standards

### A. Overview of issuance dates of important the KSA capital rules

Table A.2

Domestic regulations	Name of the document, version and date
Domestic Regulations implementing Basel II	Refer to Annex 2.
Domestic Regulations implementing Basel II.5	Refer to Annex 2.
Domestic Regulations implementing Basel III	Refer to Annex 2.

### B. Hierarchy of the KSA laws and regulatory instruments

Table A.3

Level of rules (in legal terms)	Type
SAMA Charter (1957)	Legislation
Banking Control Law (1966)	Legislation
Ministerial Decree of Minister of Finance (1986)	Legislation
SAMA Regulations (various)	Regulation
SAMA Prudential Returns and Guidance Notes (various)	Regulation
SAMA Regulations related to Basel I, II, II.5 and III	Regulation
SAMA Circulars and Guidance Documents (guidance and documents) eg (Loan-to-deposit ratio, role of audit committee etc)	Guidance/documents

## Annex 5: Details of the RCAP assessment process

### A. Off-site evaluation

- (i) Completion of a self-assessment questionnaire by SAMA
- (ii) Evaluation of the self-assessment by the RCAP Assessment Team
- (iii) Independent comparison and evaluation of the domestic regulations issued by SAMA with corresponding Basel III standards issued by the BCBS
- (iv) Identification of observations
- (v) Refinement of the list of observations based on clarifications provided by SAMA
- (vi) Assessment of materiality of deviations for all quantifiable deviations based on data and non-quantifiable deviations based on expert judgment
- (vii) Forwarding of the list of observations to SAMA

### B. On-site assessment

- (viii) Discussion of individual observations with SAMA
- (ix) Meeting with selected KSA banks and accounting firms
- (x) Discussion with SAMA and revision of findings to reflect additional information received
- (xi) Assignment of component grades and overall grade
- (xii) Submission of the detailed findings to SAMA with grades
- (xiii) Receipt of comments on the detailed findings from SAMA

### C. Review and finalisation of the RCAP report

- (xiv) Review of comments by the RCAP Assessment Team, finalisation of the draft report and forwarding to SAMA for comments
- (xv) Review of SAMA's comments by the RCAP Assessment Team
- (xvi) Review of the draft report by the RCAP Review Team
- (xvii) Review of the draft report by the Peer Review Board
- (xviii) Reporting of findings to SIG by the team leader

## Annex 6: List of rectifications by SAMA

The following amendments were published before 31 July 2015 and available at SAMA's website ([www.sama.gov.sa](http://www.sama.gov.sa)).

Basel Paragraph	Reference to SAMA document and paragraph	Brief description of the correction	Table A.4
Scope of application			
Basel II paragraph 21	Para 2.1, Basel II – SAMA's Detailed Guidance Document relating to Pillar 1, June 2006	The holding company within a banking group has been included in the scope of application.	
Basel II paragraph 22	Para 2.1, Basel II – SAMA's Detailed Guidance Document relating to Pillar 1, June 2006	The application of the framework on every tier within the banking group has been added.	
Basel II paragraph 24	Page 12 "area of national discretions", Basel II – SAMA's Detailed Guidance Document relating to Pillar 1, June 2006	The definition of other financial institutions has been added and conflicting sentences deleted.	
Transitional arrangements			
Basel II 2006, paragraphs 45–49	Pages 60 to 61, paras 5.19 to 5.23, Basel II – SAMA's Detailed Guidance Document relating to Pillar 1, June 2006	Paragraphs are rectified to be fully consistent with Basel III transitional floor arrangements, and one paragraph is added to maintain the floor arrangements after 2009.	
Basel II 2006, paragraphs 263–269	Pages 61 to 62, paras 5.24 to 5.26, Basel II – SAMA's Detailed Guidance Document relating to Pillar 1, June 2006	Paragraphs are rectified to be fully consistent with Basel II requirements.	
Definition of capital			
Basel II 2006, paragraph 43	Page 54, Heading 6.4, Basel II – SAMA's Detailed Guidance Document relating to Pillar 1, June	"Banks using the IRB approach for securitisation exposures or the PD/LGD approach for equity exposures must first deduct the EL amounts" is added.	

	2006	
Basel III 2011, paragraphs 54–56	Page 8 – Finalised Guidance Document Concerning the Implementation of Basel III	Wrong paragraph references are corrected.
Basel III 2011, paragraphs 74–75	Pages 13/14 – Finalised Guidance Document Concerning the Implementation of Basel III	Wrong subtitles are corrected.
Basel III 2011, paragraphs 87–89	Page 19 – Finalised Guidance Document Concerning the Implementation of Basel III	Wrong paragraph references are corrected.
Basel III 2011, paragraph 94	Page 20 – Finalised Guidance Document Concerning the Implementation of Basel III	Expressions such as “member countries” are corrected.
Basel III 2011, paragraphs 97–117	Page 24 – Finalised Guidance Document Concerning the Implementation of Basel III	SAMA Finalised guidance document concerning the implementation of Basel III: section 6.1 counterparty credit risk, says “SAMA had permitted only CEM under Basel II, For Basel III purposes as in Basel II, banks are to use the simpler CEM.” This contradicts the sentence on page 24: “for Basel III they (banks) can utilise IMM as well”. This has been corrected.
Basel III 2011, paragraph 99	Page 26 – Finalised Guidance Document Concerning the Implementation of Basel III	“SAMA’s methodology uses CEM for default risk which is one of the <b>four</b> methods prescribed under Basel II annex 4”, here “four” should be “three”. This is corrected.
Basel III 2011, paragraph 99	Page 33 – Finalised Guidance Document Concerning the Implementation of Basel III	“CVA which again can be calculated as per the IMM or SA or CEM”, where CEM is not a method for CVA calculation, and this is corrected.
Basel III 2011, paragraph 102	Page 39 – Finalised Guidance Document Concerning the Implementation of Basel III	Wrong paragraph references are corrected.
Credit risk: Standardised Approach		
Basel II: paragraph 57	Page 22, Basel II – SAMA’s Detailed Guidance Document relating to Pillar 1, June 2006	Basel para 57 states that PSE’s can be risk-weighted with the treatment of exposures to banks (either option 1 or 2) and if option 2 is selected it must be used <u>without the preferential treatment for short-term exposures</u> . SAMA did not state this in their regulations; this will potentially allow banks to use option 2 with preferential treatment which is a sub-equivalency. This problem was solved by stating that the short-term treatment is not available.

Basel II: paragraph 66	Page 22, Basel II – SAMA's Detailed Guidance Document relating to Pillar 1, June 2006	SAMA's rules did not seem to specify that no claim on an unrated corporate may be given a risk weight preferential to that assigned to its sovereign of incorporation. This problem was solved by stating that an unrated corporate cannot be risk-weighted with a weight preferential to that assigned to its sovereign of incorporation.
Basel II: paragraph 70	Page 23, Basel II – SAMA's Detailed Guidance Document relating to Pillar 1, June 2006	SAMA applies an SAR 5 million limit for retail receivables but this limit as of May 2015 is above the EUR1 million limit stated in Basel II. The exchange rate between euro and riyal was above 0.2 for the past year and has been increasing steadily. This issue was solved by reducing the limit from SAR 5 million to EUR 1 million. In addition, SAMA did not apply the same product criterion for claims to be included in the regulatory retail portfolio as Basel. In particular, SAMA does not specify which products are eligible for inclusion in the regulatory retail portfolios. This issue was solved by specifying the products.
Basel II: paragraph 102	Page 25, Basel II – SAMA's Detailed Guidance Document relating to Pillar 1, June 2006	The following expression in Basel footnote 37 is missing in the domestic regulation which creates a less conservative approach: "In the case of a guarantee against convertibility and transfer risk, the local currency rating can be used only for the portion that has been guaranteed. The portion of the loan not benefiting from such a guarantee will be risk-weighted based on the foreign currency rating." This issue was solved by adding the above expression into the regulation.
Basel II: paragraph 107	Page 26, Basel II – SAMA's Detailed Guidance Document relating to Pillar 1, June 2006	Reference for paragraph 107 should be page 80 of the 2006 document – but this is under the heading minimum standards <u>for IRB banks</u> . Therefore paragraph 107 which is about external ratings is not covered by any SAMA regulation. This issue was solved by adding the relevant expression for standardised banks.
Basel II: paragraph 116	Page 154, Basel II – SAMA's Detailed Guidance Document relating to Pillar 1, June 2006	While SAMA requires disclosure, this is different from stating that if there is no disclosure then capital relief is not available. Therefore Basel paragraph 116 is not reflected in SAMA capital standards. This issue was solved by stating that capital relief will not be available if there is no disclosure about the CRM techniques being used.
Basel II: paragraph 201	Page 161, Basel II – SAMA's Detailed Guidance Document relating to Pillar 1, June 2006	It is stated in the domestic regulation that the discretion in paragraph 201 is applied but it is not stated anywhere in the regulations that the conditions in paragraph 201 must be satisfied. This issue was solved by adding the relevant conditions into the regulation.
Credit risk: IRB		
Basel II paragraph 218	Section 5.0, paragraph 2.2. Basel II SAMA's Detailed Guidance Document relating to Pillar 1 – June 2006.	The requirement to manage corporate SME exposures on a pooled basis will be removed.
Basel II paragraph 219	Section 5.0, paragraph 2.2.3 Basel II SAMA's Detailed Guidance Document relating to Pillar 1 – June 2006.	All exposures possessing the relevant characteristics set out in the Basel II framework for Specialised Lending will be classified as Specialising Lending. The possibility of any exceptions will be removed.
Basel II paragraph 230	Section 5.0, paragraph	SAMA's standards will confirm that claims on securities firms may be treated as claims on banks only if these firms are subject



	2.4.1 Basel II SAMA's Detailed Guidance Document relating to Pillar 1 – June 2006.	to supervisory and regulatory arrangements comparable to those under the Basel II framework.
Basel II paragraphs 231–232	Section 5.0, paragraph 2.5.4 and 2.5.5 Basel II SAMA's Detailed Guidance Document relating to Pillar 1 – June 2006.	Properties that are rented will be excluded from the residential mortgage asset class. Detailed Basel II requirements on multiple dwellings and on how loans extended to small businesses should be managed and originated to be eligible for retail treatment will be specified.
Basel II paragraph 234	Section 5.0, paragraph 2.5.7 Basel II SAMA's Detailed Guidance Document relating to Pillar 1 – June 2006.	In applying the criteria for classification as qualifying revolving retail exposures (QRRE), segmentation at the national or country level (or below) will be the general rule. To be classified as QRRE the maximum exposure to a single individual in the sub-portfolio will be the SAR equivalent of €100,000.
Basel II paragraphs 235–237	Section 7, paragraph 7.1 Basel II SAMA's Detailed Guidance Document relating to Pillar 1 – June 2006	The details of the Basel II definition of equity exposures (including relevant footnotes) will be incorporated into SAMA's standards.
Basel II paragraph 260	Section 3, paragraph 3.1.1 Basel II SAMA's Detailed Guidance Document relating to Pillar 1 – June 2006	Once a bank has adopted the IRB approach for all or part of any of the corporate, bank, sovereign or retail asset classes, it will be required to adopt the IRB approach for its equity exposures at the same time, subject to materiality.
Basel II paragraph 264	Attachment 5.1, paragraph 5.25 Basel II SAMA's Detailed Guidance Document relating to Pillar 1 – June 2006	The transition period (for transitional arrangements) will commence on the date of the implementation of the Basel II Framework rather than at the adoption of the IRB approach.
Basel II paragraph 266	Paragraph 55, Section C Prudential Returns General Guidance Notes on IRB Approaches, 2012. Also paragraph 55, Basel III Approaches Prudential Returns and Guidance Notes, 2014.	The 10% floor for LGD for retail exposures secured by residential mortgage properties will apply at the sub-segment of exposures to which the risk-weight formula is applied. The floor will remain in place indefinitely.
Basel II paragraph 273	Section 5.0, paragraph 4.1.5 Basel II SAMA's	The firm-size adjustment made to the corporate risk weight formula will be consistent with the Basel II Framework.

	Detailed Guidance Document relating to Pillar 1 – June 2006. Also paragraph 20, Section C Prudential Returns General Guidance Notes on IRB Approaches, 2012; and paragraph 20, Basel III Approaches Prudential Returns and Guidance Notes, 2014.	
Basel II paragraph 284(ii)	Paragraph 20, Section C Prudential Returns General Guidance Notes on IRB Approaches, 2012. Also paragraph 20, Basel III Approaches Prudential Returns and Guidance Notes, 2014.	The firm-size adjustment made to the corporate risk weight formula hedged exposures under the double default framework has been revised to make it consistent with the Basel II Framework.
Basel II paragraph 289	Paragraph 31, Section C Prudential Returns General Guidance Notes on IRB Approaches, 2012.	The operational standards of the standardised approach will apply to the use of eligible financial collateral.
Basel II paragraph 302	Paragraph 126, Section C Prudential Returns General Guidance Notes on IRB Approaches, 2012.	Banks will be required to meet all the operating requirements set out in the standardised approach to receive recognition for guarantees and credit derivatives under the foundation approach.
Basel II paragraph 309	Section 6, Paragraph 6.2 Basel II SAMA's Detailed Guidance Document relating to Pillar 1 – June 2006	For corporate, sovereign and bank exposures, the qualitative requirements of the standardised approach for on-balance sheet netting of loans and deposits will apply to IRB banks.
Basel II paragraph 321	Paragraph 46, Section C Prudential Returns General Guidance Notes on IRB Approaches, 2012.	Daily re-margining <u>and</u> daily revaluation will be among the conditions for the one-year maturity floor to not apply.
Basel II paragraph 323	Section 5.0, paragraph 4.2.11 Basel II SAMA's Detailed Guidance Document relating to	The requirements of Basel II paragraph 323 for transactions subject to a master netting agreement will apply only to transactions that fall within the scope of Basel II paragraph 321.

	Pillar 1 – June 2006	
Basel II paragraph 335	Section 6, paragraph 6.2 Basel II SAMA's Detailed Guidance Document relating to Pillar 1 – June 2006.	For retail exposures, the qualitative requirements of the standardised approach for on-balance sheet netting of loans and deposits will apply to IRB banks.
Basel II paragraph 338	Section 7, paragraph 7.1 Basel II SAMA's Detailed Guidance Document relating to Pillar 1 – June 2006.	To the extent foreign exchange (FX) and interest rate commitments exist within a bank's retail portfolio for IRB purposes, banks will not be permitted to provide their internal assessments of credit equivalent amounts. Instead the rules for the standardised approach will apply.
Basel II paragraph 358	Section 7, paragraph 7.3 Basel II SAMA's Detailed Guidance Document relating to Pillar 1 – June 2006.	The threshold for exclusion from IRB treatment relevant to equity portfolios consisting of less than 10 individual holdings will be specified.
Basel II paragraph 359	Paragraph 68, Section C Prudential Returns General Guidance Notes on IRB Approaches, 2012.	For equity exposures, investments held at the lower of cost and market, exposure will be equal to the cost or market value presented in the balance sheet.
Basel II paragraph 373(i)	Paragraph 139, Section C Prudential Returns General Guidance Notes on IRB Approaches, 2012.	For purchased receivables, the use of the double default framework for dilution risk will be subject to the operational requirements set out in the Basel II framework.
Basel II paragraph 376	Paragraph 148, Section C Prudential Returns General Guidance Notes on IRB Approaches, 2012.	The Basel II requirements for calculating expected loss (EL) for equity exposures subject to the PD/LGD approach, securitisation exposures and "all other" exposures will apply.
Basel II paragraph 380	Section 5.0, Paragraph 6.3 Basel II SAMA's Detailed Guidance Document relating to Pillar 1 – June 2006.	Specific provisions set aside against equity and securitisation exposures will not be excluded from total eligible provisions.
Basel II paragraph 392	Section 5.1, paragraph 5.1.30 Basel II SAMA's Detailed Guidance Document relating to Pillar 1 – June 2006.	SAMA will require banks' overall credit risk management practices to be consistent with the evolving sound practice guidelines issued by the Basel Committee.

Basel II paragraph 397	Attachment 5.4, paragraphs 4.1.1 to 4.1.4 Basel II SAMA's Detailed Guidance Document relating to Pillar 1 – June 2006.	SAMA will require banks' credit policies to articulate the risk of each grade in terms of both a description of the probability of default risk typical for borrowers assigned the grade, and the criteria used to distinguish that level of credit risk.
Basel II paragraph 402	Attachment 5.4, paragraph 4.1.12. Basel II SAMA's Detailed Guidance Document relating to Pillar 1 – June 2006.	SAMA will remove references that imply risk pools may not need to be defined at a more granular level than asset class.
Basel II paragraph 417	Attachment 5.4, paragraph 4.6.3. Basel II SAMA's Detailed Guidance Document relating to Pillar 1 – June 2006.	SAMA will require banks to have procedures that include credible ongoing efforts to improve the performance of models.
Basel II paragraph 435(i)	Attachment 5.4, paragraph 5.5.10. Basel II SAMA's Detailed Guidance Document relating to Pillar 1 – June 2006.	Banks using the double default framework will be required to consider as part of their stress-testing framework the impact of deterioration in the credit quality of protection providers and the impact of the default of one but not both of the obligor and protection provider.
Basel II paragraph 436	Section 12, paragraph 12.1. Basel II SAMA's Detailed Guidance Document relating to Pillar 1 – June 2006.	Banks will be required to consider information on the likely effect of bigger, stress circumstances as part of stress tests used in the assessment of capital adequacy.
Basel II paragraph 445	Attachment 5.4, paragraph 7.2.2. Basel II SAMA's Detailed Guidance Document relating to Pillar 1 – June 2006.	SAMA requires each IRB bank to demonstrate it has been using a rating system that is broadly in line with Basel II requirements for at least three years prior to qualification. SAMA's discretion to reduce the length of time a bank is required to have been using a rating system will be removed.
Basel II paragraph 447	Attachment 5.5, paragraph 4.5.7. Basel II SAMA's Detailed Guidance Document relating to Pillar 1 – June 2006.	Banks on the advanced approach will be required to estimate an appropriate LGD for each of its facilities (or retail pools).
Basel II paragraph 451	Attachment 5.5, paragraph 4.1.12. Basel II SAMA's Detailed Guidance	Flexibility against the required standards for data will apply to data collected prior to the implementation of the Basel II framework rather than prior to a bank's adoption of the IRB approach.

	Document relating to Pillar 1 – June 2006.	
Basel II paragraph 456	Attachment 5.5, paragraph 4.2.5. Basel II SAMA's Detailed Guidance Document relating to Pillar 1 – June 2006.	Flexibility permitted to construct PD estimates using data that does not align with the Basel II definition of default will apply up to the implementation of the Basel II framework rather than up to the time a bank adopts the IRB approach.
Basel II paragraph 468	Attachment 5.5, paragraph 5.1.4. Basel II SAMA's Detailed Guidance Document relating to Pillar 1 – June 2006.	References that imply actual loss rates are ordinarily close to LGDs that reflect economic downturn conditions will be removed.
Basel II paragraph 506	Paragraph 31, Section C Prudential Returns General Guidance Notes on IRB Approaches, 2012.	Banks under the foundation IRB approach which do not meet the requirements for own-estimates of LGD and EAD will be required to meet the minimum requirements described in the standardised approach to receive recognition for eligible financial collateral.
Basel II paragraphs 529–536	Paragraph 60, Section C Prudential Returns General Guidance Notes on IRB Approaches, 2012.	Basel II requirements for validation and documentation regarding the calculation of capital charges for equity exposures will be explicitly incorporated into the requirements for this asset class.
Credit risk: Securitisation Framework		
Basel II paragraphs 623–636	Page 15 Pillar 1 Basel II.5 SAMA's Guidance Document Concerning Implementation	Supervisory Formula (SF): Previously SAMA had not reproduced the supervisory formula and banks were expected to refer to Basel II. Clear references have now been incorporated guiding banks to the exact paragraphs to ensure consistency across their regulations/guidance notes.
Basel II paragraphs 638,–639	Pages 15–16 Pillar 1 Basle II.5 SAMA's Guidance Document Concerning Implementation	Liquidity facilities: these paragraphs were quoted in two different guidance notes with only one of guidance notes taking into account the amendments to the requirements. SAMA has agreed to delete the incorrect paragraphs and direct banks to the amended regulations.
Basel II paragraph 643	Page 16 Pillar 1 Basle II.5 SAMA's Guidance Document Concerning Implementation	Capital requirement for early amortisation provisions: The following sentences had been omitted from paragraph 643 within SAMA guidelines: "For determining the EAD, the undrawn balances of securitised exposures would be allocated between the seller's and investors' interests on a pro rata basis, based on the proportions of the seller's and investors' shares of the securitised drawn balances. For IRB purposes, the capital charge attributed to the investors' interest is determined by the product of (a) the investors' interest, (b) the appropriate CCF, and (c) KIRB." SAMA has agreed to incorporate this within the regulations.
Basel II paragraph 555	SAMA's Guidance Document Concerning Implementation, 2012.	Clean up calls: On page 54 point (g), to avoid confusion, it was suggested that the following be inserted: clean up calls must satisfy the conditions of "paragraph 20 (557) below". SAMA agreed to amend the regulations.

	Page 54	
Basel II paragraphs 613–618 and Basel II.5 paragraph 613(c)	SAMA's Guidance Document Concerning Implementation, 2012. Page 66 for paragraph 613	Ratings-Based Approach: Under paragraph 613 the examples were not provided. Despite the examples under 613 not being included, the amendment to 613(c) is found on page 15 of the guidance note. This was deemed inconsistent and SAMA agreed to include the examples within the guidance notes.
Basel II paragraphs 619–620	This was previously not reproduced	Internal Assessment Approach: paragraphs 619–620 were not found in domestic regulations. SAMA had mentioned that paragraph 609 takes this into account as it states: "Such exposures must satisfy the conditions of paragraph 619 and 620". SAMA had incorporated proper references to the Basel text.
Counterparty credit risk framework		
Basel II Annex 4 paragraphs 31, 38, 98 and 99 as amended by the revised Basel III framework	SAMA Finalised Guidance Concerning the Implementation of Basel III, December 2012: Annex 5, paragraphs 31, 38, 98 and 99	SAMA has revised the formulas to be used by banks under the internal models method (IMM) and advanced CVA risk capital charge in their guidelines which were inconsistent with those in the Basel standard.
Basel II Annex 4 paragraph 96(i)–(vi)	SAMA Finalised Guidance Concerning the Implementation of Basel III, December 2012: Annex 5, paragraph 96 (i)–(vi) SAMA Circular 361000021954 Frequently Asked Questions concerning SAMA's various Guidance Document regarding Basel III, December 2014	In 2014, SAMA revised its capital framework to allow the bilateral netting of derivatives when calculating capital requirements for counterparty credit risk. SAMA has updated the following documents to reflect this change in policy: <ul style="list-style-type: none"> <li>• Basel II – SAMA's Detailed Guidance Document (December 2006)</li> <li>• Prudential Returns General Guidance Notes on the Internal Ratings-Based (IRB) Approaches (January 2012)</li> <li>• Basel III: Pillar III – Package of Disclosure Requirements and Guidance Notes (December 2012)</li> </ul>
Annex 4 paragraph 98 added under Basel III paragraph 99	SAMA Finalised Guidance Concerning the Implementation of Basel III, December 2012: Section 6.1.A, paragraph 98	SAMA has removed statements from the following guidelines which had earlier indicated that Basel II.5 requirements for the IMA for market risk are not implemented in Saudi Arabia: <ul style="list-style-type: none"> <li>• Finalised Guidance Document for the Implementation of Basel II.5 Standardised and IRB Approaches (October 2012)</li> <li>• Finalised Guidance Document Concerning the Implementation of Basel III (December 2012)</li> <li>• Basel III: Pillar III – Package of Disclosure Requirements and Guidance Notes (December 2012)</li> </ul> Under Basel III, a bank can adopt the advanced approach for CVA risk only where it meets specified requirements including those under Basel II.5 (ie for market risk models). If the Basel II.5 requirements are not implemented, this effectively relaxes the minimum requirements for the advanced approach for CVA risk.
Basel II paragraphs 104–105 added under Basel III paragraph 99	SAMA Finalised Guidance Concerning the Implementation of Basel	SAMA has removed text (ie additional explanations) in its guidelines that were inconsistent with the expectations of paragraphs 104 and 105.

	III, December 2012: Section 6.1.B–6.1.C	
Market risk: Standardised Approach		
Basel II paragraph 689(iv)	General and Specific Guidelines for Adjustment with regard to Market Risk (Basel II.5) Page 22	Definition of the correlation trading portfolio: Under 689(iv) bullet point 2 of the Basel text states: “within a relatively short time conforming to trade custom”. The words: “conforming to trade custom” has been omitted from the domestic regulations. SAMA has agreed to take this into account.
Basel II paragraph 718(vi) of Basel II Table: Horizontal Disallowances	SAMA’s Guidance Document Concerning Implementation page 86	General market risk-interest rates: Maturity method: Zone 2 includes “5–7 years” which is not accurate. SAMA agreed to amend the regulations.
Market risk : Internal Models Approach		
Basel II paragraph 718(Lxxiv)	Capital Adequacy for Market risk, page 44	Internal Models: Qualitative Standards: Basel states under the Qualitative Standards that:“ Only those banks whose models are in full compliance with the qualitative criteria will be eligible for application of the minimum multiplication factor.” This statement was omitted. However, SAMA agreed to add this within the domestic regulations.
Basel II paragraph 718(Lxxiv)	Capital Adequacy for Market risk, page 45	Stress testing and capital adequacy: Basel states that: “A routine and rigorous programme of stress testing should be in place as a supplement to the risk analysis based on the day-to-day output of the bank’s risk measurement model. The results of stress testing should be reviewed periodically by senior management, used in the internal assessment of capital adequacy, and reflected in the policies and limits set by management and the board of directors. Where stress tests reveal particular vulnerability to a given set of circumstances, prompt steps should be taken to manage those risks appropriately (eg by hedging against that outcome or reducing the size of the bank’s exposures, or increasing capital). Any reference to the internal assessment to capital adequacy and increasing capital as a management method in this paragraph within the domestic regulations was omitted. SAMA will amend the regulations to make this evident.
Basel II paragraph 718(Lxxvi)	Capital Adequacy for Market risk, page 49	Stricter rules: Quantitative standards: Basel states that: “Individual banks or their supervisory authorities will have discretion to apply stricter standards.” This had been omitted from domestic regulations. However SAMA agreed to take this into account within the regulations.
Basel II paragraph 718(Lxxvi) (h)	Capital Adequacy for Market risk, page 50	Options risk: Basel states that: “Banks are expected to ultimately move towards the application of a full 10-day price shock to options positions or positions that display option-like characteristics. In the interim, national authorities may require banks to adjust their capital measure for options risk through other methods, eg periodic simulations or stress testing.” The domestic regulation gives the authority to banks to adjust the capital measures for options risk. SAMA has agreed to note that banks would need to seek approval for this.
Basel II paragraph 718(Lxxvi) (e)	Capital Adequacy for Market risk, page 49	Updating of data sets: Basel states that: “Banks must update their data sets no less frequently than once every month and reassess them whenever market prices are subject to material changes. This updating process must be flexible enough to allow for more frequent updates. The supervisory authority may also require a bank to calculate its value-at-risk using a shorter observation period if, in the supervisor’s judgment; this is justified by a significant upsurge in price volatility.” The domestic regulations did not change the “three months” into “once every month” and secondly the word “must” did not replace the word “should”. SAMA agreed to amend the regulations.
Basel II paragraph 718(Lxxxi)	Capital Adequacy for	Stress testing and supervisory scenarios: Basel states the following: “Supervisory scenarios requiring no simulations by the bank.

	Market risk, page 57	718(Lxxxi). Banks should have information on the largest losses experienced during the reporting period available for supervisory review. This loss information could be compared to the level of capital that results from a bank's internal measurement system. For example, it could provide supervisory authorities with a picture of how many days of peak day losses would have been covered by a given value-at-risk estimate. " There is no indication within the domestic regulations that these scenarios are supervisory scenarios. SAMA agreed to amend this heading to avoid any confusion that may occur.
Basel II paragraph 718(Lxxv), footnote 12	Capital Adequacy for Market risk, page 48	Convenience yield: Basel states that: "The convenience yield reflects the benefits from direct ownership of the physical commodity (for example, the ability to profit from temporary market shortages), and is affected both by market conditions and by factors such as physical storage costs. " Under the domestic regulations the word "stages" is used instead of "shortages". This oversight will be amended by SAMA.
Basel II paragraph 718(Lxxvi) (i) Revisions to the Basel II market risk framework	Capital Adequacy for Market risk, page 50	Capital requirement for IMA: The Revisions to the Basel II market risk framework has amended item (i). Therefore the following has been deleted under (i) and moved to (k): "Each bank must meet, on a daily basis, a capital requirement expressed as the higher of (i) its previous day's value-at-risk number measured according to the parameters specified in this section and (ii) an average of the daily value-at-risk measures on each of the preceding sixty business days, multiplied by a multiplication factor." Despite SAMA taking into account the additional information provided by the Revisions under (i), the item has not been fully amended in respect to the deletion of the above paragraph, which SAMA has agreed to make evident.
Basel II paragraph 698	SAMA's Guidance Document Concerning Implementation page 74	Valuation Adjustments: "or reserves" has not been deleted in line with the revisions. SAMA agreed to change this within their regulations.
Operational risk		
Basel II paragraph 644	Section 10, paragraph 10.1.1A. Basel II SAMA's Detailed Guidance Document relating to Pillar 1 – June 2006.	The Basel II definition of operational risk will be set out in SAMA's standards.
Basel II paragraphs 647–648	Section 10, paragraph 10.3.1. Basel II SAMA's Detailed Guidance Document relating to Pillar 1 – June 2006.	Reference to the Basel II requirements for calculation of capital under the Alternative Standardised Approach has been included within SAMA's requirements for banks adopting one of the standardised approaches.
Basel II paragraphs 652–654	Section 10, paragraph 10.3.1. Basel II SAMA's Detailed Guidance Document relating to Pillar 1 – June 2006.	SAMA will make it clearer that the requirements of Basel II paragraphs 647 and 648 apply by directly incorporating these into the Detailed Guidance Document.
Basel II paragraphs 655–659	Section 10, paragraph 10.3.2. Basel II SAMA's Detailed Guidance	The measurement methodology for AMA will be included within the section of SAMA's requirements that applies to AMA banks.



	Document relating to Pillar 1 – June 2006.	
Basel II paragraphs 680, 682 and 683.	Section 10, paragraphs 10.4.1 to 10.4.4. Basel II SAMA's Detailed Guidance Document relating to Pillar 1 – June 2006.	SAMA will fully incorporate the Basel II requirements for partial use of AMA by: (1) specifying that a bank will be permitted to use AMA for some parts of its operations and the Basic Indicator or the Standardised Approach (rather than potentially a combination of these two approaches) for the balance; (2) specifying that a bank's timetable to move to full use of AMA should be driven by the practicality and feasibility of moving to AMA, and not by other reasons; and (3) fully incorporating the Basel II requirements relating to implementation of AMA on a permanent partial basis.  SAMA will also remove provisions for banks to elect partial use of the Standardised Approach while also using the Basic Indicator Approach.
Pillar 2: Supervisory review process		
Basel II paragraph 721	SAMA Basel II Guidance Document Pillar 2 Supervisory Review Process, February 2007: paragraph 3.4	SAMA has revised its guidelines to provide greater certainty that the bank is responsible for ensuring its capital adequacy.
Basel II paragraph 777(x), revised under Basel III paragraph 106	SAMA Finalised Guidance Concerning the Implementation of Basel III, December 2012: Section B 6.4.3 and Section C Basel III Pillar 2 Requirements	SAMA has revised its guidelines to clarify that revisions to the Pillar 2 expectations for counterparty credit risk which were introduced under Basel III are applicable to all banks and not only to those adopting the IMM.  SAMA has removed guidance text which indicated that banks are not allowed to adopt the IMM, which is inconsistent with its actual policy.
Pillar 3: Market discipline		
Basel II paragraph 809 revised under Basel II.5	Basel III Pillar 3 – Package of Disclosure Requirements and Guidance Notes, December 2012: Section 1 Introduction	SAMA has revised its guidelines to incorporate the revisions to paragraph 809 introduced under Basel II.5. These revisions expect banks to prepare their Pillar 3 disclosures such that they allow users to appropriately assess their risk profile and hence, they should not simply rely on templates provided by the Basel Committee or their national authorities.
Basel II paragraph 812	Basel III Pillar 3 – Package of Disclosure Requirements and Guidance Notes, December 2012: Section 6 Materiality	SAMA incorporated into its latest guidelines the expectation that if a disclosure requirement is a precondition for applying a lower risk weight or adopting a specific methodology under a particular area of the capital framework, a direct sanction must be applied if the disclosure is not made.
Basel II Table 6 – Credit risk: disclosures for portfolios subject to IRB approaches	Basel III Pillar 3 – Package of Disclosure Requirements and Guidance Notes,	SAMA has incorporated the expectations of the following Basel footnotes (FN) which covers qualitative disclosures required for banks adopting the IRB approach: <ul style="list-style-type: none"> <li>FN 205, which states that banks need to describe the internal rating process for their equity exposures only when they use</li> </ul>

	December 2012: Guidance Notes – Tables 6d and 6f, Worksheet “Table 6 – Credit risk – Disclosures for Portfolios subject to IRB Approaches” and Worksheet “Z – Qualitative Disclosures (Sheet 8)”.	<p>the PD/LGD approach.</p> <ul style="list-style-type: none"> <li>• FN207, which explains what banks should provide when describing their models.</li> <li>• FN208, which explains what banks should focus on when describing any deviations in the definition of default used internally from the reference definition provided by the Basel standard.</li> </ul> <p>SAMA has revised its guidelines to require advanced IRB banks to disclose the amount of undrawn commitments and the exposure-weighted average EAD for each portfolio.</p> <p>SAMA has incorporated into its guidelines the expectations of the following Basel footnotes, which provide additional guidance on the quantitative disclosures for IRB banks.</p> <ul style="list-style-type: none"> <li>• FN 209, which specifies that: (i) disclosures on PD, EAD and LGD should reflect the effects of credit risk mitigation (CRM); and (ii) the exposure-weighted PD for each PD grade should also be disclosed</li> <li>• FN 209 (and FN 212), which also specifies that where a bank aggregates PD grades (or PD/LGD and EL grades) for disclosure purposes, this breakdown of grades should be representative of the distribution of those grades in the IRB approach.</li> </ul> <p>SAMA has revised its guidelines to require banks adopting the advanced IRB approach to disclose a comparison of actual and estimated EAD and LGD. As part of this revision, it also incorporated the expectations of Basel footnote 215, which provides additional guidance for these disclosures.</p>
Basel II Table 7 revised by Basel II.5 – credit risk mitigation	Basel III Pillar 3 – Package of Disclosure Requirements and Guidance Notes, December 2012: Guidance Notes – Table 7 and Worksheet “Table 7 (STA), (FIRB) and (AIRB) – Credit risk mitigation”.	<p>SAMA has incorporated the expectations of the following Basel footnotes, which provide guidance on the quantitative disclosures on CRM:</p> <ul style="list-style-type: none"> <li>• FN 216, which specifies the need for disclosures to at a minimum include all exposures where CRM has been recognised for reducing capital requirements.</li> <li>• FN 217, which states the need for credit derivatives and other credit risk mitigants treated under the securitisation framework to be captured under Table 9 rather than Table 7.</li> <li>• FN 218, which states that in instances where the comprehensive approach for CRM is used, haircuts should be applied to not only the collateral amount but also to the exposure amount, where relevant (eg for repo transactions or SFTs) when preparing Pillar 3 disclosures.</li> </ul> <p>SAMA has clarified that banks adopting the IRB approaches should report exposures covered by CRM after, where applicable, the recognition of on- or off-balance sheet netting similar to banks adopting the standardised approach for credit risk.</p>
Basel II Table 8 – counterparty credit risk	Basel III Pillar 3 – Package of Disclosure Requirements and Guidance Notes, December 2012: Guidance Notes – Table 8 Page 28 and Worksheet “Table 8 – General Disclosures for Exposures Related to CCR”	<p>SAMA has incorporated the reporting item “net derivatives credit exposure” and the corresponding Basel footnote 219 into its Pillar 3 templates on counterparty credit risk.</p> <p>SAMA has revised its templates to clarify that bilateral netting is allowed for OTC derivatives.</p>
Basel II Table 9 revised under Basel II.5 –securitisation	Basel III Pillar 3 – Package of Disclosure Requirements and	<p>SAMA has incorporated an explicit requirement for banks to also refer to the Pillar 3 expectations introduced under Basel II.5 when preparing their disclosures on securitisation.</p> <p>SAMA has clarified in relevant templates that banks are required to report their securitisation exposures regardless of whether</p>

	Guidance Notes, December 2012: Guidance Notes – Table 9, Worksheet “Table 9 (IRB) and (STA) – Securitisation” and Worksheet Z – Qualitative Disclosures (Sheet 11).	there is a Pillar 1 capital charge or not (ie Basel footnote 230). SAMA has clarified in its templates (ie Tables 9i and 9p) that banks are required to report the amount of exposure they intend to securitise and not the outstanding amount of securitised exposures.
Basel II Table 11 – market risk	Basel III Pillar 3 – Package of Disclosure Requirements and Guidance Notes, December 2012: Guidance Notes – Table 11	SAMA has removed footnotes which indicated that banks in Saudi Arabia were only allowed to adopt the standardised method for market risk. These footnotes were inconsistent with its actual policy.
Composition of capital disclosure requirements paragraph 5	Basel III Pillar 3 – Package of Disclosure Requirements and Guidance Notes, December 2012: Guidance Notes – Other disclosure requirements	SAMA has incorporated in its latest guidelines an explicit requirement for banks to update disclosures on the full terms and conditions of capital instruments whenever a new capital instrument is issued and included in capital and whenever there is redemption, conversion/write-down or other material change in the nature of an existing capital instrument.

## Annex 7: Assessment of binding nature of regulatory documents

The following table summarises the assessment of the seven criteria used by the Assessment Team to determine the eligibility of SAMA regulatory documents.

Table A.5

Criterion	Assessment
(1) The instruments used are part of a well defined, clear and transparent hierarchy of legal and regulatory framework.	The BCL gives power to SAMA to introduce any relevant regulations as it deems fit to maintain the stability of the financial system. BCBS guidelines regarding capital requirements under Basel II, II.5, III have been issued in connection herewith which covers all the pillars of Basel framework.  The legal hierarchy includes the BCL, Ministerial Decree and Guidance Document.
(2) They are public and easily accessible.	SAMA issues draft guidelines and actively consults all concerned stakeholders before implementing final rules. Also it has published all relevant guidelines on the internet so that the general public and other stakeholders have access to them. See SAMA website: <a href="http://www.sama.gov.sa/en-US/Laws/Pages/Banking.aspx">www.sama.gov.sa/en-US/Laws/Pages/Banking.aspx</a>
(3) They are properly communicated and viewed as binding by banks as well as by the supervisors.	After the conclusion of consultation process as outlined in point (2) above, SAMA issues final regulations and where needed issues a "Frequently Asked Questions" document.  All regulatory documentation issued by SAMA is binding on the entities. SAMA monitors the implementation and enforces these regulations through the supervisory review process which comprises three blocks as explained below:  <b><u>Off-site supervision</u></b>  SAMA collects information through standardised regulatory prudential returns that range from a weekly to an annual basis. SAMA also arranges an annual meeting with banks on risk management processes wherein all elements of capital and risk management are discussed.  <b><u>On-site inspections</u></b>  SAMA carries out a full scope examination or thematic review under which it has the option to review all capital and risk-related requirements.  <b><u>Frequent interaction</u></b>  SAMA frequently interacts with the industry on various capital and liquidity-related matters and this is not just limited to annual ICAAP or SREP meetings.
(4) They would generally be expected to be legally upheld if challenged and are supported by precedent.	Under the BCL, banks that are deemed non-compliant will be subject to corrective measures and fines. Furthermore, SAMA has broad powers to take supervisory action as well as remedial and enforcement action to enforce compliance with these regulations. SAMA's powers of enforcement have never been challenged in court.
(5) Consequences of failure to comply are properly understood and carry the same practical effect as for the primary law or regulation.	Under the BCL, violations of any regulation including capital requirements will be subject to corrective measures and fines. SAMA has powers at its discretion to require or to take any remedial action depending on the nature of the issue faced by a bank. The aforementioned is properly understood by the banks.

<p>(6) The regulatory provisions are expressed in clear language that complies with the Basel provisions in both substance and spirit.</p>	<p>The capital requirement provisions have been drafted in a clear and concise language using the Basel standard as guidance in order to avoid any misinterpretation and to aid easy enforcement. Additionally, SAMA has issued guidelines to provide greater clarity and achieve harmonisation.</p> <p>As stated earlier, SAMA also issues a "Frequently Asked Questions" document to resolve any queries and aid in smooth implementation.</p>
<p>(7) The substance of the instrument is expected to remain in force for the foreseeable future</p>	<p>SAMA's capital regulations are legally issued and consist of binding laws, regulations and guidelines which are expected to remain in force for the foreseeable future.</p>

## Annex 8: Key financial indicators of the KSA's banking system

Overview of the KSA banking sector as of 31 December 2014		Table A.6
Size of banking sector (SAR millions)		
Total assets all banks operating in the jurisdiction (including off-balance sheet assets) <sup>8</sup>		4,178,393
Total assets of all locally incorporated internationally active banks <sup>9</sup>		2,178, 278
Total assets of locally incorporated banks to which capital standards under Basel framework <sup>10</sup> are applied (ie excludes foreign bank branches)		2,098,524
Number of banks		
Number of banks operating in the KSA		24
Number of internationally active banks		24
Number of banks required to implement Basel standards (according to domestic rules)		12
Number of branches of G-SIBs		3
Number of D-SIBs		6
Capital standards under the Basel framework		
Use of advanced approaches by banks		Nil
Capital adequacy (internationally active banks) (SAR millions; percent)		
Total capital		317,489
Total Tier 1 capital		287,028
Total CET1 capital		287,028
Total risk-weighted assets		1,775,980
RWAs for credit risk (percent of total RWAs)		90.1
RWAs for market risk (percent of total RWAs)		2.7
RWAs for operational risk (percent of total RWAs)		7.2
Total off-balance sheet bank assets <sup>11</sup>		2,000,115
Capital Adequacy Ratio (weighted average)		17.88
Tier 1 Ratio (weighted average)		16.16
CET1 Ratio (weighted average)		16.16

Source: SAMA internal reports.

<sup>8</sup> Includes on-balance sheet assets of locally incorporated banks and Saudi branches of foreign banks and off-balance sheet assets at notional values.

<sup>9</sup> Includes on-balance sheet assets of locally incorporated bank and Saudi branches of foreign banks.

<sup>10</sup> Includes on-balance sheet assets of only locally incorporated banks only.

<sup>11</sup> Includes all off-balance sheet exposures and derivatives at notional value.

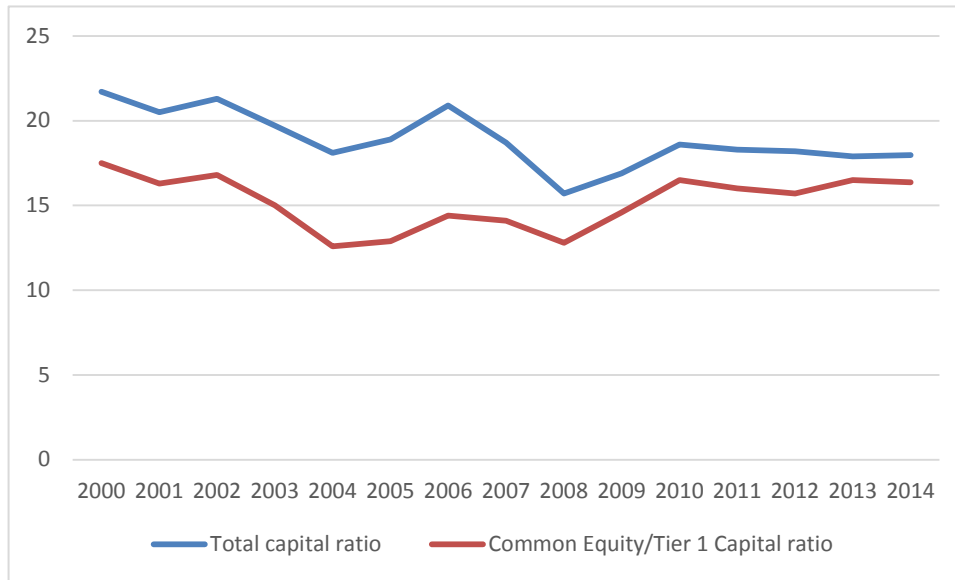
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## Evolution of capital ratios of the KSA internationally active banks

Weighted average, in percent

Figure A.7

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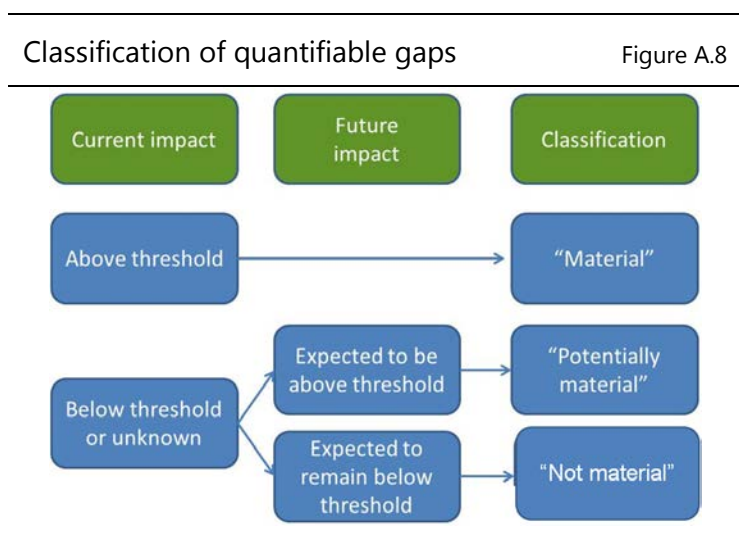


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Source: SAMA internal reports.

## Annex 9: Materiality assessment

The assessment of materiality distinguished between quantifiable and non-quantifiable gaps. For the KSA RCAP, an attempt was made to quantify the impact of all quantifiable gaps for each bank in the sample affected by the gap. Several gaps/differences were assessed based on bank data and data available to SAMA. In those cases where the computation of the impact was not straightforward, the computation erred on the conservative side. Where no data were available to quantify gaps, the review team relied on expert judgment. Following this approach, an attempt was made to determine whether gaps are “not material”, “material” or “potentially material”.



Number of gaps/differences by component Table A.9

Component	Non-material	Material	Potentially material
Scope of application	0	0	0
Transitional arrangements	0	0	0
Definition of capital	0	0	0
Capital buffers	0	0	0
Pillar 1			
Minimum capital requirements (general)	0	0	0
CR: Standardised Approach	0	0	1
CR: IRB	0	0	0
CR: Securitisation	0	0	0
Counterparty credit risk	0	0	0
MR: Standardised Approach	0	0	0
MR: Internal Models	0	0	0
OR: SA/BIA	0	0	0
OR: AMA	0	0	0
Pillar 2	0	0	0
Pillar 3	0	0	0

Note: materiality is defined based on quantitative benchmark thresholds (for the quantifiable gaps) and expert judgment (for the non-quantifiable gaps). See Section 2 with the detailed assessment findings for further information.



## Annex 10: Areas where SAMA rules are stricter than the Basel standards

In several places, SAMA has adopted a stricter approach than the minimum standards prescribed by Basel or has simplified or generalised an approach in a way that does not necessarily result in stricter requirements under all circumstances but never results in less rigorous requirements than the Basel standards. The following list provides an overview of these areas. It should be noted that these areas have not been taken into account as mitigants for the overall assessment of compliance.

### Scope of application

1. Basel II paragraphs 20: While Basel II specifies that the framework will be applied to internationally active banks, SAMA's rules are applied to all licensed banks in the KSA.
2. Basel II paragraphs 35: While Basel II adopts a materiality level of 15% of the bank's capital for individual significant investments in commercial entities, SAMA uses a stricter materiality level of 10% of the bank's capital for individual significant investments in commercial entities.

### Credit risk: standardised approach

1. Basel II paragraph 55: Basel II paragraph 55 allows the usage of Export Credit Agency (ECA) ratings but SAMA does not use the ECA ratings at all.
2. Basel II paragraph 56: Basel II paragraph 56 allows international organisations (BIS, IMF, and ECB) to be risk-weighted at 0% but SAMA considers these organisations as sovereigns and does not directly use a 0% risk weight.
3. Basel II paragraphs 72: Basel II paragraph 72 allows a risk weight of 35% for claims collateralised by residential mortgages but SAMA applies a 100% risk weight.
4. Basel II paragraphs 145: SAMA does not allow recognition of equities and mutual funds under the standardised approach for the purpose of credit risk mitigation, which is allowed by Basel paragraph 145 under certain conditions. Also SAMA has additional requirements for other eligible financial collaterals.

## Credit risk: internal ratings-based approach

1. Basel II paragraph 287: Basel II states that under the foundation approach, senior claims on corporates, sovereigns and banks not secured by recognised collateral will be assigned a 45% LGD. SAMA's standard requires an LGD of 60%.
2. Basel II paragraph 373(i): For purchased receivables, subject to certain conditions, Basel II allows the double default framework to be used for dilution risk. SAMA's standards state that the double default framework is only available when a contract covers only dilution risk, implying that if a contract covers default and dilution risk, the double default framework cannot be applied to dilution risk.
3. Basel II paragraph 459: Basel II paragraph 459 states the non-authorized overdrafts should be associated with a zero limit for IRB purposes, meaning that days past due commence once any credit is granted. SAMA's standards incorporate this requirement but also classify temporary overdrafts in the same way.

## Operational risk

1. Basel II paragraph 651: Basel II paragraph 651 states that banks using the BIA are encouraged to comply with the Basel Committee's guidance on Sound Practices for the Management and Supervision of Operational Risk, February 2003. SAMA imposes (rather than encourages) compliance with this guidance.
2. Basel II paragraph 660–663: Basel II paragraph 663 sets out criteria for internationally active banks using the Standardised Approach. The footnote to paragraph 663 recommends but does not require supervisors to impose these criteria on non-internationally active banks as well. SAMA imposes the requirements of Basel II paragraph 663 on all banks, not just internationally active banks.

## Annex 11: List of approaches not allowed by SAMA regulatory framework

The following list provides an overview of approaches that SAMA have not made available to its banks through its regulatory framework. Where the Basel standards explicitly request certain approaches to be implemented under specific circumstances, the missing approaches have been taken into account in the assessment. However, where the Basel standards do not require jurisdictions to implement these approaches, they have been implicitly treated as “not applicable” for the assessment.

### Credit risk: Internal Ratings-Based approach

1. Basel II paragraphs 241–243, and paragraph 365 allow banks to use the top-down approach for purchased corporate receivables subject to certain minimum requirements. SAMA does not allow the use of the top-down approach which means that the corporate risk quantification standards apply (and could mean a more conservative outcome).

## Annex 12: Areas for further guidance from the Basel Committee

### Recognition of bilateral netting

Paragraph 96(ii) of Annex 4 of the Basel II framework allows banks to recognise bilateral netting benefits for regulatory capital purposes only where it has satisfied its supervisor that netting contracts are enforceable under relevant laws and jurisdictions. The paragraph also requires that the national supervisor, after consultation when necessary with other relevant supervisors, must be satisfied that the netting is enforceable under the laws of each of the relevant jurisdictions. Further, footnote 250 explains that thus, if any of these supervisors are dissatisfied about enforceability under its laws, the netting contract or agreement will not meet this condition and neither counterparty could obtain supervisory benefit.

In the case of the KSA, SAMA has recently allowed banks to recognise bilateral netting for purposes of bank capital adequacy requirements under the local regime. Based on its interactions with SAMA and the industry, the Assessment Team is of the view that there is some ambiguity as to whether netting agreements for derivatives transactions are legally enforceable locally. This could have implications for the ability of banks to recognise netting benefits. Currently, there are no netting laws in the jurisdiction and the Assessment Team is unaware of any legal opinions on the status of bilateral netting in Saudi Arabia. Nonetheless, it is acknowledged that SAMA is undertaking efforts to enhance the certainty of bilateral netting contracts as part of broader measures to strengthen the local resolution framework.

This issue is indirectly related to an item raised during the RCAP assessment of Hong Kong SAR (March 2015), which sought further guidance from the Committee on the operationalisation of paragraph 96(ii). The Assessment Team believes that it is important to ensure that adequate laws and rules for the recognition of closeout netting are in place and that the laws/rules are enforceable for banks to obtain regulatory capital benefit. Such guidance would be beneficial for the operationalisation of this requirement for banks in the KSA as well where a significant portion of the derivatives transactions and netting agreements signed by Saudi banks are with international banks.

### Euro-based thresholds

The Basel II framework requires banks to classify banking book exposures into asset classes based on certain risk characteristics and definitions. In places these definitions include thresholds that are expressed in euros. For example:

- Within the Standardised Approach, to be classified as retail, exposures must meet four criteria including that the maximum aggregate retail exposure to one counterparty cannot exceed an absolute threshold of €1 million (paragraph 70).  
Within the Internal Ratings-Based Approach, for a sub-portfolio to be treated as a qualifying revolving retail exposure, six criteria must be met, including that the maximum exposure to a single individual in the sub-portfolio is €100,000 or less (paragraph 234).
- Under the Internal Ratings-Based Approach for corporate credits, banks are permitted to separately distinguish exposures to SME borrowers (defined as corporate exposures where the reported sales for the consolidated group of which the firm is a part is less than €50 million) (paragraph 273).

National supervisors could incorporate such thresholds into domestic regulation by specifying local requirements using euro amounts. This would ensure alignment with the Basel II Framework over time notwithstanding any movements in the exchange rate between the local currency and the euro. This approach means banks would need to monitor the exchange rate in order to capture any movement of exposures from one asset class to another.

Alternatively, national supervisors could convert the euro threshold into a local currency equivalent. Under this approach, although the conversion may be accurate at the time local regulations are put in place, if the exchange rate shifts over time, thresholds included in local regulation could depart (potentially materially) from the euro thresholds set out in the Basel Framework.

In the case of the KSA, following the rectifications described in Annex 6, for those thresholds contained in paragraphs 70, 234 and 273, SAMA now explicitly refers to euro amounts.

The Assessment Team considers the Basel Committee should provide guidance to national supervisors on the best way to incorporate euro thresholds into domestic regulation and on how to ensure such thresholds can be aligned to the Basel Framework when there are movements in the exchange rate over time.

## Sharia-specific requirements

SAMA regulates Sharia-compliant banks in the same way as other conventional banks in the KSA. Thus, it does not currently lead to any deviation from Basel standards. Nevertheless, if there was a greater variety of Sharia-compliant activities and/or if the International Financial Reporting Standards were differently applied to Sharia-compliant activities in the KSA, this could change. More generally, it would seem sensible for the Basel Committee to consider whether the application of its standards in practice fully captures the risk emanating from the variety of Sharia-compliant banks and activities.

## Annex 13: The KSA's implementation of the Pillar 2 supervisory review process<sup>12</sup>

- A. Implementation in the KSA of the Pillar 2 Supervisory Review Process (SRP) was achieved through the issuance of the following SAMA guidance documents.
- Basel II Guidance document Pillar 2 Supervisory Review Process issued in February 2007
  - SAMA's Guideline document on the Internal Capital Adequacy Assessment Plans issued in September 2008.
  - BCBS document titled "Enhancements to Basel II Framework" of January 2009 and issued by SAMA through its circular # BCS769 of 29 July 2009.
  - SAMA's Finalised Guidance Document for the implementation of Basel II.5 Standardised and IRB Approaches (Document) issued by SAMA through its circular # BCS 25478 of 21 October 2012.
  - Enhancements to the ICAAP document at end of 2011 issued in November 2011.
- B. The SRP is an important component of the Basel II Framework and is considered a significant supervisory tool to ensure the safety and soundness of the banking system through the following:
- Enhanced supervisory monitoring of the capital adequacy of the bank.
  - Encouragement for banks to strengthen their processes for monitoring and controlling risks; and
  - Provision of a framework for banks to adopt a more pro-active capital planning and management practice.

SAMA applies the SRP to individual banks to determine their capital adequacy and to assess if they should hold additional capital to provide for risks that are not adequately covered or not covered under the Pillar 1 minimum capital requirements. In fact, SAMA uses the SRP for a more detailed and in-depth risk assessment of a bank. This risk assessment also leads to setting of the minimum Capital Adequacy Ratio (CAR) for banks which is also referred to as a Target CAR (P1+P2) Ratio in the KSA. This takes into account Pillar 1 and Pillar 2 risks ie the overall risk profile and risk mitigants.

SAMA's SRP Implementation is predicated on the following four principles enunciated by the BCBS with regard to Pillar 2.

- Saudi banks should have a formal internal process for determining their overall capital adequacy in relation to their risk profile and a strategy for maintaining the required level of capital.
- SAMA has the responsibility for evaluating banks' internal capital adequacy assessments and establishing whether the resultant capital position is adequate.

<sup>12</sup> The information contained in this Annex has been provided by SAMA.

- SAMA expects banks to operate above the statutory minimum and has the power to require banks to do so.
- SAMA seeks to intervene at an early stage to prevent banks' capital from falling below prudent levels.

An important aspect of the SRP is that SAMA requires each bank to annually submit their formal ICAAP documentation. An analysis of the document leads to an intensive interaction of SAMA with individual banks through a formal bilateral meeting. At the meeting a discussion is carried out to ensure that this ICAAP document is built on the four principles of the SRP as described below.

## Principle 1

Saudi banks should have a formal internal process for determining their overall capital adequacy in relation to their risk profile and a strategy for maintaining the required level of capital

SAMA's ICAAP document requires banks to make an assessment of all their risks through a risk identification and quantification process during the capital planning period. Accordingly, the ICAAP document acts as a tool which ensures that a bank must possess risk capital which is commensurate with its unique risk profile and risk appetite, risk mitigation structure, etc. Essentially an ICAAP in the KSA requires a formal process through which a bank estimates its capital requirements in relation to its risk profile, stress testing strategies, business plans and risk mitigants.

## Principle 2

SAMA has the responsibility of evaluating a bank's internal capital adequacy assessment and for establishing whether the resultant capital position is adequate

SAMA annually discusses a bank's ICAAP through bilateral meetings. It evaluates if the methodology used is in compliance with SAMA requirements to ensure the resultant capital position is adequate. This includes an assessment against SAMA's requirements with regard to risk identification, risk measurement and risk aggregation for the purpose of determining Basel Capital.

## Principle 3

SAMA expects banks to operate above the statutory minimum and has the powers to require banks to do so

SAMA's minimum regulatory capital requirements are in line with the BCBS requirements. This includes compliance with minimum requirements such as CET1 Ratio, Tier 1 Capital Ratio and Total Capital Ratios inclusive of capital buffers. In addition to the aforementioned regulatory requirement, SAMA expects all bank to have a minimum CAR (P1) of 8%. Any bank below this ratio, even for a day can face regulatory penalties.

Another important ratio, banks must monitor is the Annual Target CAR (P1+P2) which is determined on the basis of a bank's risk profile, strategies, business plans, etc. The basis of determining the bank's Target CAR Ratio is the annual ICAAP discussion which takes into consideration a bank's risk profile. The banks' Target CAR Ratios currently range from 13.0% to 16.5%.

## Principle 4

SAMA seeks to intervene at an early stage to prevent a bank's capital from falling below prudent limits

SAMA has powers to take supervisory action if a bank's capital ratio deteriorates and falls below the Target CAR Ratio or the regulatory minimum CAR. Supervisory actions include requiring a bank to bring its ratio into line by reducing risk-weighted assets, increasing its capital, restricting dividend payments, and considering other measures such as mergers, outside investors etc.