Circular No.: BCS 355
Date: 29 December, 2004

From : Saudi Arabian Monetary Agency, Head Office, Riyadh

To : All Saudi Banks

Attn. : General Managers and Managing Directors

Subject: **Capital Adequacy Requirements for Market Risk**

In line with SAMA's policy to implement relevant and appropriate international banking supervisory standards, the Agency has decided to commence the implementation of the Basel II Capital Adequacy standard issued in June 2004, by the Basle Committee on Banking Supervision. While Basel II envisages major changes to the calculation of risk weightings and capital in the credit risk and operational risk areas, for market risk the 1996 Proposals will continue to apply. Consequently, SAMA requires all Saudi banks, to implement the 1996 Market Risk proposals from the first quarter of 2005. These rules do not apply to the licensed branches of foreign banks in the Kingdom as SAMA will be coordinating their capital adequacy with their home supervisors.

According to these proposals market risk emanates from trading portfolios, open positions in foreign currencies, derivatives and commodities. Consequently, banks are expected, where applicable, to include a market risk capital charge related to their relevant activities in measuring their capital adequacy.

Initially, banks should use the Standardized Methodology for calculating their total market risk. Subsequently, banks that can meet qualitative and quantitative pre-conditions for internal models may apply to SAMA for approval of their use. These applications should provide in detail information on the pre-conditions for the use of internal models. SAMA will study such applications and validate the models before granting an approval for their use in determining capital adequacy. Following the successful implementation of internal models for the general market risk, in due course, SAMA may permit the use of models for specific risk.

Earlier in May, 2003 the Agency had circulated to all banks a draft of these proposals including guidance notes and prudential returns for calculation of market risk and capital requirements. The banks' comments and the impact of the market risk proposals on the their capital adequacy ratio was reviewed by the Agency. These were considered in the finalization of this Circular, Guidance Notes and Prudential returns. In this regard, the Agency is E-Mailing following documents which banks should utilize in implementing this Circular.

1. Detailed guidance notes for maintaining adequate capital against market risk – Attachment-1.
2. Summarized guidelines and instructions to complete prudential returns on market risk – Attachment-2.
3. A set of prudential returns related to market risk–Attachment-3.

SAMA requires all banks to confirm within 10 days by E-mail or Fax that they have received attachments 1 to 3 referred to above.

Initially all prudential reporting to SAMA would be in a hard copy form. The Agency will integrate the Q14-A returns with other prudential returns at the time of the next update and enhancement of the ERMS. The specific requirements are as follows:

- All domestic banks must submit their market risk returns on an annual basis i.e. as at Dec. 31 to be due within 20 days after the year end to SAMA. However, the initial annual return as at 31.12.2004 is due on 31.4.2005 to give banks more time for its implementation.
- Quarterly reporting will apply only to a bank where at the end of a calendar year it is determined that its trading portfolio is in excess of 5% of its total assets, or the overall impact on its risk asset ratio by including market risk is in excess of 1%.

Banks should also take note of a major change to the calculation of capital adequacy under credit risk, which should be done in conjunction with the implementation of the Market Risk proposal. From 1st January 2005, banks should use the Replacement Cost methodology instead of the Original Maturity method for determining the credit risk on their derivative positions, which are reported on Q-14. Some banks are already applying this methodology.

Best regards,

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Technical Affairs