



Circular No.: 351000123076

Date: 21 July, 2014

From : Saudi Arabian Monetary Agency

To : All Banks

Attention : Managing Directors, Chief Executive Officers and General Managers

Subject : **Enhancement of SAMA Circulars Concerning Basel II, II.5 and III Capital Adequacy framework**

Over the years SAMA has issued guidance to Saudi Banks arising from the Standards issued by the Basel Committee on Banking Supervision on the capital adequacy framework including those related to Basel II, II.5 and III. In this process SAMA has sometimes prepared its own documents and guidance notes extracted from the original Basel documents and also provided specific guidance in areas where national discretion was to be exercised. On other occasions SAMA issued its relevant Basel document without any change. As SAMA documents were issued at different stages in the development of the Basel Framework and also took into account the peculiar requirements of the Saudi Banking sector at the point in time, they may have sometimes varied slightly from the underlying Basel requirements.

In this respect, SAMA has now carried out a comprehensive self-review of its regulations against the relevant BCBS documentation and identified some areas where there are gaps and omissions or further clarifications are required. The purpose of this circular is to identify the specific revisions and ensure that SAMA's documentation concerning Basel II, II.5 and III is fully in sync with the relevant BCBS requirements.

Many of the gaps identified relate to IRB Approaches for Credit risk, VAR models for Market risk, CRM for Advanced IRB approaches etc. These areas at the time of issuance of SAMA regulations and documentation were largely not relevant to Saudi Banks which were still implementing the Standardized approaches. However, going forward and given increasing sophistication of our banks to implement advanced IRB and market risk approaches, these will become relevant. Therefore, where appropriate, SAMA expects banks to implement these regulations effective 1st October 2014.

Over the years SAMA has issued the following circulars and related documents, and in this respect any gaps noted as a result of the aforementioned review are described in the attached Annexes. These identify both the description of the gaps and the documentation that is required to address these gaps. The Sections and Page numbers with regard to SAMA documents have been indicated and referenced.



<b>SAMA Regulatory Documents</b>	<b>Annexure</b>
No specific SAMA Document	General Annexure - 1
SAMA Detailed Guidance Document Relating to Pillar 1, June 2006	Annexure 2
Prudential Returns Basel II, March 2007	Annexure 3
SAMA's Basel II IRB Prudential Returns, Guidance Notes Package and Frequently Asked Questions (FAQs)	Annexure 4
Guidance On Application Procedures, For Adoption Of The IRB Approach By Banks Licensed In Saudi Arabia	Annexure 5
SAMA's Finalized Guidance Document for the Implementation of Basel II.5 , 2012	Annexure 6
Detailed Guidelines Notes on the Maintenance of Adequate Capital Against Market Risk by Saudi Banks, 2004	Annexure 7
Basel II Guidance Document Pillar 2 Supervisory Review Process, 2007	Annexure 8
SAMA's Guidelines Document on the Internal Capital Adequacy Assessment Plan, 2008	Annexure 9
Pillar 3 – Package of Disclosure Requirements and Guidance Notes, 2007	Annexure 10
Basel III Pillar 3 – Package of Disclosure Requirements and Guidance Notes	Annexure 11
Section A Finalized Guidance Document Concerning the Implementation of Basel III	Annexure 12

SAMA is issuing this Circular to ensure Banks can be ready to fully implement the relevant changes by the effective date. SAMA also plans to issue the revised documents incorporating these changes in the next quarter. Given the nature of these changes and the tight timeline SAMA does not intend to have a consultative process. However any Question raised by the banks will be addressed through an FAQ process.

For any clarifications, please contact Dr. Alwaleed Alsheikh (email: akalsheikh@sama.gov.sa), Mr. Tariq Javed (e-mail: t\_javed@sama.gov.sa) or Mr. Abbas Hassan (e-mail: ahassan@sama.org.sa)

Best regards,

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**Document Enhanced: General Section**

**Positioning of the Paragraph in SAMA's Regulatory Documentation**

As a result of certain queries by Saudi banks on the enforceability of the following SAMA circulars related to Basel II, II.5 and III, SAMA wishes to provide the following clarifications:

Banks are required to take note of the following:

(1) SAMA on June 6, 2006, had issued regulations titled "Detailed Guidance Document Consultative Draft No 2, 2006", covering matters pertaining to Basel II. Since that date, for the purpose of Basel II implementation, this document should be considered as final and binding. The title of the aforementioned document was subsequently amended to "SAMA Detailed Guidance Document Relating to Pillar 1, June 2006".

(2) SAMA on March 22, 2007, had issued regulations titled "SAMA - Basle II Prudential Returns Consultative Draft No 2", covering matter pertaining to Basel II, Prudential returns. The title of the aforementioned document was amended to "Prudential Returns Basel II, March 2007", this document should be considered as final and binding since the date of issuance.

(3) SAMA has issued circular No BCS 769 titled "Enhancements and Revisions to the Basel II Framework, Market Risk and Trading Book", dated July 29, 2009 requiring banks to establish necessary policies, systems and processes to enable them to meet the Basel requirements pertaining to:

- Enhancement to the Basel II Framework, July 2009
- Revisions to the Market Risk Framework (subsequently updated as of 31st December, 2010) and intimated by BCBS in February, 2011
- Guidelines for Computing Capital for Incremental Risk in the Trading Book

## Positioning of the Paragraph in SAMA's Regulatory Documentation

SAMA confirms that all the regulations identified above were to be implemented and were binding on banks from the date of the original issuance.

4) SAMA has issued circular No. BCS 28548, titled "Treatment of Trade Finance under Basel Capital Framework" dated 21 November, 2011 requiring banks to be fully aware of this document.

SAMA wishes to clarify that the guidelines mentioned in its circular, should be implemented and considered binding on banks from the date of the issue.

**Document Enhanced: SAMA detailed guidance document relating to Pillar 1, June 2006**

**Positioning of the Paragraph in SAMA's Regulatory Documentation**

**Section 2.1 "Owned or Controlled Financial Entities", Page 8 of the SAMA detailed guidance document relating to Pillar 1, June 2006**

**Original Paragraph to be deleted:**

SAMA Requires that owned or controlled entities and securities entities should be fully consolidated for Basel II purposes

**The revised paragraph would be as follows:**

SAMA Requires that owned or controlled entities and securities entities should be fully consolidated for Basel II purposes to ensure that it captures the risk of the banking group

Banking groups are groups that engage predominantly in banking activities and, in some countries, a banking group may be registered as a bank.

Banks are also required to ensure minimum capital adequacy on a consolidated as well as standalone basis by ensuring that the Parent banks also meet the SAMA mandated capital adequacy regulation under Pillar 1 of the Basel guidelines. Going forward all banks would be required to make two sets of prudential returns for Pillar 1 Capital Computations, the first one on a consolidated basis and the other on a standalone basis.

(Refer to Paragraph 21 of International Convergence of Capital Measurement and Capital Standards – June 2006)

## Positioning of the Paragraph in SAMA's Regulatory Documentation

**“Scope of Application and other issues”, Page 12 of the SAMA detailed guidance document relating to Pillar 1, June 2006:**

### **Original Paragraph to be deleted**

Reference to paragraph 24 & 27 (SAMA Document) - Choice of rule between consolidation and deduction. All relevant financial activities will be consolidated, but, if not consolidated, deducted.

### **The revised paragraph would be as follows:**

Reference to paragraph 24, 26 & 27 (SAMA Document) - Choice of rule between consolidation and deduction. All relevant financial activities will be consolidated, but, if not consolidated, deducted.

However, where subsidiary holdings are acquired through debt previously contracted and held on a temporary basis, are subject to different regulation, SAMA would require that the same are deducted from the Tier 1 capital base and Tier 2 Capital capital base in equal proportion i.e. 50% and 50%

SAMA will ensure that the entity that is not consolidated and for which the capital Investment is deducted meets minimum regulatory capital requirements of the concerned regulatory authority.

SAMA will monitor actions taken by the subsidiary to correct any capital shortfall and, if it is not corrected in a timely manner, the shortfall will also be deducted from the parent bank's capital

(Refer to Paragraph 26 and 27 of International Convergence of Capital Measurement and Capital Standards – June 2006)

## Positioning of the Paragraph in SAMA's Regulatory Documentation

### **Section 2.2.1 Subsidiaries and Significant Minority Interests in Insurance Entities, Page 8 of the SAMA detailed guidance document relating to Pillar 1, June 2006:**

#### **Original Paragraph to be deleted**

[30 to 34] SAMA requires that all subsidiaries and significant minority interest in insurance entities at 10% or more are to be excluded from banks capital at 50% from Tier-I, and 50% from Tier-II capital.

#### **The revised paragraph would be as follows:**

[30 to 34] ((SAMA Document) SAMA requires that all subsidiaries and significant minority interest in insurance entities at 10% or more are to be excluded from banks capital at 50% from Tier-I, and 50% from Tier-II capital.

In addition, SAMA would not permit the recognition of surplus capital of an insurance subsidiary for the capital adequacy of the group –

(Refer to Paragraph 33 of International Convergence of Capital Measurement and Capital Standards – June 2006)

### **2.2.1-A Subsidiaries and Significant Minority Interests in Insurance Entities, Page 8 of the SAMA detailed guidance document relating to Pillar 1, June 2006:**

The new paragraph (would be inserted in addition to the other amendment identified above for Section 2.2.1) which would read as follows:

SAMA will ensure that majority-owned or controlled insurance subsidiaries, which are not consolidated and for which capital investments are deducted, are themselves adequately capitalized to reduce the Possibility of future potential losses to the bank. SAMA, through the parent banks will monitor actions taken by the subsidiary to correct any capital

## Positioning of the Paragraph in SAMA's Regulatory Documentation

shortfall and, if it is not corrected in a timely manner, the shortfall will also be deducted from the parent bank's capital. (Refer to Paragraph 34 of International Convergence of Capital Measurement and Capital Standards – June 2006)

### **Section 2.3. "Significant investment in commercial entities", Page 8 of the SAMA detailed guidance document relating to Pillar 1, June 2006:**

#### **Original Paragraph to be deleted:**

[35] (SAMA Document) "The new Basel framework provides that significant minority and majority investments in commercial entities, which exceed certain materiality levels, are to be deducted from Banks capital". SAMA requires that the threshold and majority investments in commercial entities is 10% of shareholders' equity and that the deduction would be 50 percent from Tier 1 capital and 50 percent from Tier 2 capital. Investments held below the 10% threshold will be risk weighted at 100% under the Standardized Approach, and as per section 7.2.1 for the IRB Approaches.

#### **The revised paragraph would be as follows:**

[35] "The new Basel framework provides that significant minority and majority investments in commercial entities, which exceed certain materiality levels, are to be deducted from Banks capital". Materiality levels of 10% of the bank's capital for individual significant investments in commercial entities and 60% of the bank's capital for the aggregate of such investments,. The amount exceeding this threshold would be risk weighted at 1250%.

Investments held below the 10% threshold will be risk weighted at 100% under the Standardized Approach, and as per section 7.2.1 for the IRB Approaches.

(Refer Paragraph 35 of International Convergence of Capital Measurement and Capital Standards – June 2006 & Para



## Positioning of the Paragraph in SAMA's Regulatory Documentation

90 of Basel III: A global regulatory framework for more resilient banks and banking systems)

**The following guidelines will be read as part of Section 4.1.11 [82 to 89] Off balance sheet items: Page 20 of the SAMA detailed guidance document relating to Pillar 1, June 2006:**

(This is in addition to existing text)

The credit equivalent amount of OTC derivatives and SFTs that expose a bank to counterparty credit risk is to be calculated under the rules set forth in Annex 4 of International Convergence of Capital Measurement and Capital Standards , 2006.

(Refer to Paragraph 87 of International Convergence of Capital Measurement and Capital Standards – June 2006)

**The following guidelines will be read as part of Section 4.1.11 [82 to 89] Off balance sheet items: Page 20 of the SAMA detailed guidance document relating to Pillar 1, June 2006:**

(This is in addition to existing text)

With regard to unsettled securities, commodities, and foreign exchange SAMA requires that bank's prepares its Prudential return submission based on trade date rather than settlement date as per the accounting convention Banks are encouraged to develop, implement and improve systems for tracking and monitoring the credit risk exposure arising from unsettled transactions as appropriate for producing management information that facilitates action on a timely basis. Furthermore, when such transactions are not processed through a delivery-versus-payment (DvP) or payment-versus-payment (PvP) mechanism, banks must calculate a capital charge as set forth in Annex 3 of International Convergence of Capital Measurement and Capital Standards – June 2006

(Refer to Paragraph 89 of International Convergence of Capital Measurement and Capital Standards – June 2006)

**The following would be a new subsection 6.4 titled “ legal and operational certainty” on page 147, of the SAMA detailed guidance document relating to Pillar 1, June 2006:**

## Positioning of the Paragraph in SAMA's Regulatory Documentation

(This is in addition to existing text)

All documentation used in collateralized transactions and for documenting, guarantees and credit derivatives must be binding on all parties and legally enforceable in all relevant jurisdictions. Banks must have conducted sufficient legal review to verify this and have a well-founded legal basis to reach this conclusion, and undertake such further review as necessary to ensure continuing enforceability. (Refer para 118, , International Convergence of Capital Measurement and Capital Standards – June 2006)

In addition to the general requirements for legal certainty set out in paragraphs 117 and 118 of , International Convergence of Capital Measurement and Capital Standards – June 2006, the legal mechanism by which collateral is pledged or transferred must ensure that the bank has the right to liquidate or take legal possession of it, in a timely manner, in the event of the default, insolvency or bankruptcy (or one or more otherwise-defined credit events set out in the transaction documentation) of the counterparty (and, where applicable, of the custodian holding the collateral). Furthermore banks must take all steps necessary to fulfil these requirements under the law applicable to the bank's interest in the collateral for obtaining and maintaining an enforceable security interest, e.g. by registering it with a registrar, or for exercising a right to net or set off in relation to title transfer collateral. (Refer para 123, International Convergence of Capital Measurement and Capital Standards – June 2006)

In order for collateral to provide protection, the credit quality of the counterparty and the value of the collateral must not have a material positive correlation. For example, securities issued by the counterparty – or by any related group entity – would provide little protection and so would be ineligible. (Refer para 124, , International Convergence of Capital Measurement and Capital Standards – June 2006)

Banks must have clear and robust procedures for the timely liquidation of collateral to ensure that any legal conditions required for declaring the default of the counterparty and liquidating the collateral are observed, and that collateral can be liquidated promptly. (Refer para 125, , International Convergence of Capital Measurement and Capital Standards – June

## Positioning of the Paragraph in SAMA's Regulatory Documentation

2006)

Where the collateral is held by a custodian, banks must take reasonable steps to ensure that the custodian segregates the collateral from its own assets.

(Refer para 126, , International Convergence of Capital Measurement and Capital Standards – June 2006)

**To be read as part of the comprehensive scope section (Section 6.1 (ii) laid out on page 145 of the SAMA detailed guidance document relating to Pillar 1, June 2006:**

(This is in addition to existing text)

The comprehensive approach for the treatment of collateral (Also refer to paragraphs 130 to 138 and 145 to 181 - International Convergence of Capital Measurement and Capital Standards – June 2006) will also be applied to calculate the counterparty risk charges for OTC Derivatives and repo-style transactions booked in the trading book. However, SAMA's overriding requirement that netting would not be allowed for capital adequacy purposes .

(Refer para 112, , International Convergence of Capital Measurement and Capital Standards – June 2006)

**To be read as part Section 6 of Credit Risk Mitigation , Collateral Management laid out on page 145 of the SAMA detailed guidance document relating to Pillar 1, June 2006:**

(This is in addition to existing text)

No transaction in which CRM techniques are used should receive a higher capital requirement than an otherwise identical transaction where such techniques are not used.

(Refer para 113, , International Convergence of Capital Measurement and Capital Standards – June 2006)

**To be read as part Section 6 of Credit Risk Mitigation , Collateral Management laid out on page 145 of the SAMA detailed guidance document relating to Pillar 1, June 2006:**

(This is in addition to existing text)

### Positioning of the Paragraph in SAMA's Regulatory Documentation

The effects of CRM will not be double counted. Therefore, no additional supervisory recognition of CRM for regulatory capital purposes will be granted on claims for which an issue-specific rating is used that already reflects that CRM. As stated in paragraph 100, International Convergence of Capital Measurement and Capital Standards – June 2006 of the section on the standardized approach, principal-only ratings will also not be allowed within the framework of CRM. (Refer para 114, International Convergence of Capital Measurement and Capital Standards – June 2006)

**To be read as part Section 6 of Credit Risk Mitigation, Collateral Management laid out on page 145 of the SAMA detailed guidance document relating to Pillar 1, June 2006:**

(This is in addition to existing text)

While the use of CRM techniques reduces or transfers credit risk, it simultaneously may increase other risks (residual risks). Residual risks include legal, operational, liquidity and market risks. Therefore, it is imperative that banks employ robust procedures and processes to control these risks, including strategy; consideration of the underlying credit; valuation; policies and procedures; systems; control of roll-off risks; and management of concentration risk arising from the bank's use of CRM techniques and its interaction with the bank's overall credit risk profile. Where these risks are not adequately controlled, SAMA may impose additional capital charges or take other supervisory actions as outlined in Pillar 2.

(Refer para 115, International Convergence of Capital Measurement and Capital Standards – June 2006)

**To be read as part Section 6 of Credit Risk Mitigation Collateral Management laid out on page 145 of the SAMA detailed guidance document relating to Pillar 1, June 2006:**

(This is in addition to existing text)

A collateralized transaction is one in which:

- Banks have a credit exposure or potential credit exposure; and
- That credit exposure or potential credit exposure is hedged in whole or in part by collateral posted by a counterparty or by a third party on behalf of the counterparty.

## Positioning of the Paragraph in SAMA's Regulatory Documentation

Here “counterparty” is used to denote a party to whom a bank has an on- or off-balance sheet credit exposure or a potential credit exposure. That exposure may, for example, take the form of a loan of cash or securities (where the counterparty would traditionally be called the borrower), of securities posted as collateral, of a commitment or of exposure under an OTC derivatives contract.

(Refer para 119, International Convergence of Capital Measurement and Capital Standards – June 2006)

**As a new subsection 6.4.1, titled “ Repo-style transaction” on page 147, of the SAMA detailed guidance document relating to Pillar 1, June 2006**

(This is in addition to existing text)

Where a bank, acting as an agent, arranges a repo-style transaction (i.e. repurchase/reverse repurchase and securities lending/borrowing transactions) between a customer and a third party and provides a guarantee to the customer that the third party will perform on its obligations, then the risk to the bank is the same as if the bank had Entered into the transaction as a principal. In such circumstances, a bank will be required to calculate capital requirements as if it were itself the principal.

(Refer para 128, International Convergence of Capital Measurement and Capital Standards – June 2006)

**Page 147, Section 6.2, On balance sheet netting, SAMA detailed guidance document relating to Pillar 1, June 2006:**

**Original Paragraph was as follows:**

Where banks have legally enforceable netting arrangements for loans and deposits they may calculate capital

## Positioning of the Paragraph in SAMA's Regulatory Documentation

requirements on the basis of net credit exposures subject to the conditions in Basel II.

### **The revised paragraph would be as follows:**

SAMA does not recognize netting for capital adequacy purposes

### **As part of subsection 6.3 titled “ guarantees and credit derivatives” on page 147, of the SAMA detailed guidance document relating to Pillar 1, June 2006**

(This is in addition to existing text)

In addition to the legal certainty requirements in International Convergence of Capital Measurement and Capital Standards – June 2006 , paragraphs 117 and 118, in order for a guarantee to be recognized, the following conditions must be satisfied:

- (a) On the qualifying default/non-payment of the counterparty, the bank may in a timely manner pursue the guarantor for any monies outstanding under the documentation governing the transaction. The guarantor may make one lump sum payment of all monies under such documentation to the bank, or the guarantor may assume the future payment obligations of the counterparty covered by the guarantee. The bank must have the right to receive any such payments from the guarantor without first having to take legal actions in order to pursue the counterparty for payment.
- (b) The guarantee is an explicitly documented obligation assumed by the guarantor.
- (c) Except as noted in the following sentence, the guarantee covers all types of payments the underlying obligor is expected to make under the documentation governing the transaction, for example notional amount, margin payments etc. where a guarantee covers payment of principal only, interests and other uncovered payments should be treated as an unsecured amount in accordance with BIS guidelines – in International Convergence of Capital Measurement and Capital Standards – June 2006, paragraph 198.

## Positioning of the Paragraph in SAMA's Regulatory Documentation

(Refer para 190, International Convergence of Capital Measurement and Capital Standards – June 2006)

### **As a new subsection Chapter 6.3.1 “additional operational requirements for credit derivatives”, SAMA detailed guidance document relating to Pillar 1, June 2006:**

(This is in addition to existing text)

In order for a credit derivative contract to be recognized, the following conditions must be satisfied:

(a) The credit events specified by the contracting parties must at a minimum cover:

- failure to pay the amounts due under terms of the underlying obligation that are in effect at the time of such failure (with a grace period that is closely in line with the grace period in the underlying obligation);
- bankruptcy, insolvency or inability of the obligor to pay its debts, or its failure or admission in writing of its inability generally to pay its debts as they become due, and analogous events; and
- restructuring of the underlying obligation involving forgiveness or postponement of principal, interest or fees that results in a credit loss event (i.e. charge-off, specific provision or other similar debit to the profit and loss account). When restructuring is not specified as a credit event, refer to paragraph 192, International Convergence of Capital Measurement and Capital Standards – June 2006

(b) If the credit derivative covers obligations that do not include the underlying obligation, section (g) below governs whether the asset mismatch is permissible.

(c) The credit derivative shall not terminate prior to expiration of any grace period required for a default on the underlying obligation to occur as a result of a failure to pay, subject to the provisions of paragraph 203, International Convergence of Capital Measurement and Capital Standards – June 2006

## Positioning of the Paragraph in SAMA's Regulatory Documentation

- (d) Credit derivatives allowing for cash settlement are recognized for capital purposes insofar as a robust valuation process is in place in order to estimate loss reliably. There must be a clearly specified period for obtaining post-credit event valuations of the underlying obligation. If the reference obligation specified in the credit derivative for purposes of cash settlement is different than the underlying obligation, section (g) below governs whether the asset mismatch is permissible.
- (e) If the protection purchaser's right/ability to transfer the underlying obligation to the protection provider is required for settlement, the terms of the underlying obligation must provide that any required consent to such transfer may not be unreasonably withheld.
- (f) The identity of the parties responsible for determining whether a credit event has occurred must be clearly defined. This determination must not be the sole responsibility of the protection seller. The protection buyer must have the right/ability to inform the protection provider of the occurrence of a credit event.
- (g) A mismatch between the underlying obligation and the reference obligation under the credit derivative (i.e. the obligation used for purposes of determining cash settlement value or the deliverable obligation) is permissible if (1) the reference obligation ranks pari passu with or is junior to the underlying obligation, and (2) the underlying obligation and reference obligation share the same obligor (i.e. the same legal entity) and legally enforceable cross-default or cross-acceleration clauses are in place.
- (h) A mismatch between the underlying obligation and the obligation used for purposes of determining whether a credit event has occurred is permissible if (1) the latter obligation ranks pari passu with or is junior to the underlying obligation, and (2) the underlying obligation and reference obligation share the same obligor (i.e. the same legal entity) and legally enforceable cross-default or cross acceleration clauses are in place.



### Positioning of the Paragraph in SAMA's Regulatory Documentation

When the restructuring of the underlying obligation is not covered by the credit derivative, but the other requirements in paragraph 191 are met, partial recognition of the credit derivative will be allowed. If the amount of the credit derivative is less than or equal to the amount of the underlying obligation, 60% of the amount of the hedge can be recognized as covered. If the amount of the credit derivative is larger than that of the underlying obligation, then the amount of eligible hedge is capped at 60% of the amount of the underlying obligation.

Only credit default swaps and total return swaps that provide credit protection equivalent to guarantees will be eligible for recognition. The following exception applies.

Where a bank buys credit protection through a total return swap and records the net payments received on the swap as net income, but does not record offsetting deterioration in the value of the asset that is protected (either through reductions in fair value or by an addition to reserves), the credit protection will not be recognized. The treatment of first-to-default and second-to-default products is covered separately in paragraphs 207 to 210, International Convergence of Capital Measurement and Capital Standards – June 2006

Other types of credit derivatives will not be eligible for recognition at this time.

(Refer para 191-194, International Convergence of Capital Measurement and Capital Standards – June 2006)

**To be read as part of 6.3 “Credit and Guarantee Derivatives” - Page 147 of the SAMA detailed guidance document relating to Pillar 1, June 2006:**

(This is in addition to existing text)

For Credit derivatives and guarantees, Materiality thresholds on payments below which no payment is made in the event of loss are equivalent to retained first loss positions and must be deducted in full from the capital of the bank purchasing the credit protection. (Refer para 197, International Convergence of Capital Measurement and Capital Standards – June 2006)

## Positioning of the Paragraph in SAMA's Regulatory Documentation

**To be read as part of 6.3 "Credit and Guarantee Derivatives" - Page 147 of the SAMA detailed guidance document relating to Pillar 1, June 2006:**

(This is in addition to existing text)

*Tranched cover*

Where the bank transfers a portion of the risk of an exposure in one or more tranches to a protection seller or sellers and retains some level of risk of the loan and the risk transferred and the risk retained are of different seniority, banks may obtain credit protection for either the senior tranches (e.g. second loss portion) or the junior tranche (e.g. first loss portion). In this case the rules as set out in Section IV (Credit risk – securitization framework) will apply.

(Refer para 199, International Convergence of Capital Measurement and Capital Standards – June 2006)

**To be read as part of 6.3 "Credit and Guarantee Derivatives" - Page 147 of the SAMA detailed guidance document relating to Pillar 1, June 2006:**

(This is in addition to existing text)

*Currency mismatches*

Where the credit protection is denominated in a currency different from that in which the exposure is denominated — i.e. there is a currency mismatch — the amount of the exposure deemed to be protected will be reduced by the application of a haircut HFX, i.e.

$$GA = G \times (1 - HFX)$$

where:

G = nominal amount of the credit protection

HFX = haircut appropriate for currency mismatch between the credit protection and underlying obligation.

The appropriate haircut based on a 10-business day holding period (assuming daily marking-to-market) will be applied.

If a bank uses the supervisory haircuts it will be 8%. The haircuts must be scaled up using the square root of time

## Positioning of the Paragraph in SAMA's Regulatory Documentation

formula, depending on the frequency of revaluation of the credit protection as described in paragraph 168, International Convergence of Capital Measurement and Capital Standards – June 2006

(Refer para 200, International Convergence of Capital Measurement and Capital Standards – June 2006)

### **Chapter 6, Credit Risk Mitigation, Basel II SAMA guideline as a separate section 6.4 “Maturity Mismatch”, Page 147 of the SAMA detailed guidance document relating to Pillar 1, June 2006:**

(This is in addition to existing text)

For the purposes of calculating risk-weighted assets, a maturity mismatch occurs when the residual maturity of a hedge is less than that of the underlying exposure.

#### *Definition of maturity*

The maturity of the underlying exposure and the maturity of the hedge should both be defined conservatively. The effective maturity of the underlying should be gauged as the longest possible remaining time before the counterparty is scheduled to fulfil its obligation, taking into account any applicable grace period. For the hedge, embedded options which may reduce the term of the hedge should be taken into account so that the shortest possible effective maturity is used. Where a call is at the discretion of the protection seller, the maturity will always be at the first call date. If the call is at the discretion of the protection buying bank but the terms of the arrangement at origination of the hedge contain a positive incentive for the bank to call the transaction before contractual maturity, the remaining time to the first call date will be deemed to be the effective maturity. For example, where there is a step-up in cost in conjunction with a call feature or where the effective cost of cover increases over time even if credit quality remains the same or increases, the effective maturity will be the remaining time to the first call.

#### *Risk weights for maturity mismatches*

As outlined in paragraph 143 of the International Convergence of Capital Measurement and Capital Standards – June

### Positioning of the Paragraph in SAMA's Regulatory Documentation

2006, hedges with maturity mismatches are only recognized when their original maturities are greater than or equal to one year. As a result, the maturity of hedges for exposures with original maturities of less than one year must be matched to be recognized. In all cases, hedges with maturity mismatches will no longer be recognized when they have a residual maturity of three months or less.

When there is a maturity mismatch with recognized credit risk mitigants (collateral, on-balance sheet netting, guarantees and credit derivatives) the following adjustment will be applied.

$$Pa = P \times (t - 0.25) / (T - 0.25)$$

where:

Pa = value of the credit protection adjusted for maturity mismatch

P = credit protection (e.g. collateral amount, guarantee amount) adjusted for any haircuts

t = min (T, residual maturity of the credit protection arrangement) expressed in years

T = min (5, residual maturity of the exposure) expressed in years

(Refer para 202-205, International Convergence of Capital Measurement and Capital Standards – June 2006)

### **Chapter 6, Credit Risk Mitigation, Basel II SAMA guideline as a separate section 6.5 “Other items related to the treatment of CRM techniques”, Page 147 of the SAMA detailed guidance document relating to Pillar 1, June 2006:**

(This is in addition to existing text)

#### *Treatment of pools of CRM techniques*

In the case where a bank has multiple CRM techniques covering a single exposure (e.g. a bank has both collateral and guarantee partially covering an exposure), the bank will be required to subdivide the exposure into portions covered by each type of CRM technique (e.g. portion covered by collateral, portion covered by guarantee) and the risk-weighted assets of each portion must be calculated separately. When credit protection provided by a single protection provider has

## Positioning of the Paragraph in SAMA's Regulatory Documentation

differing maturities, they must be subdivided into separate protection as well.

### *First-to-default credit derivatives*

There are cases where a bank obtains credit protection for a basket of reference names and where the first default among the reference names triggers the credit protection and the credit event also terminates the contract. In this case, the bank may recognize regulatory capital relief for the asset within the basket with the lowest risk-weighted amount, but only if the notional amount is less than or equal to the notional amount of the credit derivative.

With regard to the bank providing credit protection through such an instrument, if the product has an external credit assessment from an eligible credit assessment institution, the risk weight in paragraph 567, International Convergence of Capital Measurement and Capital Standards – June 2006 applied to securitization tranches will be applied. If the product

### *Second-to-default credit derivatives*

is not rated by an eligible external credit assessment institution, the risk weights of the assets included in the basket will be aggregated up to a maximum of 1250% and multiplied by the nominal amount of the protection provided by the credit derivative to obtain the risk-weighted asset amount.

In the case where the second default among the assets within the basket triggers the credit protection, the bank obtaining credit protection through such a product will only be able to recognize any capital relief if first-default-protection has also be obtained or when one of the assets within the basket has already defaulted.

For banks providing credit protection through such a product, the capital treatment is the same as in paragraph 208, International Convergence of Capital Measurement and Capital Standards – June 2006 with one exception. The exception is that, in aggregating the risk weights, the asset with the lowest risk weighted amount can be excluded from the calculation.

(Refer para 206-210, International Convergence of Capital Measurement and Capital Standards – June 2006)

## Positioning of the Paragraph in SAMA's Regulatory Documentation

**Page 33, Specialized lending (“SL”) exposures, 2.2.4, SAMA detailed guidance document relating to Pillar 1, June 2006:**

**The original paragraph was as follows:**

The four sub-classes of SL are project finance, object finance, commodities finance and income-producing real estate, each of these sub-classes are considered below.

**The new paragraph would read as follows:**

The five sub-classes of specialized lending are project finance, object finance, commodities finance, income-producing real estate, and high-volatility commercial real estate. Each of these sub-classes is defined below. (Refer para 220, International Convergence of Capital Measurement and Capital Standards – June 2006)

**To be read as part of Specialized lending (“SL”) exposures, Page 34, SAMA detailed guidance document relating to Pillar 1, June 2006, through insertion of a heading titled “High Volatility Commercial Real Estate” subsequent to Para 2.2.10**

(This is in addition to existing text)

High-volatility commercial real estate (HVCRE) lending is the financing of commercial real estate that exhibits higher loss rate volatility (i.e. higher asset correlation) compared to other types of SL. HVCRE includes:

- Commercial real estate exposures secured by properties of types that are categorized by the national supervisor as sharing higher volatilities in portfolio default rates;
- Loans financing any of the land acquisition, development and construction (ADC) phases for properties of those types in such jurisdictions; and
- Loans financing ADC of any other properties where the source of repayment at origination of the exposure is

### Positioning of the Paragraph in SAMA's Regulatory Documentation

either the future uncertain sale of the property or cash flows whose source of repayment is substantially uncertain (e.g. the property has not yet been leased to the occupancy rate prevailing in that geographic market for that type of commercial real estate), unless the borrower has substantial equity at risk. Commercial ADC loans exempted from treatment as HVCRE loans on the basis of certainty of repayment of borrower equity are, however, ineligible for the additional reductions for SL exposures described in paragraph 277, International Convergence of Capital Measurement and Capital Standards – June 2006

(Refer para 227, International Convergence of Capital Measurement and Capital Standards – June 2006)

**To be read as part of Specialized lending (“SL”) exposures, Page 34, SAMA detailed guidance document relating to Pillar 1, June 2006, through insertion of a heading titled “High Volatility Commercial Real Estate” subsequent to Para 2.2.10:**

(This is in addition to existing text)

Where SAMA would categorize certain types of commercial real estate exposures as HVCRE in their jurisdictions, it would make public such determinations. SAMA would then ensure that such treatment is then applied equally to banks under their supervision when making such HVCRE loans in that jurisdiction

(Refer para 228, International Convergence of Capital Measurement and Capital Standards – June 2006)

**Page 30, Section 1.3.6, SAMA detailed guidance document relating to Pillar 1, June 2006:**

**The original paragraph was as follows:**

A bank must produce an implementation plan, specifying to what extent and when it intends to roll out IRB approaches across significant asset classes (or sub-classes in the case of retail) and business units over time.

**The revised paragraph would be as follows:**

The plan should be exacting, yet realistic, and must be agreed with the supervisor. It should be driven by the practicality and feasibility of moving to the more advanced approaches, and not motivated by a desire to adopt a Pillar 1 approach

### Positioning of the Paragraph in SAMA's Regulatory Documentation

that minimizes its capital charge. During the roll-out period, supervisors will ensure that no capital relief is granted for intra-group transactions which are designed to reduce a banking group's aggregate capital charge by transferring credit risk among entities on the standardized approach, foundation and advanced IRB approaches. This includes, but is not limited to, asset sales or cross guarantees.

(Refer para 258, International Convergence of Capital Measurement and Capital Standards – June 2006)

**To be read as part of Section 1.2, Application , page 29 SAMA detailed guidance document relating to Pillar 1, June 2006**  
**SAMA detailed guidance document relating to Pillar 1, June 2006**

Banks adopting an IRB approach are expected to continue to employ an IRB approach. A voluntary return to the standardized or foundation approach is permitted only in extraordinary circumstances, such as divestiture of a large fraction of the bank's credit related business, and must be approved by the supervisor.

(Refer para 261, International Convergence of Capital Measurement and Capital Standards – June 2006)

**To be read as part of Section for Criteria for transition to the IRB Approach – Page 54, SAMA detailed guidance document relating to Pillar 1, June 2006**

(This is in addition to existing text)

Given the data limitations associated with SL exposures, a bank may remain on the supervisory slotting criteria approach for one or more of the PF, OF, CF, IPRE or HVCRE sub-classes, and move to the foundation or advanced approach for other sub-classes within the corporate asset class

(Refer para 262, International Convergence of Capital Measurement and Capital Standards – June 2006)

**To be read as part of Section for Criteria for transition to the IRB Approach – Page 54, SAMA detailed guidance document relating to Pillar 1, June 2006**

(This is in addition to existing text)



## Positioning of the Paragraph in SAMA's Regulatory Documentation

Banks adopting the foundation or advanced approaches are required to calculate their capital requirement using these approaches, as well as the 1988 Accord for the time period specified in paragraphs 45 to 49, International Convergence of Capital Measurement and Capital Standards – June 2006

(Refer para 263, International Convergence of Capital Measurement and Capital Standards – June 2006)

**To be read as part of Section for Criteria for transition to the IRB Approach – Page 54, SAMA detailed guidance document relating to Pillar 1, June 2006**

(This is in addition to existing text)

Under these transitional arrangements banks are required to have a minimum of two years of data at the implementation of this Framework. This requirement will increase by one year for each of three years of transition.

(Refer para 265, International Convergence of Capital Measurement and Capital Standards – June 2006)

**To be read as part of Page 40, Section 4.1.10, 4.2 Risk components, Probability of default (PD), SAMA detailed guidance document relating to Pillar 1, June 2006:**

(This is in addition to existing text)

Banks (SAMA has disallowed the application of foundation or advanced approaches to HCVRE) must map their internal grades to five supervisory categories, each of which is associated with a specific risk weight. The slotting criteria on which this mapping must be based are the same as those for IPRE, as provided in Annex 6 International Convergence of Capital Measurement and Capital Standards – June 2006, . The risk weights associated with each category are:

Supervisory categories and UL risk weights for high-volatility commercial real estate

Strong	Good	Satisfactory	Weak	Default
95%	120%	140%	250%	0%

## Positioning of the Paragraph in SAMA's Regulatory Documentation

(Refer para 280, International Convergence of Capital Measurement and Capital Standards – June 2006)

**To be read as part of Section, 5.2.1, Probability of default (PD) and loss given default (LGD), Basel II Page 45,- SAMA detailed guidance document relating to Pillar 1, June 2006**

(This is in addition to existing text)

Banks may reflect the risk-reducing effects of guarantees and credit derivatives, either in support of an individual obligation or a pool of exposures, through an adjustment of either the PD or LGD estimate, subject to the minimum requirements in paragraphs 480 to 489 of the International Convergence of Capital Measurement and Capital Standards – June 2006. Whether adjustments are done through PD or LGD, they must be done in a consistent manner for a given guarantee or credit derivative type.

(Refer para 332, International Convergence of Capital Measurement and Capital Standards – June 2006)

**To be read as part of Section, 5.2.1, Probability of default (PD) and loss given default (LGD), Basel II Page 45,- SAMA detailed guidance document relating to Pillar 1, June 2006**

(This is in addition to existing text)

Consistent with the requirements outlined above for corporate, sovereign, and bank exposures, banks must not include the effect of double default in such adjustments. The adjusted risk weight must not be less than that of a comparable direct exposure to the protection provider. Consistent with the standardized approach, banks may choose not to recognize credit protection if doing so would result in a higher capital requirement.

(Refer para 333, International Convergence of Capital Measurement and Capital Standards – June 2006)

## Positioning of the Paragraph in SAMA's Regulatory Documentation

Page 42, of 168, Section 4.2.6, Exposure at default (EAD), SAMA detailed guidance document relating to Pillar 1, June 2006-

### The original paragraph was

4.2.6 The following paragraphs on EAD apply to both on- and off-balance sheet positions. All exposures are measured gross of specific provisions or partial write-offs. The EAD on drawn amounts should not be less than the sum of:

- (i) The amount by which a bank's regulatory capital would be reduced if the exposure were written-off fully; and
- (ii) Any specific provisions and partial write-offs.

### The revised paragraph would be as follows:

4.2.6 The following paragraphs on EAD apply to both on- and off-balance sheet positions. All exposures are measured gross of specific provisions or partial write-offs. The EAD on drawn amounts should not be less than the sum of:

- (i) The amount by which a bank's regulatory capital would be reduced if the exposure were written-off fully; and
- (ii) Any specific provisions and partial write-offs.

When the difference between the instrument's EAD and the sum of (i) and (ii) is positive, this amount is termed a discount. The calculation of risk-weighted assets is independent of any discounts. Under the limited circumstances described in paragraph 380, International Convergence of Capital Measurement and Capital Standards – June 2006, discounts may be included in the measurement of total eligible provisions for purposes of the EL-provision calculation set out in Section III.G, International Convergence of Capital Measurement and Capital Standards – June 2006. SAMA hereby intimates that the approaches laid in Annexure 4 (Treatment of Counterparty Credit Risk and Cross-Product Netting), of the International Convergence of Capital Measurement and Capital Standards, 2006, (with the exception of clauses applicable to netting) for the purpose of computing the credit equivalent amount of Securities Financing Transactions and OTC derivatives that expose a bank to counterparty credit risk, are available to banks and constitute an integral part of the "SAMA Detailed Guidance Document Relating to Pillar 1, June 2006".

## Positioning of the Paragraph in SAMA's Regulatory Documentation

(Refer para 334, International Convergence of Capital Measurement and Capital Standards – June 2006)

**Page 149, Section 7.2.1, MBA based Approach , SAMA detailed guidance document relating to Pillar 1, June 2006:**

### **The original paragraph read as follows**

Under the MBA, a bank would calculate the minimum capital requirements for their banking book equity holdings using one or both of two separate and distinct methods: a simple risk weight method or an internal models method.

### **The revised paragraph would be as follows:**

Under the market-based approach, institutions are permitted to calculate the minimum capital requirements for their banking book equity holdings using one or both of two separate and distinct methods: a simple risk weight method or an internal models method.

The method used should be consistent with the amount and complexity of the institution's equity holdings and commensurate with the overall size and sophistication of the institution.

Supervisors may require the use of either method based on the individual circumstances of an institution.

(Refer para 343, International Convergence of Capital Measurement and Capital Standards – June 2006)

**To be read as part of 6.3 "Credit and Guarantee Derivatives" - Page 147 of the SAMA detailed guidance document relating to Pillar 1, June 2006:**

(This is in addition to existing text)

Banks are permitted to recognize guarantees but not collateral obtained on an equity position wherein the capital requirement is determined through use of the market-based approach.

(Refer para 349, International Convergence of Capital Measurement and Capital Standards – June 2006)

## Positioning of the Paragraph in SAMA's Regulatory Documentation

**To be read as part of Section 8.2, Rules for purchased receivables, page 151 of SAMA detailed guidance document relating to Pillar 1, June 2006:**

(This is in addition to existing text)

### **Foundation IRB treatment**

If the purchasing bank is unable to decompose EL into its PD and LGD components in a reliable manner, the risk weight is determined from the corporate risk-weight function using the following specifications: if the bank can demonstrate that the exposures are exclusively senior claims to corporate borrowers, an LGD of 45% can be used. PD will be calculated by dividing the EL using this LGD. EAD will be calculated as the outstanding amount minus the capital charge for dilution prior to credit risk mitigation (KDilution). Otherwise, PD is the bank's estimate of EL; LGD will be 100%; and EAD is the amount outstanding minus KDilution. EAD for a revolving purchase facility is the sum of the current amount of receivables purchased plus 75% of any undrawn purchase commitments minus KDilution. If the purchasing bank is able to estimate PD in a reliable manner, the risk weight is determined from the corporate risk-weight functions according to the specifications for LGD, M and the treatment of guarantees under the foundation approach as given in paragraphs 287 to 296, 299, 300 to 305, and 318, International Convergence of Capital Measurement and Capital Standards – June 2006.

(Refer para 366, International Convergence of Capital Measurement and Capital Standards – June 2006)

**To be read as part of Section 8.2, Rules for purchased receivables, page 151 of SAMA detailed guidance document relating to Pillar 1, June 2006:**

(This is in addition to existing text)

### **Advanced IRB treatment**

If the purchasing bank can estimate either the pool's default-weighted average loss rates given default (as defined in

### Positioning of the Paragraph in SAMA's Regulatory Documentation

paragraph 468) or average PD in a reliable manner, the bank may estimate the other parameter based on an estimate of the expected long-run loss rate. The bank may (i) use an appropriate PD estimate to infer the long-run default-weighted average loss rate given default, or (ii) use a long-run default-weighted average loss rate given default to infer the appropriate PD. In either case, it is important to recognize that the LGD used for the IRB capital calculation for purchased receivables cannot be less than the long-run default-weighted average loss rate given default and must be consistent with the concepts defined in paragraph 468. The risk weight for the purchased receivables will be determined using the bank's estimated PD and LGD as inputs to the corporate risk-weight function. Similar to the foundation IRB treatment, EAD will be the amount outstanding minus KDilution. EAD for a revolving purchase facility will be the sum of the current amount of receivables purchased plus 75% of any undrawn purchase commitments minus KDilution (thus, banks using the advanced IRB approach will not be permitted to use their internal EAD estimates for undrawn purchase commitments).

(Refer para 367, International Convergence of Capital Measurement and Capital Standards – June 2006)

### **To be read as part of Section 8.2, Rules for purchased receivables, page 151 of SAMA detailed guidance document relating to Pillar 1, June 2006:**

(This is in addition to existing text)

For drawn amounts, M will equal the pool's exposure-weighted average effective maturity (as defined in paragraphs 320 to 324, International Convergence of Capital Measurement and Capital Standards – June 2006). This same value of M will also be used for undrawn amounts under a committed purchase facility provided the facility contains effective covenants, early amortization triggers, or other features that protect the purchasing bank against a significant deterioration in the quality of the future receivables it is required to purchase over the facility's term. Absent such effective protections, the M for undrawn amounts will be calculated as the sum of (a) the longest-dated potential receivable under the purchase agreement and (b) the remaining maturity of the purchase facility.

(Refer para 368, International Convergence of Capital Measurement and Capital Standards – June 2006)

### **Page 46, Section 6, Calculation of expected losses., SAMA detailed guidance document relating to Pillar 1, June**

## Positioning of the Paragraph in SAMA's Regulatory Documentation

**2006:**

**The original paragraph was as follows:**

Banks should sum the EL amount (defined as EL multiplied by EAD) associated with their exposures.

**The revised paragraph would be as follows:**

A bank must sum the EL amount (defined as EL multiplied by EAD) associated with its exposures (excluding the EL amount associated with equity exposures under the PD/LGD approach and securitization exposures) to obtain a total EL amount. While the EL amount associated with equity exposures subject to the PD/LGD approach is excluded from the total EL amount, paragraphs 376 and 386, International Convergence of Capital Measurement and Capital Standards – June 2006 apply to such exposures. The treatment of EL for securitization exposures is described in paragraph 563, International Convergence of Capital Measurement and Capital Standards – June 2006.

(Refer para 375, International Convergence of Capital Measurement and Capital Standards – June 2006)

**The following would be read as part of, Page 46, Section 6.2, Expected loss for SL exposures subject to the supervisory slotting criteria, SAMA detailed guidance document relating to Pillar 1, June 2006:**

Supervisory categories and the risk weights for HVCRE:

The risk weights for HVCRE are as follows:

Strong	Good	Satisfactory	Weak	Default
5%	5%	35%	100%	625%

Even where, at national discretion, supervisors allow banks to assign preferential risk weights to HVCRE exposures falling into the “strong” and “good” supervisory categories as outlined in paragraph 282, the corresponding EL risk weight will remain at 5% for both “strong” and “good” exposures.

## Positioning of the Paragraph in SAMA's Regulatory Documentation

(Refer para 379, International Convergence of Capital Measurement and Capital Standards – June 2006)

**Page 47, Section 6.4, Treatment of expected losses and provisions, SAMA detailed guidance document relating to Pillar 1, June 2006:**

**Original paragraph was as follows:**

Where the total EL amount is less than total eligible provisions, the SAMA would generally allow banks to recognize the difference in supplementary capital up to a maximum of 0.6% of credit risk-weighted assets.

**The revised paragraph would be as follows:**

Where the calculated EL amount is lower than the provisions of the bank, its supervisors must consider whether the EL fully reflects the conditions in the market in which it operates before allowing the difference to be included in Tier 2 capital. If specific provisions exceed the EL amount on defaulted assets this assessment also needs to be made before using the difference to offset the EL amount on non-defaulted assets.

(Refer para 385, International Convergence of Capital Measurement and Capital Standards – June 2006)

**Page 47, Section 6.4, Treatment of expected losses and provisions, SAMA detailed guidance document relating to Pillar 1, June 2006:**

**Original paragraph was as follows:**

The EL amount for equity exposures under the PD/LGD approach is deducted from the capital base. Provisions or write-offs for equity exposure under the PD/LGD approach will not be used in the calculation of EL and provision calculation.

**The revised paragraph would be as follows:**

The EL amount for equity exposures under the PD/LGD approach is deducted 50% from Tier 1 and 50% from Tier 2. Provisions or write-offs for equity exposures under the PD/LGD approach will not be used in the EL-provision calculation.



## Positioning of the Paragraph in SAMA's Regulatory Documentation

The treatment of EL and provisions related to securitization exposures is outlined in paragraph 563.  
(Refer para 386, International Convergence of Capital Measurement and Capital Standards – June 2006)

**Page 81, Section 5.2.2, Integrity of rating process, Corporate, sovereign and bank exposures - SAMA detailed guidance document relating to Pillar 1, June 2006:**

### **Original paragraph was as follows**

Borrower and facility ratings should be reviewed and updated at least annually. Higher risk borrowers or problem exposures should be subject to more frequent review.

### **The revised paragraph would be as follows:**

Borrowers and facilities must have their ratings refreshed at least on an annual basis. Certain credits, especially higher risk borrowers or problem exposures, must be subject to more frequent review. In addition, banks must initiate a new rating if material information on the borrower or facility comes to light.

(Refer para 425, International Convergence of Capital Measurement and Capital Standards – June 2006)

**Page 104, Section 4.2.8, Re-ageing, SAMA detailed guidance document relating to Pillar 1, June 2006:**

### **The original paragraph was as follows:**

Re-ageing is a process by which the delinquency status of loans, the terms of which have not been changed, is adjusted based on subsequent good performance, even though not all arrears under the original repayment schedule have been paid off.

### **The following is added to the original paragraph:**

The bank must have clearly articulated and documented policies in respect of the counting of days past due, in particular in respect of the re-ageing of the facilities and the granting of extensions, deferrals, renewals and rewrites to existing

## Positioning of the Paragraph in SAMA's Regulatory Documentation

accounts. At a minimum, the re-ageing policy must include: (a) approval authorities and reporting requirements; (b) minimum age of a facility before it is eligible for re-ageing; (c) delinquency levels of facilities that are eligible for re-ageing; (d) maximum number of re-ageings per facility; and (e) a reassessment of the borrower's capacity to repay. These policies must be applied consistently over time, and must support the 'use test' (i.e. if a bank treats a re-aged exposure in a similar fashion to other delinquent exposures more than the past-due cut off point, this exposure must be recorded as in default for IRB purposes). Some supervisors may choose to establish more specific requirements on re-ageing for banks in their jurisdiction.

(Refer para 458, International Convergence of Capital Measurement and Capital Standards – June 2006)

### **Page 104, Section 4.4.1, Data observation period - SAMA detailed guidance document relating to Pillar 1, June 2006:**

#### **Original paragraph was as follows:**

Irrespective of whether a bank is using external, internal, or pooled data sources, or a combination of the three, for its PD estimation, the length of the underlying historical observation period used should be at least 2 years for at least one source. If the available observation period spans a longer period for any source, and the data are relevant and material, this longer period should be used. Bank need not give equal importance to historical data if it can convince SAMA that more recent data are a better predictor of default rates.

#### **The revised paragraph would be as follows:**

Irrespective of whether a bank is using external, internal, or pooled data sources, or a combination of the three, for its PD estimation, the length of the underlying historical observation period used must be at least five years for at least one source. If the available observation period spans a longer period for any source, and this data are relevant and material, this longer period must be used.

(Refer para 463, International Convergence of Capital Measurement and Capital Standards – June 2006)

## Positioning of the Paragraph in SAMA's Regulatory Documentation

**Page 104, Section 4.4.1, Data observation period, SAMA detailed guidance document relating to Pillar 1, June 2006:**

**Original paragraph was as follows:**

Irrespective of whether a bank is using external, internal, or pooled data sources, or a combination of the three, for its PD estimation, the length of the underlying historical observation period used should be at least 2 years for at least one source. If the available observation period spans a longer period for any source, and the data are relevant and material, this longer period should be used. Bank need not give equal importance to historical data if it can convince SAMA that more recent data are a better predictor of default rates.

**The revised paragraph would be as follows:**

Irrespective of whether banks are using external, internal, pooled data sources, or a combination of the three, for their estimation of loss characteristics, the length of the underlying historical observation period used must be at least five years.

If the available observation spans a longer period for any source, and these data are relevant, this longer period must be used. A bank need not give equal importance to historic data if it can convince its supervisor that more recent data are a better predictor of loss rates.

(Refer para 466, International Convergence of Capital Measurement and Capital Standards – June 2006)

## Positioning of the Paragraph in SAMA's Regulatory Documentation

**Page 109, Section 4.6.7, Requirements specific to own-EAD estimates - SAMA detailed guidance document relating to Pillar 1, June 2006:**

**Original paragraph was as follows:**

Due consideration should be paid by banks to their specific policies and strategies adopted in respect of account monitoring and payment processing. Banks should also consider their ability and willingness to prevent further drawings in circumstances short of payment default, such as covenant violations or other technical default events. Banks should also have adequate systems and procedures in place to monitor facility amounts, current outstandings against committed lines and changes in outstandings per borrower and per grade. Banks should be able to monitor outstanding balances on a daily basis.

**The revised paragraph would be as follows:**

Due consideration must be paid by the bank to its specific policies and strategies adopted in respect of account monitoring and payment processing. The bank must also consider its ability and willingness to prevent further drawings in circumstances short of payment default, such as covenant violations or other technical default events. Banks must also have adequate systems and procedures in place to monitor facility amounts, current outstandings against committed lines and changes in outstandings per borrower and per grade. The bank must be able to monitor outstanding balances on a daily basis.

477(i). For transactions that expose banks to counterparty credit risk, estimates of EAD must fulfil the requirements set forth in Annex 4 of this Framework.

(Refer para 477, International Convergence of Capital Measurement and Capital Standards – June 2006)

## Positioning of the Paragraph in SAMA's Regulatory Documentation

**To be read as part of Section 4.5 , Requirements specific to own-LGD estimates, page 106 of SAMA detailed guidance document relating to Pillar 1, June 2006:**

In all cases, both the borrower and all recognized guarantors must be assigned a borrower rating at the outset and on an ongoing basis. A bank must follow all minimum requirements for assigning borrower ratings set out in this document, including the regular monitoring of the guarantor's condition and ability and willingness to honor its obligations. Consistent with the requirements in paragraphs 430 and 431, International Convergence of Capital Measurement and Capital Standards – June 2006, a bank must retain all relevant information on the borrower absent the guarantee and the guarantor. In the case of retail guarantees, these requirements also apply to the assignment of an exposure to a pool, and the estimation of PD.

(Refer para 481, International Convergence of Capital Measurement and Capital Standards – June 2006)

**Chapter 6 - Credit Risk Mitigation - Collateral Management , Page 145 of SAMA detailed guidance document relating to Pillar 1, June 2006:**

### **Original Paragraph was as following**

The new Basel framework identifies two primary types of credit risk mitigation (CRM): guarantees and collateral. Guarantees are legally binding promises from a third party that the loan obligations of the borrower would be met. The conditions for a guarantee to be eligible are the same as those in current Accord requiring that they are direct, explicit, irrevocable and unconditional. Under the new Basel framework, eligible guarantees would also include additional operational requirements and a treatment for maturity mismatches. The principle of substitution has been retained from current requirements.

### **The following is added to the above:**

The guarantee must be evidenced in writing, non-cancellable on the part of the guarantor, in force until the debt is

## Positioning of the Paragraph in SAMA's Regulatory Documentation

satisfied in full (to the extent of the amount and tenor of the guarantee) and legally enforceable against the guarantor in a jurisdiction where the guarantor has assets to attach and enforce a judgment. However, in contrast to the foundation approach to corporate, bank, and sovereign exposures, guarantees prescribing conditions under which the guarantor may not be obliged to perform (conditional guarantees) may be recognized under certain conditions. Specifically, the onus is on the bank to demonstrate that the assignment criteria adequately address any potential reduction in the risk mitigation effect.

Under the new Basel framework, eligible guarantees would also include additional operational requirements and a treatment for maturity mismatches. The principle of substitution has been retained from current requirements (Refer para 484, International Convergence of Capital Measurement and Capital Standards – June 2006)

**Page 157, 10.4.7, 10.4.8, Recognition of internally determined correlations, SAMA detailed guidance document relating to Pillar 1, June 2006:**

**Original Paragraphs were the following:**

10.4.7 Recognition of internally determined correlations

The new Basel framework allows a national supervisory authority to decide whether to permit a bank to recognize diversification benefits (less than perfect correlation) across individual operational risk estimates within a bank group. The Bank must be able to prove to the supervisor that its systems for determining correlations are sound, implemented with integrity, and take into account the uncertainty surrounding any such correlation estimate (particularly in periods of stress). The bank should also validate its assumptions using appropriate quantitative and qualitative techniques. SAMA proposes to allow a Bank to use internally determined correlations across individual operational risk estimates provided that i) such co-relations meet back testing, stress testing and other validation requirements ii) and the bank's internal estimates taken as a whole provide predictability for determining regulatory capital requirements.

## Positioning of the Paragraph in SAMA's Regulatory Documentation

### 10.4.8 Calculation of operational risk capital to UL only

The new Basel framework requires a bank to calculate its regulatory capital requirement as the sum of expected loss (EL) and unexpected loss (UL), unless the bank can demonstrate to the satisfaction of its national supervisory authority that it has measured and accounted for its EL exposure.

SAMA proposes to permit a bank to hold capital against UL only provided that the Bank can demonstrate to SAMA that it has accounted for its EL exposure.

#### **The revised paragraph would be as follows:**

This paragraph describes a series of quantitative standards that will apply to internally generated operational risk measures for purposes of calculating the regulatory minimum capital charge.

(a) Any internal operational risk measurement system must be consistent with the scope of operational risk defined by the Committee in paragraph 644, International Convergence of Capital Measurement and Capital Standards – June 2006, and the loss event types defined in Annex 9, International Convergence of Capital Measurement and Capital Standards – June 2006

(b) Supervisors will require the bank to calculate its regulatory capital requirement as the sum of expected loss (EL) and unexpected loss (UL), unless the bank can demonstrate that it is adequately capturing EL in its internal business practices. That is, to base the minimum regulatory capital requirement on UL alone, the bank must be able to demonstrate to the satisfaction of its national supervisor that it has measured and accounted for its EL exposure.

(c) A bank's risk measurement system must be sufficiently 'granular' to capture the major drivers of operational risk affecting the shape of the tail of the loss estimates.

### Positioning of the Paragraph in SAMA's Regulatory Documentation

(d) Risk measures for different operational risk estimates must be added for purposes of calculating the regulatory minimum capital requirement. However, the bank may be permitted to use internally determined correlations in operational risk losses across individual operational risk estimates, provided it can demonstrate to the satisfaction of the national supervisor that its systems for determining correlations are sound, implemented with integrity, and take into account the uncertainty surrounding any such correlation estimates (particularly in periods of stress). The bank must validate its correlation assumptions using appropriate quantitative and qualitative techniques.

(e) Any operational risk measurement system must have certain key features to meet the supervisory soundness standard set out in this section. These elements must include the use of internal data, relevant external data, scenario analysis and factors reflecting the business environment and internal control systems.

(f) A bank needs to have a credible, transparent, well-documented and verifiable approach for weighting these fundamental elements in its overall operational risk measurement system. For example, there may be cases where estimates of the 99.9th percentile confidence interval based primarily on internal and external loss event data would be unreliable for business lines with a heavy-tailed loss distribution and a small number of observed losses. In such cases, scenario analysis, and business environment and control factors, may play a more dominant role in the risk measurement system. Conversely, operational loss event data may play a more dominant role in the risk measurement system for business lines where estimates of the 99.9th percentile confidence interval based primarily on such data are deemed reliable. In all cases, the bank's approach for weighting the four fundamental elements should be internally consistent and avoid the double counting of qualitative assessments or risk mitigants already recognized in other elements of the framework.

(Refer para 669, International Convergence of Capital Measurement and Capital Standards – June 2006)



## Positioning of the Paragraph in SAMA's Regulatory Documentation

### **Page 155, 10.4, Partial Use, SAMA detailed guidance document relating to Pillar 1, June 2006: Original Paragraph was the following:**

[680-683] The new Basel framework permits a Basic Indicator Approach, a Standardized Approach and an Advanced Management Approach (AMA). SAMA initially expects banks to move to the Basic Indicator or the Standardized Approach and thereafter to the more advanced AMA approach supervisor. However, the new Basel framework also permits banks to use an AMA for some parts of its operations and the Basic Indicator Approach or Standardized Approach for the balance ("partial use"), on both a transitional and permanent basis, subject to certain conditions.

These conditions include:

- On implementation date, a significant part of the Banks operational risk should be captured by the AMA, and;
- The Bank must provide a timetable outlining how it intends to roll out the AMA across all but on immaterial part of its operations. A Bank may determine which parts of its operations would use an AMA based on a business line, legal entity, geographical or other internally determined basis.

### **The revised paragraph would be as follows:**

680-683] The new Basel framework permits a Basic Indicator Approach, a Standardized Approach and an Advanced Management Approach (AMA). SAMA initially expects banks to move to the Basic Indicator or the Standardized Approach and thereafter to the more advanced AMA approach supervisor. However, the new Basel framework also permits banks to use an AMA for some parts of its operations and the Basic Indicator Approach or Standardized Approach for the balance ("partial use"), on both a transitional and permanent basis, subject to certain conditions.

These conditions include:

- All operational risks of the bank's global, consolidated operations are captured;

### Positioning of the Paragraph in SAMA's Regulatory Documentation

- All of the bank's operations that are covered by the AMA meet the qualitative criteria for using an AMA, while those parts of its operations that are using one of the simpler approaches meet the qualifying criteria for that approach;
- On implementation date, a significant part of the Bank's operational risk should be captured by the AMA, and;
- The Bank must provide a timetable outlining how it intends to roll out the AMA across all but on immaterial part of its operations. A Bank may determine which parts of its operations would use an AMA based on a business line, legal entity, geographical or other internally determined basis.

(Refer para 680-683, International Convergence of Capital Measurement and Capital Standards – June 2006)

**Document Enhanced: Prudential Returns Basel II, March 2007**

**Positioning of the Paragraph in SAMA's Regulatory Documentation**

**The following is to be read as part of “Core Capital– Tier-I” and “Tier II Capital” guidelines (in addition to existing guidelines), Page 25, Prudential Returns Basel II, March 2007:**

(This is in addition to existing text)

The limits on Tier 2 and on innovative Tier 1 instruments will be based on the amount of Tier 1 capital after deduction of goodwill but before the deductions of investments pursuant (see Annex 1, International Convergence of Capital Measurement and Capital Standards – June 2006, for an example how to calculate the 15% limit for innovative Tier 1 instruments).

(Please refer to Paragraph 39 of International Convergence of Capital Measurement and Capital Standards – June 2006)

**The following is to be read as part of “Additional Guidance Notes I” (in addition to existing guidelines), Page 12, Paragraph No 15, Bullet point No 2, Prudential Returns Basel II, March 2007:**

(This is in addition to existing text)

The comprehensive approach

Maturity Mismatch

Where the residual maturity of the CRM is less than that of the underlying credit exposure a maturity mismatch occurs. Where there is a maturity mismatch and the CRM has an original maturity of less than one year, the CRM is not recognized for capital purposes.

### Positioning of the Paragraph in SAMA's Regulatory Documentation

In other cases where there is a maturity mismatch, partial recognition is given to the CRM for regulatory capital purposes as detailed in para 202 – 205, International Convergence of Capital Measurement and Capital Standards – June 2006. Under the simple approach for collateral maturity mismatches will not be allowed.  
(Please refer to Paragraph 143 of International Convergence of Capital Measurement and Capital Standards – June 2006)

**The following is to be read as part of “Additional Guidance Notes I” (in addition to existing guidelines), Page 13, Paragraph No 15, Bullet point No 4, Prudential Returns Basel II, March 2007:**

(This is in addition to existing text)

The comprehensive approach

Calculation of capital requirement

Where the collateral is a basket of assets, the haircut on the basket will be

$H = \sum a_i H_i$ , where  $a_i$  is the weight of the asset (as measured by units of currency) in the basket and  $H_i$  the haircut applicable to that asset.

(Please refer to Paragraph 150 of International Convergence of Capital Measurement and Capital Standards – June 2006)

**The following is to be read as part of “Additional Guidance Notes I” 17.2, Counterparty Credit Risk On Derivative Contracts, Current Exposure Method, (in addition to existing guidelines), Page 16, , Prudential Returns Basel II, March 2007:**

(This is in addition to existing text)

### Positioning of the Paragraph in SAMA's Regulatory Documentation

Under the Current Exposure Method, the calculation of the counterparty credit risk charge for an individual contract will be as follows:

$$\text{counterparty charge} = [(\text{RC} + \text{add-on}) - \text{CA}] \times r \times 8\%$$

where:

RC = the replacement cost, add-on = the amount for potential future exposure calculated according to paragraph 92(i) and 92(ii) of Annex 4, International Convergence of Capital Measurement and Capital Standards – June 2006

CA = the volatility adjusted collateral amount under the comprehensive approach prescribed in paragraphs 147 to 172, International Convergence of Capital Measurement and Capital Standards – June 2006, or zero if no eligible collateral is applied to the transaction, and

r = the risk weight of the counterparty.

(Please refer to Paragraph 186 of International Convergence of Capital Measurement and Capital Standards – June 2006)

**Document Enhanced: SAMA's Basel II IRB Prudential Returns, Guidance Notes Package and Frequently Asked Questions (FAQs)**

**Positioning of the Paragraph in SAMA's Regulatory Documentation**

Page 31 of the GN 4 – IRB Approach – Section C Prudential Returns General Guidance on IRB Approaches - January 2012:

**Original paragraph (130) to be deleted:**

130. A Bank relying on its own estimates of LGD has the option to adopt the treatment for Bank using the foundation IRB approach (see paragraphs 126 to 128, International Convergence of Capital Measurement and Capital Standards – June 2006), or to make an adjustment to its LGD estimate of the exposure to reflect the presence of the recognized guarantee/credit derivative contract under the advanced IRB approach.

**Revised paragraph would read as follows:**

A bank relying on own-estimates of LGD has the option to adopt the treatment outlined above for banks under the foundation IRB approach (paragraphs 302 to 305, International Convergence of Capital Measurement and Capital Standards – June 2006), or to make an adjustment to its LGD estimate of the exposure to reflect the presence of the guarantee or credit derivative. Under this option, there are no limits to the range of eligible guarantors although the set of minimum requirements provided in paragraphs 483 and 484, International Convergence of Capital Measurement and Capital Standards – June 2006, concerning the type of guarantee must be satisfied. For credit derivatives, the requirements of paragraphs 488 and 489, International Convergence of Capital Measurement and Capital Standards – June 2006, must be satisfied. (When credit derivatives do not cover the restructuring of the underlying obligation, the partial recognition set out in paragraph 192, International Convergence of Capital Measurement and Capital Standards – June 2006, applies.)

## Positioning of the Paragraph in SAMA's Regulatory Documentation

### *Operational requirements for recognition of double default*

130(i). A bank using an IRB approach has the option of using the substitution approach in determining the appropriate capital requirement for an exposure. However, for exposures hedged by one of the following instruments the double default framework according to paragraphs 284 (i) to 284 (iii), International Convergence of Capital Measurement and Capital Standards – June 2006, may be applied subject to the additional operational requirements set out in paragraph 307 (ii), International Convergence of Capital Measurement and Capital Standards – June 2006. A bank may decide separately for each eligible exposure to apply either the double default framework or the substitution approach.

(a) Single-name, unfunded credit derivatives (e.g. credit default swaps) or single- name guarantees.

(b) First-to-default basket products — the double default treatment will be applied to the asset within the basket with the lowest risk-weighted amount.

(c) nth-to-default basket products — the protection obtained is only eligible for consideration under the double default framework if eligible (n-1)th default protection has also been obtained or where (n-1) of the assets within the basket have already defaulted.

130(ii). The double default framework is only applicable where the following conditions are met.

(a) The risk weight that is associated with the exposure prior to the application of the framework does not already factor in any aspect of the credit protection.

(b) The entity selling credit protection is a bank,( This does not include PSEs and MDBs, even though claims on these may be treated as claims on banks according to paragraph 230, International Convergence of Capital Measurement and Capital Standards – June 2006) investment firm or insurance company (but only those that are in the business of providing credit protection, including mono-lines, re-insurers, and non-sovereign credit export agencies - By non-sovereign it is meant that credit protection in question does not benefit from any explicit sovereign counter-guarantee.), referred to as a financial firm, that:

### Positioning of the Paragraph in SAMA's Regulatory Documentation

- is regulated in a manner broadly equivalent to that in this Framework (where there is appropriate supervisory oversight and transparency/ market discipline), or externally rated as at least investment grade by a credit rating agency deemed suitable for this purpose by supervisors;
- had an internal rating with a PD equivalent to or lower than that associated with an external A- rating at the time the credit protection for an exposure was first provided or for any period of time thereafter; and •has an internal rating with a PD equivalent to or lower than that associated with an external investment-grade rating.

(c) The underlying obligation is:

- a corporate exposure as defined in paragraphs 218 to 228, International Convergence of Capital Measurement and Capital Standards – June 2006, (excluding specialised lending exposures for which the supervisory slotting criteria approach described in paragraphs 275 to 282, International Convergence of Capital Measurement and Capital Standards – June 2006, is being used); or
- A claim on a PSE that is not a sovereign exposure as defined in paragraph 229, International Convergence of Capital Measurement and Capital Standards – June 2006; or
- A loan extended to a small business and classified as a retail exposure as defined in paragraph 231, International Convergence of Capital Measurement and Capital Standards – June 2006.

(d) The underlying obligor is not:

- A financial firm as defined in (b); or
- A member of the same group as the protection provider.

(e) The credit protection meets the minimum operational requirements for such instruments as outlined in paragraphs 189 to 193, International Convergence of Capital Measurement and Capital Standards – June 2006.



### Positioning of the Paragraph in SAMA's Regulatory Documentation

(f) In keeping with paragraph 190, International Convergence of Capital Measurement and Capital Standards – June 2006, for guarantees, for any recognition of double default effects for both guarantees and credit derivatives a bank must have the right and expectation to receive payment from the credit protection provider without having to take legal action in order to pursue the counterparty for payment. To the extent possible, a bank should take steps to satisfy itself that the protection provider is willing to pay promptly if a credit event should occur.

(g) The purchased credit protection absorbs all credit losses incurred on the hedged portion of an exposure that arise due to the credit events outlined in the contract.

(h) If the payout structure provides for physical settlement, then there must be legal certainty with respect to the deliverability of a loan, bond, or contingent liability. If a bank intends to deliver an obligation other than the underlying exposure, it must ensure that the deliverable obligation is sufficiently liquid so that the bank would have the ability to purchase it for delivery in accordance with the contract.

(i) The terms and conditions of credit protection arrangements must be legally confirmed in writing by both the credit protection provider and the bank.

(j) In the case of protection against dilution risk, the seller of purchased receivables must not be a member of the same group as the protection provider.

(k) There is no excessive correlation between the creditworthiness of a protection provider and the obligor of the underlying exposure due to their performance being dependent on common factors beyond the systematic risk factor. The bank has a process to detect such excessive correlation. An example of a situation in which such excessive correlation would arise is when a protection provider guarantees the debt of a supplier of goods or services and the supplier derives a high proportion of its income or revenue from the protection provider.

## Positioning of the Paragraph in SAMA's Regulatory Documentation

**(Please refer to Paragraph 307 of International Convergence of Capital Measurement and Capital Standards – June 2006)**

**The advanced approaches have been laid out on page 13 of the GN 4 – IRB Approach – Section C Prudential Returns General Guidance on IRB Approaches - January 2012:**

**The original paragraph (60) was follows**

(a) Market-based approach

60. Under this approach, a Bank is permitted to calculate the risk-weighted amount of its equity exposures held in the banking book using one or both of the following two separate and distinct methods:

(i) Simple risk-weight method

A 300% risk-weight is to be applied to equity exposure in a publicly traded company (being an equity security traded on a recognized exchange)<sup>1</sup> and a 400% risk-weight is to be applied to all other equity exposures.

<sup>1</sup> For the definition of recognized exchange refer to SAMA's guidance document concerning the market risk issued in January 2004.

Short positions in an equity exposure (including derivative instruments) held in the banking book are permitted to offset long positions in the same equity exposure, provided that these short positions have been explicitly designated as a hedge of the long positions in that equity exposure and that they have a remaining maturity of at least one year. Other short positions (including the net short position remains after the set-off) are to be treated as if they were long positions with the relevant risk-weight applied to the absolute value of each position.

**The following content would be deemed added to the original paragraph as a continuation:**

In the context of maturity mismatched positions, the methodology is that for corporate exposures

## Positioning of the Paragraph in SAMA's Regulatory Documentation

**(Please refer to Paragraph 345 of International Convergence of Capital Measurement and Capital Standards – June 2006)**

The advanced approaches have been laid out on page 31 of the GN 4 – IRB Approach – Section C Prudential Returns General Guidance on IRB Approaches - January 2012

The following is added to para 133 of the **GN 4 – IRB Approach – Section C Prudential Returns General Guidance on IRB Approaches - January 2012**

For retail exposures, where guarantees exist, either in support of an individual obligation or a pool of exposures, a bank may reflect the risk-reducing effect either through its estimates of PD or LGD, provided this is done consistently. In adopting one or the other technique, a bank must adopt a consistent approach, both across types of guarantees and over time.

**(Please refer to Paragraph 480 of International Convergence of Capital Measurement and Capital Standards – June 2006)**

**The following text should be considered as added to Paragraph 129 , page 31 of the GN 4 “Advanced IRB Approach” – IRB Approach – Section C Prudential Returns General Guidance on IRB Approaches - January 2012**

There are no restrictions on the types of eligible guarantors. The bank must, however, have clearly specified criteria for the types of guarantors it will recognise for regulatory capital purposes.

**(Please refer to Paragraph 483 of International Convergence of Capital Measurement and Capital Standards – June 2006)**

### Positioning of the Paragraph in SAMA's Regulatory Documentation

**The following text is a new Paragraph 129-A “adjustment criteria for advanced approach”, page 31 of the GN 4 “Advanced IRB Approach” – IRB Approach – Section C Prudential Returns General Guidance on IRB Approaches - January 2012**

A bank must have clearly specified criteria for adjusting borrower grades or LGD estimates (or in the case of retail and eligible purchased receivables, the process of allocating exposures to pools) to reflect the impact of guarantees for regulatory capital purposes. These criteria must be as detailed as the criteria for assigning exposures to grades consistent with paragraphs 410 and 411, International Convergence of Capital Measurement and Capital Standards – June 2006 and must follow all minimum requirements for assigning borrower or facility ratings set out in this document. The criteria must be plausible and intuitive, and must address the guarantor's ability and willingness to perform under the guarantee. The criteria must also address the likely timing of any payments and the degree to which the guarantor's ability to perform under the guarantee is correlated with the borrower's ability to repay. The bank's criteria must also consider the extent to which residual risk to the borrower remains, for example a currency mismatch between the guarantee and the underlying exposure.

In adjusting borrower grades or LGD estimates (or in the case of retail and eligible purchased receivables, the process of allocating exposures to pools), banks must take all relevant available information into account.

**(Please refer to Paragraph 485-487 of International Convergence of Capital Measurement and Capital Standards – June 2006)**

**The following text is a new Paragraph 129 B “Credit derivatives - Advanced IRB Approach”, page 31 of the GN 4 “Advanced IRB Approach” – IRB Approach – Section C Prudential Returns General Guidance on IRB Approaches - January 2012**

The minimum requirements for guarantees are relevant also for single-name credit derivatives. Additional considerations arise in respect of asset mismatches. The criteria used for assigning adjusted borrower grades or LGD estimates (or

### Positioning of the Paragraph in SAMA's Regulatory Documentation

pools) for exposures hedged with credit derivatives must require that the asset on which the protection is based (the reference asset) cannot be different from the underlying asset, unless the conditions outlined in the foundation approach are met.

In addition, the criteria must address the payout structure of the credit derivative and conservatively assess the impact this has on the level and timing of recoveries. The bank must also consider the extent to which other forms of residual risk remain.

**(Please refer to Paragraph 488 of International Convergence of Capital Measurement and Capital Standards – June 2006)**

**The following text is a new Paragraph 129 C “For banks using foundation LGD estimates”, page 31 of the GN 4 “Advanced IRB Approach” – IRB Approach – Section C Prudential Returns General Guidance on IRB Approaches - January 2012**

The minimum requirements outlined in paragraphs 480 to 489, International Convergence of Capital Measurement and Capital Standards – June 2006, apply to banks using the foundation LGD estimates with the following exceptions:

(1)The bank is not able to use an ‘LGD-adjustment’ option; and

(2)The range of eligible guarantees and guarantors is limited to those outlined in BIS guidelines outlined in paragraph 302, International Convergence of Capital Measurement and Capital Standards – June 2006.

**(Please refer to Paragraph 490 of International Convergence of Capital Measurement and Capital Standards – June 2006)**

**The following text is a new subheading (c ) “Requirements specific to estimating PD and LGD (or EL) for qualifying purchased receivables ” main heading “Purchased Receivables”, New Para 75 A, page 17 of the GN 4 “Advanced IRB Approach” – IRB Approach – Section C Prudential Returns General Guidance on IRB Approaches - January 2012**

## Positioning of the Paragraph in SAMA's Regulatory Documentation

### *Requirements specific to estimating PD and LGD (or EL) for qualifying purchased receivables*

The following minimum requirements for risk quantification must be satisfied for any purchased receivables (corporate or retail) making use of the top-down treatment of default risk and/or the IRB treatments of dilution risk.

The purchasing bank will be required to group the receivables into sufficiently homogeneous pools so that accurate and consistent estimates of PD and LGD (or EL) for default losses and EL estimates of dilution losses can be determined. In general, the risk bucketing process will reflect the seller's underwriting practices and the heterogeneity of its customers. In addition, methods and data for estimating PD, LGD, and EL must comply with the existing risk quantification standards for retail exposures. In particular, quantification should reflect all information available to the purchasing bank regarding the quality of the underlying receivables, including data for similar pools provided by the seller, by the purchasing bank, or by external sources. The purchasing bank must determine whether the data provided by the seller are consistent with expectations agreed upon by both parties concerning, for example, the type, volume and on-going quality of receivables purchased.

Where this is not the case, the purchasing bank is expected to obtain and rely upon more relevant data.

### *Minimum operational requirements*

A bank purchasing receivables has to justify confidence that current and future advances can be repaid from the liquidation of (or collections against) the receivables pool. To qualify for the top-down treatment of default risk, the receivable pool and overall lending relationship should be closely monitored and controlled. Specifically, a bank will have to demonstrate the following:

### *Legal certainty*

- The structure of the facility must ensure that under all foreseeable circumstances the bank has effective ownership and control of the cash remittances from the receivables, including incidences of seller or servicer distress and

## Positioning of the Paragraph in SAMA's Regulatory Documentation

bankruptcy. When the obligor makes payments directly to a seller or servicer, the bank must verify regularly that payments are forwarded completely and within the contractually agreed terms. As well, ownership over the receivables and cash receipts should be protected against bankruptcy 'stays' or legal challenges that could materially delay the lender's ability to liquidate/assign the receivables or retain control over cash receipts.

### *Effectiveness of monitoring systems*

The bank must be able to monitor both the quality of the receivables and the financial condition of the seller and servicer. In particular:

- The bank must (a) assess the correlation among the quality of the receivables and the financial condition of both the seller and servicer, and (b) have in place internal policies and procedures that provide adequate safeguards to protect against such contingencies, including the assignment of an internal risk rating for each seller and servicer.
- The bank must have clear and effective policies and procedures for determining seller and servicer eligibility. The bank or its agent must conduct periodic reviews of sellers and servicers in order to verify the accuracy of reports from the seller/servicer, detect fraud or operational weaknesses, and verify the quality of the seller's credit policies and servicer's collection policies and procedures. The findings of these reviews must be well documented.
- The bank must have the ability to assess the characteristics of the receivables pool, including (a) over-advances; (b) history of the seller's arrears, bad debts, and bad debt allowances; (c) payment terms, and (d) potential contra accounts.
- The bank must have effective policies and procedures for monitoring on an aggregate basis single-obligor concentrations both within and across receivables pools.
- The bank must receive timely and sufficiently detailed reports of receivables ageings and dilutions to (a) ensure compliance with the bank's eligibility criteria and advancing policies governing purchased receivables, and (b) provide an effective means with which to monitor and confirm the seller's terms of sale (e.g. invoice date ageing) and dilution.

## Positioning of the Paragraph in SAMA's Regulatory Documentation

### *Effectiveness of work-out systems*

An effective programme requires systems and procedures not only for detecting deterioration in the seller's financial condition and deterioration in the quality of the receivables at an early stage, but also for addressing emerging problems pro-actively. In particular,

- The bank should have clear and effective policies, procedures, and information systems to monitor compliance with (a) all contractual terms of the facility (including covenants, advancing formulas, concentration limits, early amortisation triggers, etc.) as well as (b) the bank's internal policies governing advance rates and receivables eligibility. The bank's systems should track covenant violations and waivers as well as exceptions to established policies and procedures.
- To limit inappropriate draws, the bank should have effective policies and procedures for detecting, approving, monitoring, and correcting over-advances.
- The bank should have effective policies and procedures for dealing with financially weakened sellers or servicers and/or deterioration in the quality of receivable pools.
- These include, but are not necessarily limited to, early termination triggers in revolving facilities and other covenant protections, a structured and disciplined approach to dealing with covenant violations, and clear and effective policies and procedures for initiating legal actions and dealing with problem receivables.

### *Effectiveness of systems for controlling collateral, credit availability, and cash*

The bank must have clear and effective policies and procedures governing the control of receivables, credit, and cash. In particular,

- Written internal policies must specify all material elements of the receivables purchase programme, including the advancing rates, eligible collateral, necessary documentation, concentration limits, and how cash receipts are to be handled. These elements should take appropriate account of all relevant and material factors, including the seller's/servicer's financial condition, risk concentrations, and trends in the quality of the receivables and the seller's customer base.



## Positioning of the Paragraph in SAMA's Regulatory Documentation

- Internal systems must ensure that funds are advanced only against specified supporting collateral and documentation (such as servicer attestations, invoices, shipping documents, etc.).

### *Compliance with the bank's internal policies and procedures*

Given the reliance on monitoring and control systems to limit credit risk, the bank should have an effective internal process for assessing compliance with all critical policies and procedures, including

- Regular internal and/or external audits of all critical phases of the bank's receivables purchase programme.
- Verification of the separation of duties (i) between the assessment of the seller/servicer and the assessment of the obligor and (ii) between the assessment of the seller/servicer and the field audit of the seller/servicer.

A bank's effective internal process for assessing compliance with all critical policies and procedures should also include evaluations of back office operations, with particular focus on qualifications, experience, staffing levels, and supporting systems

**(Please refer to Paragraph 491-499 of International Convergence of Capital Measurement and Capital Standards – June 2006)**

**Page 14 of the GN 4 “(ii) Internal models method” – IRB Approach – Section F “Equity Exposure” Prudential Returns General Guidance on IRB Approaches - January 2012**

**The original paragraphs were as follows:**

(ii) Internal models method

## Positioning of the Paragraph in SAMA's Regulatory Documentation

A Bank may use its internal models to calculate the risk-weighted amount of its equity exposures, subject to fulfilling the relevant requirements set out in the Rules described in SAMA's documents relating to the market risk amendment of 2004.

Under this method, the Bank should calculate the risk-weighted amount of its equity exposures by multiplying the potential loss of its equity exposures as derived by using its internal models (e.g. VaR models) subject to the one-tailed 99% confidence interval of the difference between quarterly returns of the exposures and an appropriate risk-free rate computed over a long-term observation period (i.e. not less than three years) by 12.5. The risk-weighted amount calculated under the internal models method should be no less than the risk-weighted amount calculated under the simple risk weight method using a 200% risk-weight for equity exposure in a publicly traded company and a 300% risk-weight for all other equity exposures. Such minimum risk-weighted amount should be calculated separately using the simple risk-weight method at individual exposure level rather than at portfolio level.

### **The revised paragraph would read as follows**

#### Internal Models Market Based Approach

To be eligible for the internal models market-based approach a bank must demonstrate to its supervisor that it meets certain quantitative and qualitative minimum requirements at the outset and on an ongoing basis. A bank that fails to demonstrate continued compliance with the minimum requirements must develop a plan for rapid return to compliance, obtain its supervisor's approval of the plan, and implement that plan in a timely fashion. In the interim, banks would be expected to compute capital charges using a simple risk weight approach.

#### Capital charge risk and quantification

The following minimum quantitative standards apply for the purpose of calculating minimum capital charges under the internal models approach.

### Positioning of the Paragraph in SAMA's Regulatory Documentation

- The capital charge is equivalent to the potential loss on the institution's equity portfolio arising from an assumed instantaneous shock equivalent to the 99<sup>th</sup> percentile, one-tailed confidence interval of the difference between quarterly returns and an appropriate risk-free rate computed over a long-term sample period.
- The estimated losses should be robust to adverse market movements relevant to the long-term risk profile of the institution's specific holdings. The data used to represent return distributions should reflect the longest sample period for which data are available and meaningful in representing the risk profile of the bank's specific equity holdings. The data used should be sufficient to provide conservative, statistically reliable and robust loss estimates that are not based purely on subjective or judgmental considerations. Institutions must demonstrate to supervisors that the shock employed provides a conservative estimate of potential losses over a relevant long-term market or business cycle. Models estimated using data not reflecting realistic ranges of long-run experience, including a period of reasonably severe declines in equity market values relevant to a bank's holdings, are presumed to produce optimistic results unless there is credible evidence of appropriate adjustments built into the model. In the absence of built-in adjustments, the bank must combine empirical analysis of available data with adjustments based on a variety of factors in order to attain model outputs that achieve appropriate realism and conservatism. In constructing Value at Risk (VaR) models estimating potential quarterly losses, institutions may use quarterly data or convert shorter horizon period data to a quarterly equivalent using an analytically appropriate method supported by empirical evidence. Such adjustments must be applied through a well-developed and well-documented thought process and analysis. In general, adjustments must be applied conservatively and consistently over time. Furthermore, where only limited data are available, or where technical limitations are such that estimates from any single method will be of uncertain quality, banks must add appropriate margins of conservatism in order to avoid over-optimism.
- No particular type of VaR model (e.g. variance-covariance, historical simulation, or Monte Carlo) is prescribed. However, the model used must be able to capture adequately all of the material risks embodied in equity returns including both the general market risk and specific risk exposure of the institution's equity portfolio. Internal models must adequately explain historical price variation, capture both the magnitude and changes in the composition of potential concentrations, and be robust to adverse market environments. The population of risk exposures represented in the data used for estimation must be closely matched to or at least comparable with those of the

## Positioning of the Paragraph in SAMA's Regulatory Documentation

bank's equity exposures.

- Banks may also use modelling techniques such as historical scenario analysis to determine minimum capital requirements for banking book equity holdings. The use of such models is conditioned upon the institution demonstrating to its supervisor that the methodology and its output can be quantified in the form of the loss percentile specified under (a).
- Institutions must use an internal model that is appropriate for the risk profile and complexity of their equity portfolio. Institutions with material holdings with values that are highly non-linear in nature (e.g. equity derivatives, convertibles) must employ an internal model designed to capture appropriately the risks associated with such instruments.
- Subject to supervisory review, equity portfolio correlations can be integrated into a bank's internal risk measures. The use of explicit correlations (e.g. utilisation of a variance/covariance VaR model) must be fully documented and supported using empirical analysis. The appropriateness of implicit correlation assumptions will be evaluated by supervisors in their review of model documentation and estimation techniques.
- Mapping of individual positions to proxies, market indices, and risk factors should be plausible, intuitive, and conceptually sound. Mapping techniques and processes should be fully documented, and demonstrated with both theoretical and empirical evidence to be appropriate for the specific holdings. Where professional judgement is combined with quantitative techniques in estimating a holding's return volatility, the judgement must take into account the relevant and material information not considered by the other techniques utilised.
- Where factor models are used, either single or multi-factor models are acceptable depending upon the nature of an institution's holdings. Banks are expected to ensure that the factors are sufficient to capture the risks inherent in the equity portfolio. Risk factors should correspond to the appropriate equity market characteristics (for example, public, private, market capitalisation industry sectors and sub-sectors, operational characteristics) in which the bank holds significant positions. While banks will have discretion in choosing the factors, they must demonstrate through empirical analyses the appropriateness of those factors, including their ability to cover both general and specific risk.
- Estimates of the return volatility of equity investments must incorporate relevant and material available data, information, and methods. A bank may utilise independently reviewed internal data or data from external sources (including pooled data). The number of risk exposures in the sample, and the data period used for quantification must

## Positioning of the Paragraph in SAMA's Regulatory Documentation

be sufficient to provide the bank with confidence in the accuracy and robustness of its estimates. Institutions should take appropriate measures to limit the potential of both sampling bias and survivorship bias in estimating return volatilities.

- Risk Management processes and controls

A rigorous and comprehensive stress-testing programme must be in place. Banks are expected to subject their internal model and estimation procedures, including volatility computations, to either hypothetical or historical scenarios that reflect worst-case losses given underlying positions in both public and private equities. At a minimum, stress tests should be employed to provide information about the effect of tail events beyond the level of confidence assumed in the internal models approach.

Banks' overall risk management practices used to manage their banking book equity investments are expected to be consistent with the evolving sound practice guidelines issued by the Committee and national supervisors. With regard to the development and use of internal models for capital purposes, institutions must have established policies, procedures, and controls to ensure the integrity of the model and modelling process used to derive regulatory capital standards.

These policies, procedures, and controls should include the following:

- Full integration of the internal model into the overall management information systems of the institution and in the management of the banking book equity portfolio. Internal models should be fully integrated into the institution's risk management infrastructure including use in: (i) establishing investment hurdle rates and evaluating alternative investments; (ii) measuring and assessing equity portfolio performance (including the risk-adjusted performance); and (iii) allocating economic capital to equity holdings and evaluating overall capital adequacy as required under Pillar 2. The institution should be able to demonstrate, through for example, investment committee minutes, that internal model output plays an essential role in the investment management process.
- Established management systems, procedures, and control functions for ensuring the periodic and independent review of all elements of the internal modelling process, including approval of model revisions, vetting of model inputs,

### Positioning of the Paragraph in SAMA's Regulatory Documentation

and review of model results, such as direct verification of risk computations. Proxy and mapping techniques and other critical model components should receive special attention. These reviews should assess the accuracy, completeness, and appropriateness of model inputs and results and focus on both finding and limiting potential errors associated with known weaknesses and identifying unknown model weaknesses. Such reviews may be conducted as part of internal or external audit programmes, by an independent risk control unit, or by an external third party.

- Adequate systems and procedures for monitoring investment limits and the risk exposures of equity investments.
- The units responsible for the design and application of the model must be functionally independent from the units responsible for managing individual investments.
- Parties responsible for any aspect of the modelling process must be adequately qualified. Management must allocate sufficient skilled and competent resources to the modelling function.

Under this method, the Bank should calculate the risk-weighted amount of its equity exposures by multiplying the potential loss of its equity exposures as derived by using its internal models (e.g. VaR models) subject to the one-tailed 99% confidence interval of the difference between quarterly returns of the exposures and an appropriate risk-free rate computed over a long-term observation period (i.e. not less than three years) by 12.5.

The risk-weighted amount calculated under the internal models method should be no less than the risk-weighted amount calculated under the simple risk weight method using a 200% risk-weight for equity exposure in a publicly traded company and a 300% risk-weight for all other equity exposures. Such minimum risk-weighted amount should be calculated separately using the simple risk-weight method at individual exposure level rather than at portfolio level.

**(Please refer to Paragraph 525, 527 and 528 of International Convergence of Capital Measurement and Capital Standards – June 2006)**

## ANNEXURE 5

**Document Enhanced: SAMA's implementation document titled "Guidance On Application Procedures, For Adoption Of The IRB Approach By Banks Licensed In Saudi Arabia":**

### **Positioning of the Paragraph in SAMA's Regulatory Documentation**

**Page 51 Guidance On Application Procedures "PD/LGD/EAD estimation", For Adoption Of The IRB Approach By Banks Licensed In Saudi Arabia**

**The original paragraph was as follows**

4.1.9 Banks may utilise internal data and data from external sources (including pooled data) in their own estimation. Where such data are used, banks should demonstrate that their estimates are representative of long run experience.

**The revised paragraph would read as follows**

Banks should make use of other quantitative validation tools and comparisons with external data sources. The analysis must be based on data that are appropriate to the portfolio, are updated regularly, and cover a relevant observation period. Banks' internal assessments of the performance of their own model must be based on long data histories, covering a range of economic conditions, and ideally one or more complete business cycles.

(Refer Paragraph 532 of International Convergence of Capital Measurement and Capital Standards – June 2006)

**Page 19, 4.6.3,(last bullet point) Guidance On Application Procedures, For Adoption Of The IRB Approach By Banks Licensed In Saudi Arabia**

The original bullet point read as follows:

**Requirements for using models:**

Banks should have procedures for management review of model-based rating assignments. Such procedures should focus on finding and limiting errors associated with model weaknesses. Banks should have a regular cycle of model

### Positioning of the Paragraph in SAMA's Regulatory Documentation

validation that includes monitoring of model performance and stability, review of model relationships, and testing of model outputs against outcomes.

**The revised bullet would read as follows :**

Since the evaluation of actual performance to expected performance over time provides a basis for banks to refine and adjust internal models on an ongoing basis, it is expected that banks using internal models will have established well-articulated model review standards. These standards are especially important for situations where actual results significantly deviate from expectations and where the validity of the internal model is called into question. These standards must take account of business cycles and similar systematic variability in equity returns. All adjustments made to internal models in response to model reviews must be well documented and consistent with the bank's model review standards.

(Refer Paragraph 534 of International Convergence of Capital Measurement and Capital Standards – June 2006)



**Document Enhanced: SAMA's Finalized Guidance Document for the Implementation of Basel II.5 , 2012**

**Positioning of the Paragraph in SAMA's Regulatory Documentation**

**The following guideline to read as part of Section 3.8 “Securitization liquidity facilities – IRB Approach”, Page 14 of the SAMA's Finalized Guidance Document for the Implementation of Basel II.5, 2012**

(In addition to the original text)

If a bank's internal assessment process is no longer considered adequate, SAMA may preclude the bank from applying the internal assessment approach to its ABCP (Asset Backed Commercial Paper) exposures, both existing and newly originated, for determining the appropriate capital treatment until the bank has remedied the deficiencies. In this instance, the bank must revert to the Supervisory Formula or, if not available, to the method described in paragraph 639, International Convergence of Capital Measurement and Capital Standards  
(Refer to Paragraph 622 of International Convergence of Capital Measurement and Capital Standards – June 2006)

**The following guideline to be included in Section G “IRB Approaches”, Page 23 of the SAMA's Finalized Guidance Document for the Implementation of Basel II.5, 2012**

(In addition to the original text)

Liquidity Facility

Liquidity facilities are treated as any other securitisation exposure and receive a CCF of 100% unless specified differently in paragraphs 638 to 641 of International Convergence of Capital Measurement and Capital Standards – June 2006. If the facility is externally rated, the bank may rely on the external rating under the RBA. If the facility is not rated and an inferred rating is not available, the bank must apply the SF, unless the IAA can be applied.

### Positioning of the Paragraph in SAMA's Regulatory Documentation

An eligible liquidity facility that can only be drawn in the event of a general market disruption as defined in paragraph 580 of International Convergence of Capital Measurement and Capital Standards – June 2006, is assigned a 20% CCF under the SF. That is, an IRB bank is to recognise 20% of the capital charge generated under the SF for the facility. If the eligible facility is externally rated, the bank may rely on the external rating under the RBA provided it assigns a 100% CCF rather than a 20% CCF to the facility.

When it is not practical for the bank to use either the bottom-up approach or the topdown approach for calculating KIRB, the bank may, on an exceptional basis and subject to SAMA's consent, temporarily be allowed to apply the following method. If the liquidity facility meets the definition in paragraph 578 or 580 of International Convergence of Capital Measurement and Capital Standards – June 2006, the highest risk weight assigned under the standardised approach to any of the underlying individual exposures covered by the liquidity facility can be applied to the liquidity facility. If the liquidity facility meets the definition in paragraph 578 of International Convergence of Capital Measurement and Capital Standards – June 2006, the CCF must be 50% for a facility with an original maturity of one year or less, or 100% if the facility has an original maturity of more than one year. If the liquidity facility meets the definition in paragraph 580 of International Convergence of Capital Measurement and Capital Standards – June 2006, the CCF must be 20%. In all other cases, the notional amount of the liquidity facility must deducted.

(Refer to Paragraph 637- 639 of International Convergence of Capital Measurement and Capital Standards – June 2006)

### **The following guideline to be included in Section G “IRB Approaches”, Page 23 of the SAMA's Finalized Guidance Document for the Implementation of Basel II.5, 2012**

(In addition to the original text)

Treatment of credit risk mitigation for securitization exposures

As with the RBA, banks are required to apply the CRM techniques as specified in the foundation IRB approach of Section III when applying the SF. The bank may reduce the capital charge proportionally when the credit risk mitigant

### Positioning of the Paragraph in SAMA's Regulatory Documentation

covers first losses or losses on a proportional basis. For all other cases, the bank must assume that the credit risk mitigant covers the most senior portion of the securitisation exposure (i.e. that the most junior portion of the securitisation exposure is uncovered). Examples for recognising collateral and guarantees under the SF are provided in Annex 7 of International Convergence of Capital Measurement and Capital Standards – June 2006.

(Refer to Paragraph 642 of International Convergence of Capital Measurement and Capital Standards – June 2006)

### **The following guideline to be included in Section G “IRB Approaches”, Page 23 of the SAMA's Finalized Guidance Document for the Implementation of Basel II.5, 2012**

(In addition to the original text)

Capital requirement for early amortization provision

An originating bank must use the methodology and treatment described in paragraphs 590 to 605 of International Convergence of Capital Measurement and Capital Standards – June 2006, for determining if any capital must be held against the investors' interest. For banks using the IRB approach to securitisation, investors' interest is defined as investors' drawn balances related to securitisation exposures and EAD associated with investors' undrawn lines related to securitisation exposures.

(Refer to Paragraph 643 of International Convergence of Capital Measurement and Capital Standards – June 2006)

### **The following guideline to be included in B “Specific Changes with regard to Market Risk Under Basel II.5” - Page 20 of the SAMA's Finalized Guidance Document for the Implementation of Basel II.5, 2012**

(In addition to the original text)

709(iii). The capital charge for specific risk is designed to protect against an adverse movement in the price of an individual security owing to factors related to the individual issuer. In measuring the risk, offsetting will be restricted to matched positions in the identical issue (including positions in derivatives). Even if the issuer is the same, no offsetting

## Positioning of the Paragraph in SAMA's Regulatory Documentation

will be permitted between different issues since differences in coupon rates, liquidity, call features, etc. mean that prices may diverge in the short run.

( Refer to Paragraph 709(iii) of International Convergence of Capital Measurement and Capital Standards – June 2006)

### **The following guideline to be included in Section 2 “Prudent valuation guidance ”, Page 70 of the SAMA's Finalized Guidance Document for the Implementation of Basel II.5, 2012**

(In addition to the original text)

The original paragraph was as follows:

Prudent valuation guidance

690. This section provides banks with guidance on prudent valuation for positions in the trading book. This guidance is especially important for less liquid positions which, although they will not be excluded from the trading book solely on grounds of lesser liquidity, raise supervisory concerns about prudent valuation.

The revised paragraph would read as follows:

Prudent valuation guidance

690). This section provides banks with guidance on prudent valuation for positions that are accounted for at fair value, whether they are in the trading book or in the banking book. This guidance is especially important for positions without actual market prices or observable inputs to valuation, as well as less liquid positions which, raise supervisory concerns about prudent valuation. The valuation guidance set forth below is not intended to require banks to change valuation procedures for financial reporting purposes. SAMA would assess a bank's valuation procedures for consistency with this guidance. One factor in a supervisor's assessment of whether a bank must take a valuation adjustment for regulatory purposes under paragraphs 718(cx) to 718(cxii) of International Convergence of Capital Measurement and Capital Standards – June 2006, should be the degree of consistency between the bank's valuation procedures and these guidelines

.(Refer to revisions to the Basel II Market Risk Framework 2010 (718 c))

## Positioning of the Paragraph in SAMA's Regulatory Documentation

**The following guideline to be included in Section 2 “Prudent valuation guidance ” (i). Systems and controls, Page 70 of the SAMA’s Finalized Guidance Document for the Implementation of Basel II.5, 2012**

(In addition to the original text)

The original paragraph was as follows:

### **Systems and controls**

692. Banks must establish and maintain adequate systems and controls sufficient to give management and supervisors the confidence that their valuation estimates are prudent and reliable. These systems must be integrated with other risk management systems within the organisation (such as credit analysis). Such systems must include:

- Documented policies and procedures for the process of valuation. This includes clearly defined responsibilities of the various areas involved in the determination of the valuation, sources of market information and review of their appropriateness, frequency of independent valuation, timing of closing prices, procedures for adjusting valuations, end of the month and ad-hoc verification procedures; and
- Clear and independent (i.e. independent of front office) reporting lines for the department accountable for the valuation process. The reporting line should ultimately be to a main board executive director.

The revised paragraph would read as follows:

692. Banks must establish and maintain adequate systems and controls sufficient to give management and SAMA the confidence that their valuation estimates are prudent and reliable. These systems must be integrated with other risk management systems within the organisation (such as credit analysis). Such systems must include:

- Documented policies and procedures for the process of valuation. This includes clearly defined responsibilities of the various areas involved in the determination of the valuation, sources of market information and review of their appropriateness, guidelines for the use of unobservable inputs reflecting the bank’s assumptions of what market participants would use in pricing the position, frequency of independent valuation, timing of closing prices, procedures for adjusting valuations, end of the month and ad-hoc verification procedures; and

## Positioning of the Paragraph in SAMA's Regulatory Documentation

- Clear and independent (ie independent of front office) reporting lines for the department accountable for the valuation process. The reporting line should ultimately be to a main board executive director.  
(Refer to revisions to the Basel II Market Risk Framework 2010 (718 cii))

### **The following guideline to be included in Section 2 “Prudent valuation guidance ” (ii) Valuation Methodologies, Marking to Market , Page 70 of the SAMA’s Finalized Guidance Document for the Implementation of Basel II.5, 2012**

(In addition to the original text)

Original paragraph was as follows:

694. Banks must mark-to-market as much as possible. The more prudent side of bid/offer must be used unless the institution is a significant market maker in a particular position type and it can close out at mid-market.

The revised paragraph would read as follows:

Banks must mark-to-market as much as possible. The more prudent side of bid/offer should be used unless the institution is a significant market maker in a particular position type and it can close out at mid-market. Banks should maximise the use of relevant observable inputs and minimise the use of unobservable inputs when estimating fair value using a valuation technique. However, observable inputs or transactions may not be relevant, such as in a forced liquidation or distressed sale, or transactions may not be observable, such as when markets are inactive. In such cases, the observable data should be considered, but may not be determinative.

(Refer to revisions to the Basel II Market Risk Framework 2010 (718 civ))

### **The following guideline to be included in Section 2 “Prudent valuation guidance ” (ii) Valuation Methodologies, Marking to Model , Page 70 of the SAMA’s Finalized Guidance Document for the Implementation of Basel II.5, 212**

## Positioning of the Paragraph in SAMA's Regulatory Documentation

(In addition to the original text)

The original paragraph was as follows

### ***Marking to model***

695. Where marking-to-market is not possible, banks may mark-to-model, where this can be demonstrated to be prudent. Marking-to-model is defined as any valuation which has to be benchmarked, extrapolated or otherwise calculated from a market input. When marking to model, an extra degree of conservatism is appropriate. Supervisory authorities will consider the following in assessing whether a mark-to-model valuation is prudent:

- Senior management should be aware of the elements of the trading book which are subject to mark to model and should understand the materiality of the uncertainty this creates in the reporting of the risk/performance of the business.
- Market inputs should be sourced, to the extent possible, in line with market prices (as discussed above). The appropriateness of the market inputs for the particular position being valued should be reviewed regularly.
- Where available, generally accepted valuation methodologies for particular products should be used as far as possible.
- Where the model is developed by the institution itself, it should be based on appropriate assumptions, which have been assessed and challenged by suitably qualified parties independent of the development process. The model should be developed or approved independently of the front office. It should be independently tested. This includes validating the mathematics, the assumptions and the software implementation.
- There should be formal change control procedures in place and a secure copy of the model should be held and periodically used to check valuations.
-

## Positioning of the Paragraph in SAMA's Regulatory Documentation

- Risk management should be aware of the weaknesses of the models used and how best to reflect those in the valuation output.
- The model should be subject to periodic review to determine the accuracy of its performance (e.g. assessing continued appropriateness of the assumptions, analysis of P&L versus risk factors, comparison of actual close out values to model outputs).
- Valuation adjustments should be made as appropriate, for example, to cover the uncertainty of the model valuation (see also valuation adjustments in 698 to 701).

The revised paragraph would read as follow

Only where marking-to-market is not possible, should banks mark-to-model, but this must be demonstrated to be prudent. Marking-to-model is defined as any valuation which has to be benchmarked, extrapolated or otherwise calculated from a market input. When marking to model, an extra degree of conservatism is appropriate. Supervisory authorities will consider the following in assessing whether a mark-to-model valuation is prudent:

- Senior management should be aware of the elements of the trading book or of other fair-valued positions which are subject to mark to model and should understand the materiality of the uncertainty this creates in the reporting of the risk/performance of the business.
- Market inputs should be sourced, to the extent possible, in line with market prices (as discussed above). The appropriateness of the market inputs for the particular position being valued should be reviewed regularly.
- Where available, generally accepted valuation methodologies for particular products should be used as far as possible.



### Positioning of the Paragraph in SAMA's Regulatory Documentation

- Where the model is developed by the institution itself, it should be based on appropriate assumptions, which have been assessed and challenged by suitably qualified parties independent of the development process. The model should be developed or approved independently of the front office. It should be independently tested. This includes validating the mathematics, the assumptions and the software implementation.
- There should be formal change control procedures in place and a secure copy of the model should be held and periodically used to check valuations.
- Risk management should be aware of the weaknesses of the models used and how best to reflect those in the valuation output.
- The model should be subject to periodic review to determine the accuracy of its performance (eg assessing continued appropriateness of the assumptions, analysis of P&L versus risk factors, comparison of actual close out values to model outputs).
- Valuation adjustments should be made as appropriate, for example, to cover the uncertainty of the model valuation (see also valuation adjustments in 698 to 701).  
(Refer to revisions to the Basel II Market Risk Framework 2010 (718 cv))

**The following guideline to be included in Section 2 “Prudent valuation guidance ” (iii) Valuation adjustments or reserves , Page 71/72 of the SAMA’s Finalized Guidance Document for the Implementation of Basel II.5, 2012**  
(In addition to the original text)

The original paragraph was as follows:

698. Banks must establish and maintain procedures for considering valuation adjustments/reserves. Supervisory authorities expect banks using third-party valuations to consider whether valuation adjustments are necessary. Such

## Positioning of the Paragraph in SAMA's Regulatory Documentation

considerations are also necessary when marking to model.

The revised paragraph would read as follow

698. As part of their procedures for marking to market, banks must establish and maintain procedures for considering valuation adjustments/reserves. Supervisory authorities expect banks using third-party valuations to consider whether valuation adjustments are necessary. Such considerations are also necessary when marking to model. (Refer to revisions to the Basel II Market Risk Framework 2010 (718 cviii))

**The following guideline would be a new subsection to be included in Section 2 “Prudent valuation guidance ” (iv) Adjustment to the current valuation of less liquid positions for regulatory capital purposes , Page 71/72 of the SAMA’s Finalized Guidance Document for the Implementation of Basel II.5, 2012**

Adjustment to the current valuation of less liquid positions for regulatory capital purposes

701 A. Banks must establish and maintain procedures for judging the necessity of and calculating an adjustment to the current valuation of less liquid positions for regulatory capital purposes. This adjustment may be in addition to any changes to the value of the position required for financial reporting purposes and should be designed to reflect the illiquidity of the position. SAMA expect banks to consider the need for an adjustment to a position’s valuation to reflect current illiquidity whether the position is marked to market using market prices or observable inputs, third-party valuations or marked to model.

Bearing in mind that assumptions made about liquidity in the market risk capital charge may not be consistent with the bank’s ability to sell or hedge out less liquid positions where appropriate, banks must take an adjustment to the current valuation of these positions, and review their continued appropriateness on an on-going basis. Reduced liquidity may have arisen from market events. Additionally, close-out prices for concentrated positions and/or stale positions should be considered in establishing the adjustment. Banks must consider all relevant factors when determining the

### Positioning of the Paragraph in SAMA's Regulatory Documentation

appropriateness of the adjustment for less liquid positions. These factors may include, but are not limited to, the amount of time it would take to hedge out the position/risks within the position, the average volatility of bid/offer spreads, the availability of independent market quotes (number and identity of market makers), the average and volatility of trading volumes (including trading volumes during periods of market stress), market concentrations, the aging of positions, the extent to which valuation relies on marking-to-model, and the impact of other model risks not included in paragraph 718 (cx), the Basel II Market Risk Framework 2010.

For complex products including, but not limited to, securitisation exposures and n-th-to-default credit derivatives, banks must explicitly assess the need for valuation adjustments to reflect two forms of model risk: the model risk associated with using a possibly incorrect valuation methodology; and the risk associated with using unobservable (and possibly incorrect) calibration parameters in the valuation model.

The adjustment to the current valuation of less liquid positions made under paragraph 718 (cxi), the Basel II Market Risk Framework 2010, must impact Tier 1 regulatory capital and may exceed those valuation adjustments made under financial reporting standards and paragraphs 718 (cviii) and 718 (cix), the Basel II Market Risk Framework 2010 (Refer to revisions to the Basel II Market Risk Framework 2010 (718 cx))

### **The following guideline to be included in B “Specific Changes with regard to Market Risk Under Basel II.5”, Page 20 of the SAMA's Finalized Guidance Document for the Implementation of Basel II.5, 2012**

(In addition to the original text)

Original Paragraph to be deleted:

- Para 709 (ii)1 relating to co-relation Trading portfolio – refer to para 709.
- Para 709 (ii-1)1: Transitional period to 31/12/2013 for securitized exposure which are not included in the co-relation trading portfolio according to para 709ii.
- Para 712 (ii)1 of the Basel II Framework relating to specific risk for unrated securitized securities will be amended.

## Positioning of the Paragraph in SAMA's Regulatory Documentation

- Changes as per para 712iii.

The amended paragraph would read as follows:

709(ii). The minimum capital requirement is expressed in terms of two separately calculated charges, one applying to the “specific risk” of each security, whether it is a short or a long position, and the other to the interest rate risk in the portfolio (termed “general market risk”) where long and short positions in different securities or instruments can be offset. The bank must, however, determine the specific risk capital charge for the correlation trading portfolio as follows: The bank computes (i) the total specific risk capital charges that would apply just to the net long positions from the net long correlation trading exposures combined, and (ii) the total specific risk capital charges that would apply just to the net short positions from the net short correlation trading exposures combined. The larger of these total amounts is then the specific risk capital charge for the correlation trading portfolio.

709(ii-1-). During a transitional period until 31 December 2013, the bank may exclude positions in securitisation instruments which are not included in the correlation trading portfolio from the calculation according to paragraph 709(ii) and determine the specific risk capital charge as follows: The bank computes (i) the total specific risk capital charge that would apply just to the net long positions in securitisation instruments in the trading book, and (ii) the total specific risk capital charge that would apply just to the net short positions in securitisation instruments in the trading book. The larger of these total amounts is then the specific risk capital charge for the securitisation positions in the trading book. This calculation must be undertaken separately from the calculation for the correlation trading portfolio.

709(iii). The capital charge for specific risk is designed to protect against an adverse movement in the price of an individual security owing to factors related to the individual issuer. In measuring the risk, offsetting will be restricted to matched positions in the identical issue (including positions in derivatives). Even if the issuer is the same, no offsetting will be permitted between different issues since differences in coupon rates, liquidity, call features, etc. mean that prices may diverge in the short run. **(This clause is also referred to in a row above, in this annexure)**

## Positioning of the Paragraph in SAMA's Regulatory Documentation

712(ii). However, since this may in certain cases considerably underestimate the specific risk for debt instruments which have a high yield to redemption relative to government debt securities, SAMA will have the discretion:

- To apply a higher specific risk charge to such instruments; and/or
- To disallow offsetting for the purposes of defining the extent of general market risk between such instruments and any other debt instruments.

(Refer to Paragraph 709(ii), 709(ii-1-), and 712(ii) of Revisions to the Basel II Market Risk Framework – Dec 2010.)

(Refer to Paragraph 709(iii) International Convergence of Capital Measurement and Capital Standards – June 2006)

### **The following guideline to be included in 718(xxi) “Specific and general Market Risk”, Page 87 of the SAMA's Finalized Guidance Document for the Implementation of Basel II.5, 2012**

(In addition to the original text)

Original Paragraph to be deleted:

718 (xxi)The capital charge for specific risk will be 8%, unless the portfolio is both liquid and well-diversified, in which case the charge will be 4%. Given the different characteristics of national markets in terms of marketability and concentration, national authorities will have discretion to determine the criteria for liquid and diversified portfolios. The general market risk charge will be 8%.

The amended paragraph would reads as follows:

The capital charge for specific risk and for general market risk will each be 8%.

(Refer to Paragraph 718(xxi) of Revisions to the Basel II Market Risk Framework – Dec 2010.)

**Document Enhanced: Detailed Guidelines Notes on the Maintenance of Adequate Capital Against Market Risk by Saudi Banks, 2004**

**Positioning of the Paragraph in SAMA's Regulatory Documentation**

**The following guideline to be included in Section 4.3 “Qualitative Standards” (b), Page 46 of the SAMA's Detailed Guidelines Notes on the Maintenance of Adequate Capital Against Market Risk by Saudi Banks, 2004**  
**Qualitative Standards**

The unit should also conduct the initial and on-going validation of the internal model.

The following footnotes to be included in **Section 4.3 Qualitative Standards of the SAMA's Detailed Guidelines Notes on the Maintenance of Adequate Capital Against Market Risk by Saudi Banks, 2004**

**Page 46 Section 4.3 (b)** - Further guidance regarding the standards that SAMA will expect can be found in paragraph 718(xcix) of Revisions to the Basel II market risk framework – Dec 2010

**Page 46 Section 4.3 (c)** - The report, Risk management guidelines for derivatives, issued by the Basel Committee in July 1994 further discusses the responsibilities of the board of directors and senior management.

**Page 47 Section 4.3 (f)** - Though banks will have some discretion as to how they conduct stress tests, their SAMA will wish to see that they follow the general lines set out in paragraphs 718(Lxxvii) to 718(Lxxxiii) of Revisions to the Basel II market risk framework – Dec 2010f

(Refer to Paragraph 718(Lxxiv) of Revisions to the Basel II market risk framework – Dec 2010)

**The following guideline is added to Section 4.4 “Specification of Market Risk Factors” (a), Page 48 of the SAMA's Detailed Guidelines Notes on the Maintenance of Adequate Capital Against Market Risk by Saudi Banks, 2004**

## Positioning of the Paragraph in SAMA's Regulatory Documentation

### Specification of market risk factors

(a) Factors that are deemed relevant for pricing should be included as risk factors in the value-at-risk model. Where a risk factor is incorporated in a pricing model but not in the value-at-risk model, the bank must justify this omission to the satisfaction of SAMA. In addition, the value-at-risk model must capture nonlinearities for options and other relevant products (e.g. mortgage-backed securities, tranching exposures or n-th-to-default credit derivatives), as well as correlation risk and basis risk (e.g. between credit default swaps and bonds). Moreover, SAMA has to be satisfied that proxies are used which show a good track record for the actual position held (i.e. an equity index for a position in an individual stock).

(Refer to Paragraph 718(Lxxv)(a) of Revisions to the Basel II Market Risk Frameworks – Dec 2010)

### The following guideline to be included in Section 4.5 “Quantitative Standards”, Page 50 of the SAMA's Detailed Guidelines Notes on the Maintenance of Adequate Capital Against Market Risk by Saudi Banks, 2004

#### Quantitative standards

Original Paragraph to be deleted:

(c) In calculating value-at-risk, an instantaneous price shock equivalent to a 10 days movement in prices is to be used, i.e. the minimum “holding period” will be ten trading days. Banks may use value-at-risk numbers calculated according to shorter holding periods scaled up to ten days by the square root of time (for the treatment of options, also see (h) below).

The amended paragraph would read as follows:

(c) In calculating value-at-risk, an instantaneous price shock equivalent to a 10 days movement in prices is to be used, i.e. the minimum “holding period” will be ten trading days. Banks may use value-at-risk numbers calculated according to shorter holding periods scaled up to ten days by the square root of time (for the treatment of options, also see (h) below). A bank using this approach must periodically justify the reasonableness of its approach to the satisfaction of SAMA.

## Positioning of the Paragraph in SAMA's Regulatory Documentation

Original Paragraph to be deleted:

(e) Banks should update their data sets no less frequently than once every three months and should also reassess them whenever market prices are subject to material changes. SAMA may also require a bank to calculate its value-at-risk using a shorter observation period if, in SAMA's judgment, this is justified by a significant upsurge in price volatility.

The amended paragraph would read as follows:

(e) Banks should update their data sets no less frequently than once every three months and should also reassess them whenever market prices are subject to material changes. This updating process must be flexible enough to allow for more frequent updates. SAMA may also require a bank to calculate its value-at-risk using a shorter observation period if, in the SAMA's judgment, this is justified by a significant upsurge in price volatility.

Original Paragraph to be deleted:

(i) 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 measure 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.

The amended paragraph would read as follows:

(i) 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 measure 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.

In addition, a bank must calculate a 'stressed value-at-risk' measure. This measure is intended to replicate a value-at-risk calculation that would be generated on the bank's current portfolio if the relevant market factors were experiencing a period of stress; and should therefore be based on the 10-day, 99th percentile, one-tailed confidence interval value-at-risk measure of the current portfolio, with model inputs calibrated to historical data from a continuous 12-month period of significant financial stress relevant to the bank's portfolio. The period used must be approved by SAMA and regularly



## Positioning of the Paragraph in SAMA's Regulatory Documentation

reviewed. As an example, for many portfolios, a 12-month period relating to significant losses in 2007/2008 would adequately reflect a period of such stress; although other periods relevant to the current portfolio must be considered by the bank.

As no particular model is prescribed under paragraph (f) above, different techniques might need to be used to translate the model used for value-at-risk into one that delivers a stressed value-at-risk. For example, banks should consider applying anti-thetic<sup>14</sup> data, or applying absolute rather than relative volatilities to deliver an appropriate stressed value-at-risk. The stressed value-at-risk should be calculated at least weekly.

Each bank must meet, on a daily basis, a capital requirement expressed as the sum of:

- The higher of (1i) its previous day's value-at-risk number measured according to the parameters specified in this section ( $VaR_{t-1}$ ); and (2ii) an average of the daily value-at-risk measures on each of the preceding sixty business days ( $VaR_{avg}$ ), multiplied by a multiplication factor ( $m_c$ );  
plus.
- The higher of (1) its latest available stressed-value-at-risk number calculated according to (i) above ( $sVaR_{t-1}$ ); and (2) an average of the stressed value-at-risk numbers calculated according to (i) above over the preceding sixty business days ( $sVaR_{avg}$ ), multiplied by a multiplication factor ( $m_s$ ).

Therefore, the capital requirement ( $c$ ) is calculated according to the following formula:

$$c = \max \{ VaR_{t-1}; m_c \cdot VaR_{avg} \} + \max \{ sVaR_{t-1}; m_s \cdot sVaR_{avg} \}$$

Original Paragraph to be deleted:

(j) The multiplication factor will be set by SAMA on the basis of their assessment of the quality of the bank's risk management system, subject to an absolute minimum of 3. Banks will be required to add to this factor a "plus" directly related to the ex-post performance of the model, thereby introducing a built-in positive incentive to keep high the predictive quality of the model. The plus will range from 0 to 1 based on the outcome of so-called "backtesting". If the

## Positioning of the Paragraph in SAMA's Regulatory Documentation

backtesting results are satisfactory and the bank meets all of the qualitative and quantitative standards the plus factor could be zero.

In specific the following methods is to be appropriated:

### Multiplication Factor

The multiplication factor is the summation of the following three elements.

- (a) The minimum multiplication factor of 3;
- (b) The "plus" factor ranging from 0 to 1 based on the number of back testing exceptions in the past 250 trading days as set out in Table below, or the backtesting "plus" factor agreed with SAMA; and
- (c) Any additional "plus" factor as agreed with SAMA

### "Plus" Factor Based on the Number of Backtesting

#### Exceptions for the Past 250 Trading Days

#### Number of Exceptions "Plus" factor

0	0.00
1	0.00

#### Green zone

2	0.00
3	0.00
4	0.00
5	0.40

### Positioning of the Paragraph in SAMA's Regulatory Documentation

6	0.50
Yellow zone	
7	0.65
8	0.75
9	0.85
Red zone	
10 or more	1.00

The amended paragraph would read as follows:

The multiplication factors  $m_c$  and  $m_s$  will be set by SAMA on the basis of their assessment of the quality of the bank's risk management system, subject to an absolute minimum of 3 for  $m_c$  and an absolute minimum of 3 for  $m_s$ . Banks will be required to add to these factors a "plus" directly related to the ex-post performance of the model, thereby introducing a built-in positive incentive to maintain the predictive quality of the model. The plus will range from 0 to 1 based on the outcome of so-called "backtesting." The backtesting results applicable for calculating the plus are based on value-at-risk only and not stressed value-at-risk. If the backtesting results are satisfactory and the bank meets all of the qualitative standards set out in paragraph 718(Lxxiv), Revisions to the Basel II Market Risk Frameworks – Dec 2010, the plus factor could be zero. The Annex 10a of this Framework (International Convergence of Capital Measurement and Capital Standards – June 2006) presents in detail the approach to be applied for backtesting and the plus factor. SAMA will have national discretion to require banks to perform backtesting on either hypothetical (i.e. using changes in portfolio value that would occur were end-of-day positions to remain unchanged), or actual trading (i.e. excluding fees, commissions, and net interest income) outcomes, or both.

Original Paragraph to be deleted:

(k) As stated earlier in Section 4.1 banks using models will be subject to a separate capital charge to cover the specific risk of interest rate related instruments and equity securities as defined in the standardized approach to the extent that

## Positioning of the Paragraph in SAMA's Regulatory Documentation

this risk is not incorporated into their models. However, for banks using models, the total specific risk charge applied to interest rate related instruments or to equities should in no case be less than half the specific risk charges calculated according to the standardized methodology.

The amended paragraph would read as follows:

Banks using models will also be subject to a capital charge to cover specific risk (as defined under the standardised approach for market risk) of interest rate related instruments and equity securities. The manner in which the specific risk capital charge is to be calculated is set out in paragraphs 718(Lxxxvii) to 718(xcviii) , Revisions to the Basel II Market Risk Frameworks – Dec 2010

The following footnotes to be included in Section 4.5 of the SAMA's Detailed Guidelines Notes on the Maintenance of Adequate Capital Against Market Risk by Saudi Banks, 2004

**Page 50 Section 4.5 (d)** - A bank may calculate the value-at-risk estimate using a weighting scheme that is not fully consistent with (d) as long as that method results in a capital charge at least as conservative as that calculated according to (d)

**Page 52 Section 4.5 (j)** - Firms should consider modelling valuation changes that are based on the magnitude of historic price movements, applied in both directions – irrespective of the direction of the historic movement.  
(Refer to Paragraph 718(Lxxvi) of Revisions to the Basel II Market Risk Frameworks – Dec 2010)

**The following guidelines to be included in Section 4.9 “Combination of Internal Models and the Standardized Methodology” point (a) Pg 58 of the SAMA's Detailed Guidelines Notes on the Maintenance of Adequate Capital Against Market Risk by Saudi Banks, 2004**  
(The following is added to the original content)

### Positioning of the Paragraph in SAMA's Regulatory Documentation

However, banks may incur risks in positions which are not captured by their models, for example, in remote locations, in minor currencies or in negligible business areas. Such risks should be measured according to the standardised methodology

(Refer to Paragraph 718(Lxxxvi) of Revisions to the Basel II market risk framework – Dec 2010)

The following guidelines to be included in Section 4.7” Stress Testing” (a)Scenarios requiring no simulations by the bank, Pg 56 of the SAMA's Detailed Guidelines Notes on the Maintenance of Adequate Capital Against Market Risk by Saudi Banks, 2004

The original paragraph was as follows

Scenarios requiring a simulation by the bank.

Banks should subject their portfolios to a series of simulated stress scenarios and provide SAMA with the results. These scenarios could include testing the current portfolio against past periods of significant disturbance, for example the 1987 equity crash, the ERM crisis of 1993 or the fall in bond markets in the first quarter of 1994, incorporating both the large price movements and the sharp reduction in liquidity associated with these events. A second type of scenario would evaluate the sensitivity of the bank's market risk exposure to changes in the assumptions about volatilities and correlation. Applying this test would require an evaluation of the historical range of variation for volatilities and correlation's and evaluation of the bank's current positions against the extreme values of the historical range. Due consideration should be given to the sharp variation that at times has occurred in a matter of days in periods of significant market disturbance. The 1987 equity crash, the suspension of the ERM, or the fall in bond markets in the first quarter of 1994, for example, all involved correlation within risk factors approaching the extreme values of 1 or -1 for several days at the height of the disturbance.

## Positioning of the Paragraph in SAMA's Regulatory Documentation

The revised paragraph would read as follows:

Scenarios requiring a simulation by the bank

Banks should subject their portfolios to a series of simulated stress scenarios and provide SAMA with the results. These scenarios could include testing the current portfolio against past periods of significant disturbance, for example, the 1987 equity crash, the Exchange Rate Mechanism crises of 1992 and 1993 or, the fall in bond markets in the first quarter of 1994, the 1998 Russian financial crisis, the 2000 bursting of the technology stock bubble or the 2007/2008 sub-prime crisis, incorporating both the large price movements and the sharp reduction in liquidity associated with these events. A second type of scenario would evaluate the sensitivity of the bank's market risk exposure to changes in the assumptions about volatilities and correlations. Applying this test would require an evaluation of the historical range of variation for volatilities and correlations and evaluation of the bank's current positions against the extreme values of the historical range. Due consideration should be given to the sharp variation that at times has occurred in a matter of days in periods of significant market disturbance. For example, the above-mentioned situations involved correlations within risk factors approaching the extreme values of 1 or -1 for several days at the height of the disturbance.

(Refer to Paragraph 718 (Lxxxii) of Revisions to the Basel II Market Risk Frameworks – Dec 2010)

**The following guidelines to be included as a separate section "Treatment of specific risk" on Pg 53 of the SAMA's Detailed Guidelines Notes on the Maintenance of Adequate Capital Against Market Risk by Saudi Banks, 2004 as a replacement of the original section 4.6, Specific Risk Calculation, Pg 53 of the SAMA's Detailed Guidelines Notes on the Maintenance of Adequate Capital Against Market Risk by Saudi Banks, 2004.**

Where a bank has a VaR measure that incorporates specific risk from equity risk positions and where the supervisor has determined that the bank meets all the qualitative and quantitative requirements for general market risk models, as well as the additional criteria and requirements set out in paragraphs 718(Lxxxviii) to 718(xci-2-) Revisions to the Basel II market risk framework – Dec 2010, the bank is not required to subject its equity positions to the capital charge according

## Positioning of the Paragraph in SAMA's Regulatory Documentation

to the standardised measurement method as specified in paragraphs 718(xix) to 718(xxviii) Revisions to the Basel II market risk framework – Dec 2010.

For interest rate risk positions other than securitisation exposures and n-th-to-default credit derivatives, the bank will not be required to subject these positions to the standardised capital charge for specific risk, as specified in paragraphs 709(ii) to 718, Revisions to the Basel II market risk framework – Dec 2010, when all of the following conditions hold:

- The bank has a value-at-risk measure that incorporates specific risk and SAMA has determined that the bank meets all the qualitative and quantitative requirements for general market risk models, as well as the additional criteria and requirements set out in paragraphs 718(Lxxxviii) to 718(xci-2-) , Revisions to the Basel II market risk framework – Dec 2010; and
- SAMA is satisfied that the bank's internally developed approach adequately captures incremental default and migration risks for positions subject to specific interest rate risk according to the standards laid out in paragraphs 718(xcii) and 718(xciii), Revisions to the Basel II market risk framework – Dec 2010.

The bank is allowed to include its securitisation exposures and n-th-to-default credit derivatives in its value-at-risk measure. Notwithstanding, it is still required to hold additional capital for these products according to the standardised measurement methodology, with the exceptions noted in paragraphs 718(xcv) to 718(xcviii) , Revisions to the Basel II market risk framework – Dec 2010.

### **Treatment of specific risk**

The criteria for supervisory recognition of banks' modelling of specific risk require that a bank's model must capture all material components of price risk. Banks need not capture default and migration risks for positions subject to the incremental risk capital charge referred to in paragraphs 718(xcii) and 718(xciii) Revisions to the Basel II market risk framework – Dec 2010) and be responsive to changes in market conditions and compositions of portfolios. In particular,

## Positioning of the Paragraph in SAMA's Regulatory Documentation

the model must:

- Explain the historical price variation in the portfolio; (The key ex ante measures of model quality are “goodness-of-fit” measures which address the question of how much of the historical variation in price value is explained by the risk factors included within the model. One measure of this type which can often be used is an R-squared measure from regression methodology. If this measure is to be used, the risk factors included in the bank’s model would be expected to be able to explain a high percentage, such as 90%, of the historical price variation or the model should explicitly include estimates of the residual variability not captured in the factors included in this regression. For some types of models, it may not be feasible to calculate a goodness-of-fit measure. In such instance, a bank is expected to work with SAMA to define an acceptable alternative measure which would meet this regulatory objective.)
- Capture concentrations (magnitude and changes in composition); (The bank would be expected to demonstrate that the model is sensitive to changes in portfolio construction and that higher capital charges are attracted for portfolios that have increasing concentrations in particular names or sectors.)
- Be robust to an adverse environment; (The bank should be able to demonstrate that the model will signal rising risk in an adverse environment. This could be achieved by incorporating in the historical estimation period of the model at least one full credit cycle and ensuring that the model would not have been inaccurate in the downward portion of the cycle. Another approach for demonstrating this is through simulation of historical or plausible worst-case environments.)
- Capture name-related basis risk; (Banks should be able to demonstrate that the model is sensitive to material idiosyncratic differences between similar but not identical positions, for example debt positions with different levels of subordination, maturity mismatches, or credit derivatives with different default events.)
- Capture event risk;( For equity positions, events that are reflected in large changes or jumps in prices must be captured, e.g. merger break-ups/takeovers. In particular, firms must consider issues related to survivorship bias.)



## Positioning of the Paragraph is SAMA's Regulatory Documentation

- Be validated through backtesting (Aimed at assessing whether specific risk, as well as general market risk, is being captured adequately.)

The bank's model must conservatively assess the risk arising from less liquid positions and/or positions with limited price transparency under realistic market scenarios. In addition, the model must meet minimum data standards. Proxies may be used only where available data is insufficient or is not reflective of the true volatility of a position or portfolio, and only where they are appropriately conservative.

Further, as techniques and best practices evolve, banks should avail themselves of these advances.

1- Banks which apply modelled estimates of specific risk are required to conduct backtesting aimed at assessing whether specific risk is being accurately captured. The methodology a bank should use for validating its specific risk estimates is to perform separate backtests on sub-portfolios using daily data on sub-portfolios subject to specific risk. The key sub-portfolios for this purpose are traded-debt and equity positions. However, if a bank itself decomposes its trading portfolio into finer categories (e.g. emerging markets, traded corporate debt, etc.), it is appropriate to keep these distinctions for sub-portfolio backtesting purposes. Banks are required to commit to a sub-portfolio structure and stick to it unless it can be demonstrated to SAMA that it would make sense to change the structure.

2- Banks are required to have in place a process to analyse exceptions identified through the backtesting of specific risk. This process is intended to serve as the fundamental way in which banks correct their models of specific risk in the event they become inaccurate. There will be a presumption that models that incorporate specific risk are “unacceptable” if the results at the sub-portfolio level produce a number of exceptions commensurate with the Red Zone as defined in Annex 10a of this Framework (International Convergence of Capital Measurement and Capital Standards – June 2006). Banks with “unacceptable” specific risk models are expected to take immediate action to correct the problem in the model and to ensure that there is a sufficient capital buffer to absorb the risk that the backtest showed had not been adequately captured.

## Positioning of the Paragraph in SAMA's Regulatory Documentation

In addition,

The bank must have an approach in place to capture in its regulatory capital default risk and migration risk in positions subject to a capital charge for specific interest rate risk, with the exception of securitisation exposures and n-th-to-default credit derivatives, that are incremental to the risks captured by the VaR-based calculation as specified in paragraph 718(Lxxxviii) of Revisions to the Basel II market risk framework – Dec 2010 (“incremental risks”). No specific approach for capturing the incremental default risks is prescribed; The Committee provides guidelines to specify the positions and risks to be covered by this incremental risk capital charge. meets its aim.

The bank must demonstrate that the approach used to capture incremental risks meets a soundness standard comparable to that of the internal-ratings based approach for credit risk as set forth in this Framework, under the assumption of a constant level of risk, and adjusted where appropriate to reflect the impact of liquidity, concentrations, hedging, and optionality. A bank that does not capture the incremental default risks through an internally developed approach must use the specific risk capital charges under the standardised measurement method as set out in paragraphs 710 to 718 and 718(xxi) of Revisions to the Basel II market risk framework – Dec 2010 / International Convergence of Capital Measurement and Capital Standards – June 2006 (for paragraph not superceded by Revisions to the Basel II market risk framework, 2010).

Subject to SAMA's approval, a bank may incorporate its correlation trading portfolio in an internally developed approach that adequately captures not only incremental default and migration risks, but all price risks (“comprehensive risk measure”). The value of such products is subject in particular to the following risks which must be adequately captured:

- the cumulative risk arising from multiple defaults, including the ordering of defaults, in tranching products;
- credit spread risk, including the gamma and cross-gamma effects;
- volatility of implied correlations, including the cross effect between spreads and correlations;
- basis risk, including both:

### Positioning of the Paragraph in SAMA's Regulatory Documentation

- the basis between the spread of an index and those of its constituent single names; and
- the basis between the implied correlation of an index and that of bespoke portfolios;
- recovery rate volatility, as it relates to the propensity for recovery rates to affect tranche prices; and
- to the extent the comprehensive risk measure incorporates benefits from dynamic hedging, the risk of hedge slippage and the potential costs of rebalancing such hedges.

The approach must meet all of the requirements specified in paragraphs 718(XCiii), 718(XCvi) and 718(xcvii) of Revisions to the Basel II market risk framework – Dec 2010. This exception only applies to banks that are active in buying and selling these products. For the exposures that the bank does incorporate in this internally developed approach, the bank will be required to subject them to a capital charge equal to the higher of the capital charge according to this internally developed approach and 8% of the capital charge for specific risk according to the standardised measurement method. It will not be required to subject these exposures to the treatment according to paragraph 718(XCiii) of Revisions to the Basel II market risk framework – Dec 2010. It must, however, incorporate them in both the value-at-risk and stressed value-at-risk measures

For a bank to apply this exception, it must

- Have sufficient market data to ensure that it fully captures the salient risks of these exposures in its comprehensive risk measure in accordance with the standards set forth above;
- Demonstrate (for example, through backtesting) that its risk measures can appropriately explain the historical price variation of these products; and
- Ensure that it can separate the positions for which it holds approval to incorporate them in its comprehensive risk measure from those positions for which it does not hold this approval.

In addition to these data and modelling criteria, for a bank to apply this exception it must regularly apply a set of specific, predetermined stress scenarios to the portfolio that receives internal model regulatory capital treatment (i.e., the 'correlation trading portfolio'). These stress scenarios will examine the implications of stresses to (i) default rates, (ii)

### Positioning of the Paragraph in SAMA's Regulatory Documentation

recovery rates, (iii) credit spreads, and (iv) correlations on the correlation trading desk's P&L. The bank must apply these stress scenarios at least weekly and report the results, including comparisons with the capital charges implied by the banks' internal model for estimating comprehensive risks, at least quarterly to SAMA. Any instances where the stress tests indicate a material shortfall of the comprehensive risk measure must be reported to SAMA in a timely manner. Based on these stress testing results, SAMA may impose a supplemental capital charge against the correlation trading portfolio, to be added to the bank's internally modelled capital requirement. For guidance on conducting stress tests for correlation trading portfolio, refer Annex of Revisions to the Basel II market risk framework – Dec 2010.

A bank must calculate the incremental risk measure according to paragraph 718(xcii) of Revisions to the Basel II market risk framework – Dec 2010, and the comprehensive risk measure according to paragraph 718(xcv) of Revisions to the Basel II market risk framework – Dec 2010, at least weekly, or more frequently as directed by SAMA. The capital charge for incremental risk is given by a scaling factor of 1.0 times the maximum of (i) the average of the incremental risk measures over 12 weeks; and (ii) the most recent incremental risk measure. Likewise, the capital charge for comprehensive risk is given by a scaling factor of 1.0 times the maximum of (i) the average of the comprehensive risk measures over 12 weeks; and (ii) the most recent comprehensive risk measure. Both capital charges are added up. There will be no adjustment for double counting between the comprehensive risk measure and any other risk measures. (Refer to Paragraph 718(xc) of Revisions to the Basel II market risk framework – Dec 2010)

The following guidelines to be included as a separate section "Model Validation Standards" on Pg 55 of the SAMA's Detailed Guidelines Notes on the Maintenance of Adequate Capital Against Market Risk by Saudi Banks, 2004

#### **Model Validation Standards**

It is important that banks have processes in place to ensure that their internal models have been adequately validated by suitably qualified parties independent of the development process to ensure that they are conceptually sound and adequately capture all material risks. This validation should be conducted when the model is initially developed and when any significant changes are made to the model. The validation should also be conducted on a periodic basis but

## Positioning of the Paragraph in SAMA's Regulatory Documentation

especially where there have been any significant structural changes in the market or changes to the composition of the portfolio which might lead to the model no longer being adequate. More extensive model validation is particularly important where specific risk is also modelled and is required to meet the further specific risk criteria. As techniques and best practices evolve, banks should avail themselves of these advances. Model validation should not be limited to backtesting, but should, at a minimum, also include the following:

(a) Tests to demonstrate that any assumptions made within the internal model are appropriate and do not underestimate risk. This may include the assumption of the normal distribution, the use of the square root of time to scale from a one day holding period to a 10 day holding period or where extrapolation or interpolation techniques are used, or pricing models;

(b) Further to the regulatory backtesting programmes, testing for model validation should be carried out using additional tests, which may include, for instance:

- Testing carried out using hypothetical changes in portfolio value that would occur were end-of-day positions to remain unchanged. It therefore excludes fees, commissions, bid-ask spreads, net interest income and intra-day trading;
- Testing carried out for longer periods than required for the regular backtesting programme (e.g. 3 years). The longer time period generally improves the power of the backtesting. A longer time period may not be desirable if the VaR model or market conditions have changed to the extent that historical data is no longer relevant;
- Testing carried out using confidence intervals other than the 99 percent interval required under the quantitative standards;
- Testing of portfolios below the overall bank level;

(c) The use of hypothetical portfolios to ensure that the model is able to account for particular structural features that may arise, for example:

Where data histories for a particular instrument do not meet the quantitative standards in paragraph 718(Lxxvi) and where the bank has to map these positions to proxies, then the bank must ensure that the proxies produce

### Positioning of the Paragraph in SAMA's Regulatory Documentation

conservative results under relevant market scenarios;

- Ensuring that material basis risks are adequately captured. This may include mismatches between long and short positions by maturity or by issuer;
- Ensuring that the model captures concentration risk that may arise in an undiversified portfolio.

(Refer to Paragraph 718(xcix) of Revisions to the Basel II market risk framework – Dec 2010)

**Document Enhanced: Basel II Guidance Document Pillar 2 Supervisory Review Process, 2007**

**Positioning of the Paragraph in SAMA's Regulatory Documentation**

**The following guidelines to be included in Pg 5 Section 1.2 “Background and Scope” of the SAMA's Basel II Guidance Document Pillar 2 Supervisory Review Process, 2007**

(In addition to the original text)

SAMA requires formal interaction intended to foster an active dialogue between banks and SAMA such that when deficiencies are identified, prompt and decisive action can be taken to reduce risk or restore capital.

Accordingly, SAMA may adopt an approach to focus more intensely on those banks with risk profiles or operational experience that warrants such attention.

(Refer to Paragraph 722 of International Convergence of Capital Measurement and Capital Standards – June 2006)

**The following guidelines to be included in Pg 6 Section 2.3 “Determination of the minimum CAR and or other supervisory measures” of the SAMA's Basel II Guidance Document Pillar 2 Supervisory Review Process, 2007**

(In addition to the original text)

Other means for addressing risk, such as strengthening risk management, applying internal limits, strengthening the level of provisions and reserves, and improving internal controls, would also be considered by SAMA

## Positioning of the Paragraph in SAMA's Regulatory Documentation

(Refer to Paragraph 723 of International Convergence of Capital Measurement and Capital Standards – June 2006)

### **The following guidelines to be included in Pg 8 Section 5.3 “Preliminary Assessment of Inherent additional Risks” of the SAMA's Basel II Guidance Document Pillar 2 Supervisory Review Process, 2007**

(In addition to the original text)

A further important aspect of Pillar 2 is the assessment of compliance with the minimum standards and disclosure requirements of the more advanced methods in Pillar 1, in particular the IRB framework for credit risk and the Advanced Measurement Approaches for operational risk. SAMA must ensure that these requirements are being met, both as qualifying criteria and on a continuing basis.

(Refer to Paragraph 724 of International Convergence of Capital Measurement and Capital Standards – June 2006)

### **The following guidelines to be included in Pg 16 Section 6.2.8 “SAMA's Standards #8: Documentation of CAAP” of the SAMA's Basel II Guidance Document Pillar 2 Supervisory Review Process, 2007**

(In addition to the original text)

The bank's board of directors has responsibility for setting the bank's tolerance for risks.

(Refer to Paragraph 730 of International Convergence of Capital Measurement and Capital Standards – June 2006)



## Positioning of the Paragraph in SAMA's Regulatory Documentation

### **The following guidelines to be included in Pg 8 Section 5.3 “Preliminary Assessment of Inherent additional Risks” of the SAMA's Basel II Guidance Document Pillar 2 Supervisory Review Process, 2007**

(In addition to the original text)

Credit risk: Banks should have methodologies that enable them to assess the credit risk involved in exposures to individual borrowers or counterparties as well as at the portfolio level. For more sophisticated banks, the credit review assessment of capital adequacy, at a minimum, should cover four areas: risk rating systems, portfolio analysis/aggregation, securitization/complex credit derivatives, and large exposures and risk concentrations.

Internal risk ratings should be adequate to support the identification and measurement of risk from all credit exposures, and should be integrated into an institution's overall analysis of credit risk and capital adequacy. The ratings system should provide detailed ratings for all assets, not only for criticized or problem assets. Loan loss reserves should be included in the credit risk assessment for capital adequacy.

The analysis of credit risk should adequately identify any weaknesses at the portfolio level, including any concentrations of risk. It should also adequately take into consideration the risks involved in managing credit concentrations and other portfolio issues through such mechanisms as securitization programmes and complex credit derivatives.

Further, the analysis of counterparty credit risk should include consideration of public evaluation of the supervisor's compliance with the Core Principles for Effective Banking Supervision.

(Refer to Paragraph 733-735 of of International Convergence of Capital Measurement and Capital Standards – June

## Positioning of the Paragraph in SAMA's Regulatory Documentation

2006)

### **The following guidelines to be included in Pg 8 Section 5.3 “Preliminary Assessment of Inherent additional Risks” of the SAMA’s Basel II Guidance Document Pillar 2 Supervisory Review Process, 2007**

(In addition to the original text)

#### **Operational Risk**

A bank should develop a framework for managing operational risk and evaluate the adequacy of capital given this framework. The framework should cover the bank’s appetite and tolerance for operational risk, as specified through the policies for managing this risk, including the extent and manner in which operational risk is transferred outside the bank. It should also include policies outlining the bank’s approach to identifying, assessing, monitoring and controlling/mitigating the risk.

(Refer to Paragraph 737 of of International Convergence of Capital Measurement and Capital Standards – June 2006)

### **The following guidelines to be included in Pg 8 Section 5.3 “Preliminary Assessment of Inherent additional Risks” of the SAMA’s Basel II Guidance Document Pillar 2 Supervisory Review Process, 2007**

(In addition to the original text)

#### **Market Risk**

For more sophisticated banks, their assessment of internal capital adequacy for market risk, at a minimum, should be based on both VaR modelling and stress testing, including an assessment of concentration risk and the assessment of

## Positioning of the Paragraph in SAMA's Regulatory Documentation

illiquidity under stressful market scenarios, although all firms' assessments should include stress testing appropriate to their trading activity.

- (i). VaR is an important tool in monitoring aggregate market risk exposures and provides a common metric for comparing the risk being run by different desks and business lines. A bank's VaR model should be adequate to identify and measure risks arising from all its trading activities and should be integrated into the bank's overall internal capital assessment as well as subject to rigorous on-going validation. A VaR model estimates should be sensitive to changes in the trading book risk profile.
- (ii). Banks must supplement their VaR model with stress tests (factor shocks or integrated scenarios whether historic or hypothetical) and other appropriate risk management techniques. In the bank's internal capital assessment it must demonstrate that it has enough capital to not only meet the minimum capital requirements but also to withstand a range of severe but plausible market shocks. In particular, it must factor in, where appropriate:

  - Illiquidity/gapping of prices;
  - Concentrated positions (in relation to market turnover);
  - One-way markets;
  - Non-linear products/deep out-of-the money positions;
  - Events and jumps-to-defaults;
  - Significant shifts in correlations;
  - Other risks that may not be captured appropriately in VaR (e.g. recovery rate uncertainty, implied correlations, or skew risk).

The stress tests applied by a bank and, in particular, the calibration of those tests (e.g. the parameters of the shocks or

## Positioning of the Paragraph in SAMA's Regulatory Documentation

types of events considered) should be reconciled back to a clear statement setting out the premise upon which the bank's internal capital assessment is based (e.g. ensuring there is adequate capital to manage the traded portfolios within stated limits through what may be a prolonged period of market stress and illiquidity, or that there is adequate capital to ensure that, over a given time horizon to a specified confidence level, all positions can be liquidated or the risk hedged in an orderly fashion). The market shocks applied in the tests must reflect the nature of portfolios and the time it could take to hedge out or manage risks under severe market conditions.

**(iii).** Concentration risk should be pro-actively managed and assessed by firms and concentrated positions should be routinely reported to senior management.

**(iv).** Banks should design their risk management systems, including the VaR methodology and stress tests, to properly measure the material risks in instruments they trade as well as the trading strategies they pursue. As their instruments and trading strategies change, the VaR methodologies and stress tests should also evolve to accommodate the changes.

**(v).** Banks must demonstrate how they combine their risk measurement approaches to arrive at the overall internal capital for market risk.

(Refer to Paragraph 738 of International Convergence of Capital Measurement and Capital Standards – June 2006)

**The following guidelines to be included in Pg 13 Section 6.2.2 "SAMA's Standards #2" of the SAMA's Basel II Guidance Document Pillar 2 Supervisory Review Process, 2007**

(In addition to the original text)

Monitoring and reporting

## Positioning of the Paragraph in SAMA's Regulatory Documentation

The bank's senior management or board of directors should, on a regular basis, receive reports on the bank's risk profile and capital needs. These reports should allow senior management to:

- Evaluate the level and trend of material risks and their effect on capital levels;
- Evaluate the sensitivity and reasonableness of key assumptions used in the capital assessment measurement system;
- Determine that the bank holds sufficient capital against the various risks and is in compliance with established capital adequacy goals; and
- Assess its future capital requirements based on the bank's reported risk profile and make necessary adjustments to the bank's strategic plan accordingly.

(Refer to Paragraph 743 of International Convergence of Capital Measurement and Capital Standards – June 2006)

### **The following guidelines to be included in Pg 11 Section 5.6 “On-going monitoring of Capital Adequacy” of the SAMA's Basel II Guidance Document Pillar 2 Supervisory Review Process, 2007**

(In addition to the original text)

As part of the supervisory review process, SAMA would ensure that these conditions are being met on an ongoing basis.

(Refer to Paragraph 753 of International Convergence of Capital Measurement and Capital Standards – June 2006)

## Positioning of the Paragraph in SAMA's Regulatory Documentation

**The following guidelines to be included in Pg 8 Section 5.3 “Preliminary Assessment of Inherent additional Risks” of the SAMA's Basel II Guidance Document Pillar 2 Supervisory Review Process, 2007**

(In addition to the original text)

### **Supervisory review of compliance with minimum standards**

There is also an important role for SAMA's to review of compliance with certain conditions and requirements set for standardized approaches. In this context, there will be a particular need to ensure that use of various instruments that can reduce Pillar 1 capital requirements are utilized and understood as part of a sound, tested, and properly documented risk management process.

(Refer to Paragraph 755 of of International Convergence of Capital Measurement and Capital Standards – June 2006)

**The following guidelines to be included in Pg 12 Paragraph 6.1.3 (part of Section 6.1 General) of the SAMA's Basel II Guidance Document Pillar 2 Supervisory Review Process, 2007**

(In addition to the original text)

### **Supervisory response**

SAMA typically requires (or encourages) banks to operate with a buffer, over and above the Pillar 1 standard. Banks should maintain this buffer for a combination of the following:

- a) Pillar 1 minimums are anticipated to be set to achieve a level of bank creditworthiness in markets that is below the

## Positioning of the Paragraph in SAMA's Regulatory Documentation

level of creditworthiness sought by many banks for their own reasons. For example, most international banks appear to prefer to be highly rated by internationally recognized rating agencies. Thus, banks are likely to choose to operate above Pillar 1 minimums for competitive reasons.

- b) In the normal course of business, the type and volume of activities will change, as will the different risk exposures, causing fluctuations in the overall capital ratio.
- c) It may be costly for banks to raise additional capital, especially if this needs to be done quickly or at a time when market conditions are unfavorable.
- d) For banks to fall below minimum regulatory capital requirements is a serious matter. It may place banks in breach of the relevant law and/or prompt non-discretionary corrective action on the part of supervisors.
- e) There may be risks, either specific to individual banks, or more generally to an economy at large, that are not taken into account in Pillar 1

(Refer to Paragraph 757 of International Convergence of Capital Measurement and Capital Standards – June 2006)

### **The following guidelines to be included in Pg 12 Paragraph 6.1.3 (Part of Section 6.1 General) of the SAMA's Basel II Guidance Document Pillar 2 Supervisory Review Process, 2007**

(In addition to the original text)

#### **Supervisory response**

There are several means available to SAMA for ensuring that individual banks are operating with adequate levels of capital. Among other methods, SAMA may set trigger and target capital ratios or define categories above minimum ratios

## Positioning of the Paragraph in SAMA's Regulatory Documentation

(e.g. well capitalized and adequately capitalized) for identifying the capitalization level of the bank.

(Refer to Paragraph 758 of of International Convergence of Capital Measurement and Capital Standards – June 2006)

**The following guidelines to be included in Pg 6 Section 2.3 “Determination of the minimum CAR and or other supervisory measures” of the SAMA's Basel II Guidance Document Pillar 2 Supervisory Review Process, 2007**

(In addition to the original text)

### **Supervisory response**

The permanent solution to banks' difficulties is not always increased capital. However, some of the required measures (such as improving systems and controls) may take a period of time to implement. Therefore, increased capital might be used as an interim measure while permanent measures to improve the bank's position are being put in place.

Once these permanent measures have been put in place and have been seen by SAMA to be effective, the interim increase in capital requirements can be removed.

(Refer to Paragraph 760 of of International Convergence of Capital Measurement and Capital Standards – June 2006)



## Positioning of the Paragraph in SAMA's Regulatory Documentation

**The following guidelines to be included in Pg 14 Section 6.2.6 “SAMA's Standards #6: Setting of capital adequacy goals” of the SAMA's Basel II Guidance Document Pillar 2 Supervisory Review Process, 2007**

(In addition to the original text)

### **Interest rate risk in the banking book**

If SAMA determine that banks are not holding capital commensurate with the level of interest rate risk, they must require the bank to reduce its risk, to hold a specific additional amount of capital or some combination of the two. SAMA should be particularly attentive to the sufficiency of capital of 'outlier banks' where economic value declines by more than 20% of the sum of Tier 1 and Tier 2 capital as a result of a standardized interest rate shock (200 basis points) or its equivalent, as described in the supporting document *Principles for the Management and Supervision of Interest Rate Risk*

(Refer to Paragraph 764 of of International Convergence of Capital Measurement and Capital Standards – June 2006)

**The following guidelines to be included in Pg 14 Section 6.2.6 “SAMA's Standards #6: Setting of capital adequacy goals” of the SAMA's Basel II Guidance Document Pillar 2 Supervisory Review Process, 2007**

(In addition to the original text)

### **Credit Risk – Stress testing under IRB approaches**

SAMA may wish to review how the stress test has been carried out. The results of the stress test will thus contribute directly to the expectation that a bank will operate above the Pillar 1 minimum regulatory capital ratios. SAMA will

## Positioning of the Paragraph in SAMA's Regulatory Documentation

consider whether a bank has sufficient capital for these purposes. To the extent that there is a shortfall, SAMA will react appropriately. This will usually involve requiring the bank to reduce its risks and/or to hold additional capital/provisions, so that existing capital resources could cover the Pillar 1 requirements plus the result of a recalculated stress test.

(Refer to Paragraph 765 of International Convergence of Capital Measurement and Capital Standards – June 2006)

### **The following guidelines to be included in Pg 14 section 6.2.6 “SAMA's Standards #6: Setting of capital adequacy goals” of the SAMA's Basel II Guidance Document Pillar 2 Supervisory Review Process, 2007**

(In addition to the original text)

#### 2. Definition of default

SAMA will assess individual banks' application of the reference definition of default and its impact on capital requirements. In particular, SAMA will focus on the impact of deviations from the reference definition according to paragraph 456 (use of external data or historic internal data not fully consistent with the reference definition of default).

(Refer to Paragraph 766 of International Convergence of Capital Measurement and Capital Standards – June 2006)

## Positioning of the Paragraph in SAMA's Regulatory Documentation

**The following guidelines to be included in Pg 18 Section "Compliance with Pillar 2" of the SAMA's Basel II Guidance Document Pillar 2 Supervisory Review Process, 2007**

(In addition to the original text)

### **3. Residual risk**

The Framework allows banks to offset credit or counterparty risk with collateral, guarantees or credit derivatives, leading to reduced capital charges. While banks use credit risk mitigation (CRM) techniques to reduce their credit risk, these techniques give rise to risks that may render the overall risk reduction less effective. Accordingly these risks (e.g. legal risk, documentation risk, or liquidity risk) to which banks are exposed are of SAMA's concern. Where such risks arise, and irrespective of fulfilling the minimum requirements set out in Pillar 1, a bank could find itself with greater credit risk exposure to the underlying counterparty than it had expected. Examples of these risks include:

- Inability to seize, or realize in a timely manner, collateral pledged (on default of the counterparty);
- Refusal or delay by a guarantor to pay; and
- Ineffectiveness of untested documentation

(Refer to Paragraph 767 of of International Convergence of Capital Measurement and Capital Standards – June 2006)

## Positioning of the Paragraph in SAMA's Regulatory Documentation

**The following guidelines to be included in Pg 14 Section 6.2.4 “SAMA's Standards #4: Risk management policies and procedures” of the SAMA's Basel II Guidance Document Pillar 2 Supervisory Review Process, 2007**

(In addition to the original text)

### **Residual risk**

Therefore, SAMA will require banks to have in place appropriate written CRM policies and procedures in order to control these residual risks. A bank may be required to submit these policies and procedures to SAMA and must regularly review their appropriateness, effectiveness and operation.

(Refer to Paragraph 768 of of International Convergence of Capital Measurement and Capital Standards – June 2006)

**The following guidelines to be included in Pg 14 Section 6.2.6 “SAMA's Standards #6: Setting of capital adequacy goals” of the SAMA's Basel II Guidance Document Pillar 2 Supervisory Review Process, 2007**

(In addition to the original text)

### **Residual risk**

In its CRM policies and procedures, a bank must consider whether, when calculating capital requirements, it is appropriate to give the full recognition of the value of the credit risk mitigant as permitted in Pillar 1 and must

## Positioning of the Paragraph in SAMA's Regulatory Documentation

demonstrate that its CRM management policies and procedures are appropriate to the level of capital benefit that it is recognizing. Where SAMA is not satisfied as to the robustness, suitability or application of these policies and procedures they may direct the bank to take immediate remedial action or hold additional capital against residual risk until such time as the deficiencies in the CRM procedures are rectified to the satisfaction of SAMA . For example, SAMA may direct a bank to:

- Make adjustments to the assumptions on holding periods, supervisory haircuts, or volatility (in the own haircuts approach);
- Give less than full recognition of credit risk mitigants (on the whole credit portfolio or by specific product line); and/or
- Hold a specific additional amount of capital

(Refer to Paragraph 769 of of International Convergence of Capital Measurement and Capital Standards – June 2006)

**The following guidelines to be included in as a separate sub-section “Credit Concentration Risk” in Section 6 “Supervisory Standards on CAAP” of the SAMA’s Basel II Guidance Document Pillar 2 Supervisory Review Process, 2007**

(In addition to the original text)

**Credit Concentration Risk**

## Positioning of the Paragraph in SAMA's Regulatory Documentation

Concentration risk arises in both direct exposures to obligors and may also occur through exposures to protection providers. Such concentrations are not addressed in the Pillar 1 capital charge for credit risk.

Banks should have in place effective internal policies, systems and controls to identify, measure, monitor, and control their credit risk concentrations. Banks should explicitly consider the extent of their credit risk concentrations in their assessment of capital adequacy under Pillar 2. These policies should cover the different forms of credit risk concentrations to which a bank may be exposed. Such concentrations include:

- Credit exposures to counterparties whose financial performance is dependent on the same activity or commodity; and
- Indirect credit exposures arising from a bank's CRM activities (e.g. exposure to a single collateral type or to credit protection provided by a single counterparty).

A bank's framework for managing credit risk concentrations should be clearly documented and should include a definition of the credit risk concentrations relevant to the bank and how these concentrations and their corresponding limits are calculated. Limits should be defined in relation to a bank's capital, total assets or, where adequate measures exist, its overall risk level.

A bank should ensure that, in respect of credit risk concentrations, it complies with the Committee document Principles for the Management of Credit Risk (September 2000) and the more detailed guidance in the Appendix to that paper.

(Refer to Paragraph 772-776 of International Convergence of Capital Measurement and Capital Standards – June 2006)

**The following guidelines to be included as a separate sub-section "Counterparty Credit Risk" in Section 6 of the**

## Positioning of the Paragraph in SAMA's Regulatory Documentation

### SAMA's Basel II Guidance Document Pillar 2 Supervisory Review Process, 2007

(In addition to the original text)

#### Counterparty Credit Risk

- (i)** As counterparty credit risk (CCR) represents a form of credit risk, this would include meeting this Framework's standards regarding their approaches to stress testing, "residual risks" associated with credit risk mitigation techniques, and credit concentrations.
- (ii).** The bank must have counterparty credit risk management policies, processes and systems that are conceptually sound and implemented with integrity relative to the sophistication and complexity of a firm's holdings of exposures that give rise to CCR. A sound counterparty credit risk management framework shall include the identification, measurement, management, approval and internal reporting of CCR.
- (iii).** The bank's risk management policies must take account of the market, liquidity, legal and operational risks that can be associated with CCR and, to the extent practicable, interrelationships among those risks. The bank must not undertake business with a counterparty without assessing its creditworthiness and must take due account of both settlement and pre-settlement credit risk. These risks must be managed as comprehensively as practicable at the counterparty level (aggregating counterparty exposures with other credit exposures) and at the firm-wide level.
- (iv).** The board of directors and senior management must be actively involved in the CCR control process and must regard this as an essential aspect of the business to which significant resources need to be devoted. Where the bank is using an internal model for CCR, senior management must be aware of the limitations and assumptions of the model used and the impact these can have on the reliability of the output. They should also consider the uncertainties of the market environment (e.g. timing of realization of collateral) and operational issues (e.g. pricing

## Positioning of the Paragraph in SAMA's Regulatory Documentation

feed irregularities) and be aware of how these are reflected in the model.

- (v).** In this regard, the daily reports prepared on a firm's exposures to CCR must be reviewed by a level of management with sufficient seniority and authority to enforce both reductions of positions taken by individual credit managers or traders and reductions in the firm's overall CCR exposure.
- (vi)** The bank's CCR management system must be used in conjunction with internal credit and trading limits. In this regard, credit and trading limits must be related to the firm's risk measurement model in a manner that is consistent over time and that is well understood by credit managers, traders and senior management.
- (vii).** The measurement of CCR must include monitoring daily and intra-day usage of credit lines. The bank must measure current exposure gross and net of collateral held where such measures are appropriate and meaningful (e.g. OTC derivatives, margin lending, etc.).  
Measuring and monitoring peak exposure or potential future exposure (PFE) at a confidence level chosen by the bank at both the portfolio and counterparty levels is one element of a robust limit monitoring system. Banks must take account of large or concentrated positions, including concentrations by groups of related counterparties, by industry, by market, customer investment strategies, etc.
- (viii).** The bank must have a routine and rigorous program of stress testing in place as a supplement to the CCR analysis based on the day-to-day output of the firm's risk measurement model. The results of this stress testing must be reviewed periodically by senior management and must be reflected in the CCR policies and limits set by management and the board of directors. Where stress tests reveal particular vulnerability to a given set of circumstances, management should explicitly consider appropriate risk management strategies (e.g. by hedging against that outcome, or reducing the size of the firm's exposures).
- (ix).** The bank must have a routine in place for ensuring compliance with a documented set of internal policies, controls



## Positioning of the Paragraph in SAMA's Regulatory Documentation

and procedures concerning the operation of the CCR management system. The firm's CCR management system must be well documented, for example, through a risk management manual that describes the basic principles of the risk management system and that provides an explanation of the empirical techniques used to measure CCR.

**(x).** The bank must conduct an independent review of the CCR management system regularly through its own internal auditing process. This review must include both the activities of the business credit and trading units and of the independent CCR control unit. A review of the overall CCR management process must take place at regular intervals (ideally not less than once a year) and must specifically address, at a minimum:

- the adequacy of the documentation of the CCR management system and process;
- the organization of the CCR control unit;
- the integration of CCR measures into daily risk management;
- the approval process for risk pricing models and valuation systems used by front and back-office personnel;
- the validation of any significant change in the CCR measurement process;
- the scope of counterparty credit risks captured by the risk measurement model;
- the integrity of the management information system;
- the accuracy and completeness of CCR data;
- the verification of the consistency, timeliness and reliability of data sources used to run internal models, including the independence of such data sources;
- the accuracy and appropriateness of volatility and correlation assumptions;
- the accuracy of valuation and risk transformation calculations;
- the verification of the model's accuracy through frequent backtesting.

## Positioning of the Paragraph in SAMA's Regulatory Documentation

- (xi).** A bank that receives approval to use an internal model to estimate its exposure amount or EAD for CCR exposures must monitor the appropriate risks and have processes to adjust its estimation of EPE when those risks become significant. This includes the following:
- Banks must identify and manage their exposures to specific wrong-way risk.
  - For exposures with a rising risk profile after one year, banks must compare on a regular basis the estimate of EPE over one year with the EPE over the life of the exposure.
  - For exposures with a short-term maturity (below one year), banks must compare on a regular basis the replacement cost (current exposure) and the realised exposure profile, and/or store data that allow such a comparisons.
- (xii).** When assessing an internal model used to estimate EPE, and especially for banks that receive approval to estimate the value of the alpha factor, SAMA would review the characteristics of the firm's portfolio of exposures that give rise to CCR. In particular, SAMA would consider the following characteristics, namely:
- the diversification of the portfolio (number of risk factors the portfolio is exposed to);
  - the correlation of default across counterparties; and
  - the number and granularity of counterparty exposures.
- (xiii).** Supervisors will take appropriate action where the firm's estimates of exposure or EAD under the Internal Model Method or alpha do not adequately reflect its exposure to CCR. Such action might include directing the bank to revise its estimates; directing the bank to apply a higher estimate of exposure or EAD under the IMM or alpha; or disallowing a bank from recognizing internal estimates of EAD for regulatory capital purposes.

## Positioning of the Paragraph in SAMA's Regulatory Documentation

**(xiv).** For banks that make use of the standardized method, supervisors should review the bank's evaluation of the risks contained in the transactions that give rise to CCR and the bank's assessment of whether the standardized method captures those risks appropriately and satisfactorily. If the standardized method does not capture the risk inherent in the bank's relevant transactions (as could be the case with structured, more complex OTC derivatives), supervisors may require the bank to apply the CEM or the SM on a transaction-by-transaction basis (i.e. no netting will be recognized).

(Refer to Paragraph 777 of of International Convergence of Capital Measurement and Capital Standards – June 2006)

### **The following guidelines to be included in Section 6 "Supervisory Standards on CAAP" of the SAMA's Basel II Guidance Document Pillar 2 Supervisory Review Process, 2007**

(In addition to the original text)

#### **Market risk**

##### ***1. Policies and procedures for trading book eligibility***

**(i).** Clear policies and procedures used to determine the exposures that may be included in, and those that should be excluded from, the trading book for purposes of calculating regulatory capital are critical to ensure the consistency and integrity of firms' trading book. Such policies must conform to paragraph 687(i) of this Framework. SAMA has been satisfied that the policies and procedures clearly delineate the boundaries of the firm's trading book, in

## Positioning of the Paragraph in SAMA's Regulatory Documentation

compliance with the general principles set forth in paragraphs 684 to 689(iii) of this Framework, and consistent with the bank's risk management capabilities and practices. SAMA also needs to be satisfied that transfers of positions between banking and trading books can only occur in a very limited set of circumstances. SAMA will require a firm to modify its policies and procedures when they prove insufficient for preventing the booking in the trading book of positions that are not compliant with the general principles set forth in paragraphs 684 to 689(iii) of this Framework, or not consistent with the bank's risk management capabilities and practices.

### **2. Valuation**

- (ii). Prudent valuation policies and procedures form the foundation on which any robust assessment of market risk capital adequacy should be built. For a well-diversified portfolio consisting of highly liquid cash instruments, and without market concentration, the valuation of the portfolio, combined with the minimum quantitative standards set out in paragraph 718(Lxxvi), as revised in this section, may deliver sufficient capital to enable a bank, in adverse market conditions, to close out or hedge its positions within 10 days in an orderly fashion. However, for less well diversified portfolios, for portfolios containing less liquid instruments, for portfolios with concentrations in relation to market turnover, and/or for portfolios which contain large numbers of positions that are marked-to-model this is less likely to be the case. In such circumstances, SAMA will consider whether a bank has sufficient capital. To the extent there is a shortfall SAMA will react appropriately. This will usually require the bank to reduce its risks and/or hold an additional amount of capital.

### **3. Stress testing under the internal models approach**

- (iii). A bank must ensure that it has sufficient capital to meet the minimum capital requirements set out in paragraphs

## Positioning of the Paragraph in SAMA's Regulatory Documentation

718(Lxx) to 718(xciv) and to cover the results of its stress testing required by paragraph 718(Lxxiv) (g), taking into account the principles set forth in paragraphs 738(ii) and 738(iv). SAMA will consider whether a bank has sufficient capital for these purposes, taking into account the nature and scale of the bank's trading activities and any other relevant factors such as valuation adjustments made by the bank. To the extent that there is a shortfall, or if SAMA are not satisfied with the premise upon which the bank's assessment of internal market risk capital adequacy is based, SAMA will take the appropriate measures. This will usually involve requiring the bank to reduce its risk exposures and/or to hold an additional amount of capital, so that its overall capital resources at least cover the Pillar 1 requirements plus the result of a stress test acceptable to SAMA .

### ***4. Specific risk modelling under the internal models approach***

**(iv)**. For banks wishing to model the specific risk arising from their trading activities, additional criteria have been set out in paragraph 718(Lxxxix) , including conservatively assessing the risk arising from less liquid positions and/or positions with limited price transparency under realistic market scenarios. Where SAMA consider that limited liquidity or price transparency undermines the effectiveness of a bank's model to capture the specific risk, they will take appropriate measures, including requiring the exclusion of positions from the bank's specific risk model. SAMA should review the adequacy of the bank's measure of the default risk surcharge; where the bank's approach is inadequate, the use of the standardized specific risk charges will be required.

(Refer to Paragraph 778 of of International Convergence of Capital Measurement and Capital Standards – June 2006)

**The following guidelines to be included in Pg 2 Section 2 “Key components of Supervisory Review Process” of**

## Positioning of the Paragraph in SAMA's Regulatory Documentation

### **the SAMA's Basel II Guidance Document Pillar 2 Supervisory Review Process, 2007**

(In addition to the original text)

#### **Supervisory transparency and accountability**

SAMA would set target and trigger ratios and the Categories of capital in excess of the regulatory minimum, factors that may be considered in doing so, would be made publicly available.

(Refer to Paragraph 779 of International Convergence of Capital Measurement and Capital Standards – June 2006)

### **The following guidelines to be included in Pg 8 Section 4.1 "Application to Banks Licensed in Saudi Arabia" of the SAMA's Basel II Guidance Document Pillar 2 Supervisory Review Process, 2007**

(In addition to the original text)

In order to reduce the compliance burden and avoid regulatory arbitrage, the methods and approval processes used by a bank at the group level may be accepted by SAMA at the local level, provided that they adequately meet the SAMA's requirements. Wherever possible, SAMA will avoid performing redundant and uncoordinated approval and validation work in order to reduce the implementation burden on banks, and conserve supervisory resources

(Refer to Paragraph 781 of International Convergence of Capital Measurement and Capital Standards – June 2006)

## Positioning of the Paragraph in SAMA's Regulatory Documentation

### **The following guidelines to be included in Pg 8 Section 6 “Supervisory Standards on CAAP” of the SAMA's Basel II Guidance Document Pillar 2 Supervisory Review Process, 2007**

(In addition to the original text)

Amongst other things, SAMA may review where relevant a bank's own assessment of its capital needs and how that has been reflected in the capital calculation as well as the documentation of certain transactions to determine whether the capital requirements accord with the risk profile (e.g. substitution clauses). SAMA will also review the manner in which banks have addressed the issue of maturity mismatch in relation to retained positions in their economic capital calculations. In particular, they will be vigilant in monitoring for the structuring of maturity mismatches in transactions to artificially reduce capital requirements. Additionally, SAMA may review the bank's economic capital assessment of actual correlation between assets in the pool and how they have reflected that in the calculation. Where SAMA consider that a bank's approach is not adequate, they will take appropriate action. Such action might include denying or reducing capital relief in the case of originated assets, or increasing the capital required against securitization exposures acquired.

Significance of risk transfer Securitization transactions may be carried out for purposes other than credit risk transfer (e.g. funding). Where this is the case, there might still be a limited transfer of credit risk. However, for an originating bank to achieve reductions in capital requirements, the risk transfer arising from a securitization has to be deemed significant by SAMA. If the risk transfer is considered to be insufficient or non-existent, SAMA can require the application of a higher capital requirement than prescribed under Pillar 1 or, alternatively, may deny a bank from obtaining any capital relief from the securitizations. Therefore, the capital relief that can be achieved will correspond to the amount of credit risk that is effectively transferred. The following includes a set of examples where SAMA may have concerns about the degree of

## Positioning of the Paragraph in SAMA's Regulatory Documentation

risk transfer, such as retaining or repurchasing significant amounts of risk or “cherry picking” the exposures to be transferred via a securitization

Retaining or repurchasing significant securitization exposures, depending on the proportion of risk held by the originator, might undermine the intent of a securitization to transfer credit risk. Specifically, SAMA might expect that a significant portion of the credit risk and of the nominal value of the pool be transferred to at least one independent third party at inception and on an ongoing basis. Where banks repurchase risk for market making purposes, SAMA could find it appropriate for an originator to buy part of a transaction but not, for example, to repurchase a whole tranche. SAMA would expect that where positions have been bought for market making purposes, these positions should be resold within an appropriate period, thereby remaining true to the initial intention to transfer risk.

Another implication of realising only a non-significant risk transfer, especially if related to good quality unrated exposures, is that both the poorer quality unrated assets and most of the credit risk embedded in the exposures underlying the securitised transaction are likely to remain with the originator. Accordingly, and depending on the outcome of the supervisory review process, SAMA may increase the capital requirement for particular exposures or even increase the overall level of capital the bank is required to hold.

### **Market innovations**

As the minimum capital requirements for securitization may not be able to address all potential issues, SAMA would consider new features of securitization transactions as they arise. Such assessments would include reviewing the impact new features may have on credit risk transfer and, where appropriate, SAMA will take appropriate action under Pillar 2. A Pillar 1 response may be formulated to take account of market innovations. Such a response may take the form of a set



## Positioning of the Paragraph in SAMA's Regulatory Documentation

of operational requirements and/or a specific capital treatment.

### **Provision of implicit support**

Support to a transaction, whether contractual (i.e. credit enhancements provided at the inception of a securitized transaction) or non-contractual (implicit support) can take numerous forms. For instance, contractual support can include over collateralization, credit derivatives, spread accounts, contractual recourse obligations, subordinated notes, credit risk mitigants provided to a specific tranche, the subordination of fee or interest income or the deferral of margin income, and clean-up calls that exceed 10 percent of the initial issuance.

Examples of implicit support include the purchase of deteriorating credit risk exposures from the underlying pool, the sale of discounted credit risk exposures into the pool of securitized credit risk exposures, the purchase of underlying exposures at above market price or an increase in the first loss position according to the deterioration of the underlying exposures.

The provision of implicit (or non-contractual) support, as opposed to contractual credit support (i.e. credit enhancements), raises significant supervisory concerns. For traditional securitization structures the provision of implicit support undermines the clean break criteria, which when satisfied would allow banks to exclude the securitized assets from regulatory capital calculations. For synthetic securitization structures, it negates the significance of risk transference. By providing implicit support, banks signal to the market that the risk is still with the bank and has not in effect been transferred. The institution's capital calculation therefore understates the true risk. Accordingly, SAMA would take appropriate action when a banking organization provides implicit support.

## Positioning of the Paragraph in SAMA's Regulatory Documentation

When a bank has been found to provide implicit support to a securitization, it will be required to hold capital against all of the underlying exposures associated with the structure as if they had not been securitized. It will also be required to disclose publicly that it was found to have provided non-contractual support, as well as the resulting increase in the capital charge (as noted above). The aim is to require banks to hold capital against exposures for which they assume the credit risk, and to discourage them from providing non-contractual support.

The following guidelines to be included in Pg 8 Section 6 of the SAMA's Basel II Guidance Document Pillar 2 Supervisory Review Process, 2007

If a bank is found to have provided implicit support on more than one occasion, the bank is required to disclose its transgression publicly and SAMA will take appropriate action that may include, but is not limited to, one or more of the following:

- The bank may be prevented from gaining favorable capital treatment on securitized assets for a period of time to be determined by SAMA ;
- The bank may be required to hold capital against all securitized assets as though the bank had created a commitment to them, by applying a conversion factor to the risk weight of the underlying assets;
- For purposes of capital calculations, the bank may be required to treat all securitized assets as if they remained on the balance sheet
- The bank may be required by SAMA to hold regulatory capital in excess of the minimum risk-based capital ratios.

SAMA will be vigilant in determining implicit support and will take appropriate supervisory action to mitigate the effects. Pending any investigation, the bank may be prohibited from any capital relief for planned securitization transactions

## Positioning of the Paragraph in SAMA's Regulatory Documentation

(moratorium). SAMA's response will be aimed at changing the bank's behavior with regard to the provision of implicit support, and to correct market perception as to the willingness of the bank to provide future recourse beyond contractual obligations

### **Residual risks**

As with credit risk mitigation techniques more generally, SAMA will review the appropriateness of banks' approaches to the recognition of credit protection. In particular, with regard to securitizations, SAMA will review the appropriateness of protection recognized against first loss credit enhancements. On these positions, expected loss is less likely to be a significant element of the risk and is likely to be retained by the protection buyer through the pricing. Therefore, SAMA will expect banks' policies to take account of this in determining their economic capital. Where SAMA do not consider the approach to protection recognized is adequate, they will take appropriate action. Such action may include increasing the capital requirement against a particular transaction or class of transactions.

### **Call provisions**

SAMA expect a bank not to make use of clauses that entitles it to call the securitization transaction or the coverage of credit protection prematurely if this would increase the bank's exposure to losses or deterioration in the credit quality of the underlying exposures.

Besides the general principle stated above, SAMA expect banks to only execute clean-up calls for economic business purposes, such as when the cost of servicing the outstanding credit exposures exceeds the benefits of servicing the underlying credit exposures

## Positioning of the Paragraph in SAMA's Regulatory Documentation

Subject to national discretion, SAMA may require a review prior to the bank exercising a call which can be expected to include consideration of:

- The rationale for the bank's decision to exercise the call; and
- The impact of the exercise of the call on the bank's regulatory capital ratio.

SAMA may also require the bank to enter into a follow-up transaction, if necessary, depending on the bank's overall risk profile, and existing market conditions

Date related calls should be set at a date no earlier than the duration or the weighted average life of the underlying securitization exposures. Accordingly, SAMA may require a minimum period to elapse before the first possible call date can be set, given, for instance, the existence of up-front sunk costs of a capital market securitization transaction.

### **Early amortization**

SAMA would review how banks internally measure, monitor, and manage risks associated with securitizations of revolving credit facilities, including an assessment of the risk and likelihood of early amortization of such transactions. At a minimum, SAMA would ensure that banks have implemented reasonable methods for allocating economic capital against the economic substance of the credit risk arising from revolving securitizations and should expect banks to have adequate capital and liquidity contingency plans that evaluate the probability of an early amortization occurring and address the implications of both scheduled and early amortization. In addition, the capital contingency plan should address the possibility that the bank will face higher levels of required capital under the early amortization Pillar 1 capital

## Positioning of the Paragraph in SAMA's Regulatory Documentation

requirement.

Because most early amortization triggers are tied to excess spread levels, the factors affecting these levels should be well understood, monitored, and managed, to the extent possible (see paragraphs 790 to 794 on implicit support), by the originating bank. For example, the following factors affecting excess spread should generally be considered:

- Interest payments made by borrowers on the underlying receivable balances;
- Other fees and charges to be paid by the underlying obligors (e.g. late-payment fees, cash advance fees, over-limit fees);
- Gross charge-offs;
- Principal payments;
- Recoveries on charged-off loans;
- Interchange income;
- Interest paid on investors' certificates;
- Macroeconomic factors such as bankruptcy rates, interest rate movements, unemployment rates; etc.

Banks should consider the effects that changes in portfolio management or business strategies may have on the levels of excess spread and on the likelihood of an early amortization event. For example, marketing strategies or underwriting changes that result in lower finance charges or higher charge-offs, might also lower excess spread levels and increase the likelihood of an early amortization event.

Banks should use techniques such as static pool cash collections analyses and stress tests to better understand pool performance. These techniques can highlight adverse trends or potential adverse impacts. Banks should have policies in

## Positioning of the Paragraph in SAMA's Regulatory Documentation

place to respond promptly to adverse or unanticipated changes. SAMA will take appropriate action where they do not consider these policies adequate. Such action may include, but is not limited to, directing a bank to obtain a dedicated liquidity line or raising the early amortization credit conversion factor, thus, increasing the bank's capital requirements.

While the early amortization capital charge described in Pillar 1 is meant to address potential supervisory concerns associated with an early amortization event, such as the inability of excess spread to cover potential losses, the policies and monitoring described in this section recognize that a given level of excess spread is not, by itself, a perfect proxy for credit performance of the underlying pool of exposures. In some circumstances, for example, excess spread levels may decline so rapidly as to not provide a timely indicator of underlying credit deterioration. Further, excess spread levels may reside far above trigger levels, but still exhibit a high degree of volatility which could warrant supervisory attention. In addition, excess spread levels can fluctuate for reasons unrelated to underlying credit risk, such as a mismatch in the rate at which finance charges re-price relative to investor certificate rates.

Routine fluctuations of excess spread might not generate supervisory concerns, even when they result in different capital requirements. This is particularly the case as a bank moves in or out of the first step of the early amortization credit conversion factors. On the other hand, existing excess spread levels may be maintained by adding (or designating) an increasing number of new accounts to the master trust, an action that would tend to mask potential deterioration in a portfolio. For all of these reasons, SAMA will place particular emphasis on internal management, controls, and risk monitoring activities with respect to securitizations with early amortization features.

SAMA expect that the sophistication of a bank's system in monitoring the likelihood and risks of an early amortization

## Positioning of the Paragraph in SAMA's Regulatory Documentation

event will be commensurate with the size and complexity of the bank's securitization activities that involve early amortization provisions.

For controlled amortizations specifically, SAMA may also review the process by which a bank determines the minimum amortization period required to pay down 90% of the outstanding balance at the point of early amortization. Where SAMA does not consider this adequate it will take appropriate action, such as increasing the conversion factor associated with a particular transaction or class of transactions.

(Refer to Paragraphs 785-807 of International Convergence of Capital Measurement and Capital Standards – June 2006)

**Document Enhanced: SAMA's Guidelines Document on the Internal Capital Adequacy Assessment Plan, 2008**

**Positioning of the Paragraph in SAMA's Regulatory Documentation**

**The following guidelines to be included in Pg 6 Section 3.3 "ICAAP as a part of Pillar 2" of the SAMA's Guideines Document on the Internal Capital Adequacy Assessment Plan, 2008**

(In addition to the original text)

**Interest rate risk in the banking book:**

The measurement process should include all material interest rate positions of the bank and consider all relevant repricing and maturity data. Such information will generally include current balance and contractual rate of interest associated with the instruments and portfolios, principal payments, interest reset dates, maturities, the rate index used for repricing, and contractual interest rate ceilings or floors for adjustable-rate items. The system should also have well-documented assumptions and techniques.

Regardless of the type and level of complexity of the measurement system used, bank management should ensure the adequacy and completeness of the system. Because the quality and reliability of the measurement system is largely dependent on the quality of the data and various assumptions used in the model, management should give particular attention to these items.

(Refer to Paragraph 739-740 of of International Convergence of Capital Measurement and Capital Standards – June 2006)



## Positioning of the Paragraph in SAMA's Regulatory Documentation

### **The following guidelines to be included in Pg 6 Section 3.3 "ICAAP as a part of Pillar 2" of the SAMA's Guideines Document on the Internal Capital Adequacy Assessment Plan, 2008**

(In addition to the original text)

**Liquidity risk:** Liquidity is crucial to the ongoing viability of any banking organization. Banks' capital positions can have an effect on their ability to obtain liquidity, especially in a crisis. Each bank must have adequate systems for measuring, monitoring and controlling liquidity risk. Banks should evaluate the adequacy of capital given their own liquidity profile and the liquidity of the markets in which they operate.

(Referto Paragraph 741 of of International Convergence of Capital Measurement and Capital Standards – June 2006)

### **The following guidelines to be included in Pg 19 Section 11 "Challenge and Adoption of the ICAAP" of the SAMA's Guideines Document on the Internal Capital Adequacy Assessment Plan, 2008**

(In addition to the original text)

#### **Internal control review**

The bank should conduct periodic reviews of its risk management process to ensure its integrity, accuracy, and reasonableness. Areas that should be reviewed include:

- Appropriateness of the bank's capital assessment process given the nature, scope and complexity of its activities;

## Positioning of the Paragraph in SAMA's Regulatory Documentation

- Identification of large exposures and risk concentrations;
- Accuracy and completeness of data inputs into the bank's assessment process;
- Reasonableness and validity of scenarios used in the assessment process; and
- Stress testing and analysis of assumptions and inputs.

(Refer to Paragraph 745 of International Convergence of Capital Measurement and Capital Standards – June 2006)

### **The following guidelines to be included in Pg 16 Section "Risk Covered in the ICAAP" of the SAMA's Guidelines Document on the Internal Capital Adequacy Assessment Plan, 2008**

(In addition to the original text)

#### **Risk Covered in the ICAAP**

SAMA recognizes banks' internal systems as the principal tool for the measurement of interest rate risk in the banking book and the supervisory response. To facilitate SAMA's monitoring of interest rate risk exposures across institutions, banks would have to provide the results of their internal measurement systems, expressed in terms of economic value relative to capital, using a standardized interest rate shock.

(Refer to Paragraph 763 of International Convergence of Capital Measurement and Capital Standards – June 2006)

**Document Enhanced: Pillar 3 – Package of Disclosure Requirements and Guidance Notes, 2007**

**Positioning of the Paragraph in SAMA's Regulatory Documentation**

**The following guidelines to be included in Pg 11 Section 4 “Materiality” of the SAMA's Pillar 3 – Package of Disclosure Requirements and Guidance Notes, 2007**

(In addition to the original guidance)

**Materiality**

This Framework also anticipates a role for specific measures. Where disclosure is a qualifying criterion under Pillar 1 to obtain lower risk weightings and/or to apply specific methodologies, there would be a direct sanction (not being allowed to apply the lower weighting or the specific methodology).

(Refer to Paragraph 812 of International Convergence of Capital Measurement and Capital Standards – June 2006)

**The following guidelines to be included in Pg 12 Section 5.2 “Location of Disclosures” of the SAMA's Pillar 3 – Package of Disclosure Requirements and Guidance Notes, 2007**

(In addition to the original guidance)

**Location of Disclosures**

### Positioning of the Paragraph in SAMA's Regulatory Documentation

In situations where the disclosures are made under accounting requirements or are made to satisfy listing requirements promulgated by securities regulators, banks may rely on them to fulfil the applicable Pillar 3 expectations. In these situations, banks should explain material differences between the accounting or other disclosure and the supervisory basis of disclosure. This explanation does not have to take the form of a line by line reconciliation.

(Refer to Paragraph 814 of International Convergence of Capital Measurement and Capital Standards – June 2006)

**Document Addressed: Basel III Pillar 3 – Package of Disclosure Requirements and Guidance Notes**

**Positioning of the Paragraph in SAMA's Regulatory Documentation**

**Basel III Pillar 3 - Package of Disclosure Requirements and Guidance Notes Page No. 14, Frequency and Location of Disclosure**

Original paragraph was as follows:

**7. Frequency and Location of Disclosure**

**Frequency**

Banks are expected to comply with the Basel III enhanced requirements from 1 Jan 2013.

All disclosures will be made semi-annually with the exception of the following:

- Table and 2b, 2c and 2d 3f will be disclosed quarterly.
- All Qualitative Disclosure Requirements will be reported annually.

**Location of Disclosures**

- All quarterly disclosures will be in the regular quarterly financial statements.
- All semi-annual disclosures will be made on a bank's websites.
- All annual disclosures will be in the annual reports of banks and web sites.

## Positioning of the Paragraph in SAMA's Regulatory Documentation

- A reporting bank shall provide in its Annual Report and Periodic Financial Statements the location of all disclosures required under Pillar
- A reporting bank may exercise its discretion in determining the form of the disclosure required and may choose to use graphical and other representations where appropriate.
- The frequency and location of reporting has been specified in each Disclosure Template. The following are the abbreviations on the top right hand side of each template:

Location	Frequency
Annual Financial Statement Report (AR)	Annual: A
Quarterly Financial Statement Report (QR)	Quarterly: Q
Website (W)	Semi-Annually: SA

### **The following is considered added to the above paragraph:**

Under Pillar 3, large banks are required to make certain minimum disclosures with respect to certain defined key capital ratios and elements on a quarterly basis, regardless of the frequency of financial statement publication.<sup>2</sup> The disclosure of key capital ratios/elements for these banks will continue to be required under Basel III.

Banks must also make available on their websites, or through publicly available regulatory reports, an archive (for a suitable retention period determined by the relevant national authority) of all templates relating to prior reporting periods.

## Positioning of the Paragraph in SAMA's Regulatory Documentation

Irrespective of the location of the disclosure (published financial reports, bank websites or publicly available regulatory reports), all disclosures must be in the format required by this document

For the relevant Pillar 3 disclosure requirements see paragraph 818 of the Basel II Framework: International Convergence of Capital Measurement and Capital Standards – A Revised Framework – Comprehensive Version (June 2006).

(Refer to Paragraphs 5-7: Implementation date and frequency of reporting, Composition of capital disclosure requirements - Rules text (June 2012))

## Basel III Pillar 3 - Package of Disclosure Requirements and Guidance Notes Page 16, 3.1 Reconciliation requirements

Original paragraphs were as follows:

### 3.1 **Reconciliation requirements**

There is a three step approach to be undertaken in preparing the enhanced P3 disclosures to show the link between the bank's published financial statements and the numbers that are used in the composition of capital disclosures set out in Section 1 (post 2018) and Section 5 (transition).

#### 3.1.1 **Step 1: Disclose the reported balance sheet under the regulatory scope of consolidation Table (2b).**

In this step, banks are required to take their published balance sheet and report the numbers when the regulatory scope of consolidation is applied.

Banks must list which legal entities (along with disclosure of such entities balance sheet assets, balance sheet equity and principal activities) are included within one scope of consolidation that do not appear in the other scope.

If some entities are included in both the regulatory scope of consolidation and accounting scope of consolidation, but the method of consolidation differs between these two scopes, banks are required to list these legal entities separately and explain the differences in consolidation.

If the scopes of consolidation are identical, then banks can skip this step by noting that there is no difference and move onto step 2.

Table 2b will be used for this step with the balance sheet under the accounting scope of consolidation and regulatory scope of consolidation updated in columns C and E respectively.

An example of where the basis of consolidation for regulatory purposes differs from that used for the financial consolidation is where holdings in insurance and financial entities are excluded from regulatory capital if they qualify as significant minority investments. Column D in table 2b will be used for such a purpose.

On this note, where the two scopes of consolidation differ, the totals of the balance sheet (i.e: total assets, total shareholders equity) in the published financial



statements will not be the same as the totals of the balance sheet under the regulatory scope of consolidation.

**With respect to the above paragraphs, the content highlighted in “bold font” has been added :**

### 3.1 **Reconciliation requirements**

There is a three step approach to be undertaken in preparing the enhanced P3 disclosures to show the link between the bank's published financial statements and the numbers that are used in the composition of capital disclosures set out in Section 1 (post 2018) and Section 5 (transition).

#### 3.1.1 **Step 1: Disclose the reported balance sheet under the regulatory scope of consolidation Table (2b).**

In this step, banks are required to take their published balance sheet and report the numbers when the regulatory scope of consolidation is applied.

Banks must list which legal entities (along with disclosure of such entities balance sheet assets, balance sheet equity and principal activities) are included within one scope of consolidation that do not appear in the other scope. **Regarding each legal entity that is required to be disclosed by this paragraph, banks must also disclose its total balance sheet assets and total balance sheet equity (as stated on the accounting balance sheet of the legal entity)] and a description of the principle activities of the entity.**

(Refer to, Paragraphs 10-13: section 2: Reconciliation requirements, Composition of capital disclosure requirements - Rules text (June 2012))

**Basel III – Pillar 3 Package of Disclosure Requirements and Guidance Notes, Page 22, Table 2 – Capital Structure "All B", Table 2 (e) – Main features template**

The original paragraph was as follows:

Table 2 (e) – Main features template

- Disclose the key features of all regulatory capital instruments. In this template, banks are required to complete all of the shaded cells for each outstanding regulatory capital instrument (banks should insert "NA" if the question is not applicable).

The revised paragraph would read as follows:

Table 2 (e) – Main features template

- Disclose the key features of all regulatory capital instruments. In this template, banks are required to complete all of the shaded cells for each outstanding regulatory capital instrument (banks should insert "NA" if the question is not applicable).

Banks are required to keep the completed main features report up-to-date, such that the report is updated and made publicly available whenever a bank issues or repays a capital instrument and whenever there is a redemption, conversion/write-down or other material change in the nature of an existing capital instrument.

Given that the template includes information on the amount recognised in regulatory capital at the latest reporting date, the main features report should either be included in the bank's published financial reports or, at a minimum, these financial reports must provide a direct link to where the report can be found on the bank's website or publicly available regulatory reporting.

(Refer to Paragraphs 27-31: Section 3; Main features template, Composition of capital disclosure requirements - Rules text (June 2012))

## **The following is inserted as Annexure A, Pillar 3 Package of Disclosure Requirements and Guidance Notes**

### **Other disclosure requirements**

In addition to the disclosure requirements set out in this document, and aside from the transitional disclosure requirements set out in Section 5 of Composition of Capital Disclosure Requirement, Rules Text, June 2012, the Basel III rules text makes the following requirements in respect of the composition of capital:

**Non-regulatory ratios:** banks which disclose ratios involving components of regulatory capital (eg “Equity Tier 1”, “Core Tier 1” or “Tangible Common Equity” ratios) must accompany such disclosures with a comprehensive explanation of how these ratios are calculated.

**Full terms and conditions:** banks are required to make available on their websites the full terms and conditions of all instruments included in regulatory capital.

The requirement for banks to make available the full terms and conditions of regulatory capital instruments on their websites will allow market participants and supervisors to investigate the specific features of individual capital instruments. An additional related requirement is that all banks must maintain a Regulatory Disclosures section of their websites, where all of the information relating to disclosure of regulatory capital is made available to market participants. In cases where disclosure requirements set out in this document are met via publication through publicly available regulatory reports, the regulatory disclosures section of the bank’s website should provide specific links to the relevant regulatory reports that relate to the bank. This requirement stems from the supervisory experience that, in many cases, the benefit of Pillar 3 disclosures is severely diminished by the challenge of finding the disclosure in the first place.

Ideally much of the information that would be reported in the Regulatory Disclosures section of the website would also included in the published financial reports of the bank. The Basel Committee has agreed that, at minimum, the published financial reports must direct users to the relevant section of their websites where the full set of required regulatory disclosure is provided.

Refer to Paragraphs 31-33: Section 4: Other disclosure requirements, Composition of capital disclosure requirements - Rules text (June 2012)

**Document Enhanced: Section A Finalized Guidance Document Concerning the Implementation of Basel III**

**Positioning of the Paragraph in SAMA's Regulatory Documentation**

**Refer Page 7 & 8 of Section A – Finalized guidance document concerning the implementation of Basel III, 2.2 Details on Components of Regulatory Capital , 2.2.1 Common Equity Tier 1**

The original paragraphs were as follows

**2.2.1 Common Equity Tier 1**

Common Equity Tier 1 capital consists of the sum of the following elements:

- Common shares issued by the bank that meet the criteria for classification as common shares for regulatory purposes (or the equivalent for non-joint stock companies);
- Stock surplus (share premium) resulting from the issue of instruments included Common Equity Tier 1;
- Retained earnings;
- Accumulated other comprehensive income and other disclosed reserves;
- Common shares issued by consolidated subsidiaries of the bank and held by third parties (i.e. minority interest) that meet the criteria for inclusion in Common Equity Tier 1 capital.
- Retained earnings and other comprehensive income include interim profit or loss.

## Positioning of the Paragraph in SAMA's Regulatory Documentation

- Dividends are removed from Common Equity Tier 1 in accordance with applicable accounting standards. The treatment of minority interest and the regulatory adjustments applied in the calculation of Common Equity Tier 1 are addressed in separate sections.

### ***Common shares issued by the bank***

For an instrument to be included in Common Equity Tier 1 capital it must meet all of the criteria that are outlined in Annex-2. The vast majority of internationally active banks are structured as joint stock companies and for these banks the criteria must be met solely with common shares.

In the rare cases where banks need to issue non-voting common shares as part of Common Equity Tier 1, they must be identical to voting common shares of the issuing bank in all respects except the absence of voting rights.

- Common shares issued by consolidated subsidiaries are described in section 3 of this document.

Regulatory adjustments applied in the calculation of Common Equity Tier 1 are described in section 4 of this document.

- Common shares issued by consolidated subsidiaries are described in section 3 of this document.

**The following content has been added against certain assertions in the original paragraph above, these are highlighted in bold font – the rest of the original content remains “as is”:**

### **2.2.1 Common Equity Tier 1**

- Accumulated other comprehensive income and other disclosed reserves; **(There is no adjustment applied to remove from Common Equity Tier 1 unrealised gains or losses recognized on the balance sheet. Unrealised losses are subject to the transitional arrangements set out in paragraph 94 (c) and (d) Basel III: A global regulatory**

## Positioning of the Paragraph in SAMA's Regulatory Documentation

framework for more resilient banks and banking systems, 2011).

### ***Common shares issued by the bank***

For an instrument to be included in Common Equity Tier 1 capital it must meet all of the criteria that are outlined in Annex-2. The vast majority of internationally active banks are structured as joint stock companies (**Joint stock companies are defined as companies that have issued common shares, irrespective of whether these shares are held privately or publically. These will represent the vast majority of internationally active banks**) and for these banks the criteria must be met solely with common shares.

(Refer to Paragraphs 53: Basel III: A global regulatory framework for more resilient banks and banking systems - revised version (rev June 2011))

### **Refer Page 77 Section A – Finalized guidance document concerning the implementation of Basel III, Annex 2, Criteria for Classification as Common Shares for Regulatory Capital purposes**

The original heading was as follows

### **Annex-2 Criteria for Classification as Common Shares for Regulatory Capital purposes**

The revised heading would be accompanied by a foot note

### **Annex-2 Criteria for Classification as Common Shares for Regulatory Capital purposes<sup>a</sup>**

## Positioning of the Paragraph in SAMA's Regulatory Documentation

Footnote a: The criteria also apply to non joint stock companies, such as mutuals, cooperatives or savings institutions, taking into account their specific constitution and legal structure. The application of the criteria should preserve the quality of the instruments by requiring that they are deemed fully equivalent to common shares in terms of their capital quality as regards loss absorption and do not possess features which could cause the condition of the bank to be weakened as a going concern during periods of market stress. Supervisors will exchange information on how they apply the criteria to non joint stock companies in order to ensure consistent implementation.

(Refer to Paragraphs 52: Basel III: A global regulatory framework for more resilient banks and banking systems - revised version (rev June 2011))

Refer Page 77 Section A – Finalized guidance document concerning the implementation of Basel III, Annex 2, Criteria for Classification as Common Shares for Regulatory Capital purposes

The original paragraph was as follows:

1. Represents the most subordinated claim in liquidation of the bank.
2. Entitled to a claim on the residual assets that is proportional with its share of issued capital, after all senior claims have been repaid in liquidation (ie has an unlimited and variable claim, not a fixed or capped claim).
3. Principal is perpetual and never repaid outside of liquidation (setting aside discretionary repurchases or other means of effectively reducing capital in a discretionary manner that is allowable under relevant law).
4. The bank does nothing to create an expectation at issuance that the instrument will be bought back, redeemed or cancelled nor do the statutory or contractual terms provide any feature which might give rise to such an expectation.



## Positioning of the Paragraph in SAMA's Regulatory Documentation

5. Distributions are paid out of distributable items (retained earnings included). The level of distributions is not in any way tied or linked to the amount paid in at issuance and is not subject to a contractual cap (except to the extent that a bank is unable to pay distributions that exceed the level of distributable items).
6. There are no circumstances under which the distributions are obligatory. Non payment is therefore not an event of default.
7. Distributions are paid only after all legal and contractual obligations have been met and payments on more senior capital instruments have been made. This means that there are no preferential distributions, including in respect of other elements classified as the highest quality issued capital.
8. It is the issued capital that takes the first and proportionately greatest share of any losses as they occur. Within the highest quality capital, each instrument absorbs losses on a going concern basis proportionately and pari passu with all the others.
9. The paid in amount is recognised as equity capital (ie not recognised as a liability) for determining balance sheet insolvency.
10. The paid in amount is classified as equity under the relevant accounting standards.
11. It is directly issued and paid-in and the bank can not directly or indirectly have funded the purchase of the instrument.
12. The paid in amount is neither secured nor covered by a guarantee of the issuer or related entity or subject to any other arrangement that legally or economically enhances the seniority of the claim.
13. It is only issued with the approval of the owners of the issuing bank, either given directly by the owners or, if

## Positioning of the Paragraph in SAMA's Regulatory Documentation

permitted by applicable law, given by the Board of Directors or by other persons duly authorised by the owners.

14. It is clearly and separately disclosed on the bank's balance sheet.

**The following content has been added against certain assertions in the original paragraph above, these are highlighted in bold font – the rest of the original content remains “as is”:**

8. It is the issued capital that takes the first and proportionately greatest share of any losses as they occur **(In cases where capital instruments have a permanent write-down feature, this criterion is still deemed to be met by common shares.)**. Within the highest quality capital, each instrument absorbs losses on a going concern basis proportionately and pari passu with all the others.

12. The paid in amount is neither secured nor covered by a guarantee of the issuer or related entity **(A related entity can include a parent company, a sister company, a subsidiary or any other affiliate. A holding company is a related entity irrespective of whether it forms part of the consolidated banking group.)** or subject to any other arrangement that legally or economically enhances the seniority of the claim.

**(Refer to 54-56, Tier 2 capital, Basel III: A global regulatory framework for more resilient banks and banking systems - revised version (rev June 2011))**

**Refer Page 7 & 8 of Section A – Finalized guidance document concerning the implementation of Basel III, 2.2 Details on Components of Regulatory Capital , Common shares issued by the bank**

**Original paragraph was as follows:**

## Positioning of the Paragraph in SAMA's Regulatory Documentation

### 2.2.2. Additional Tier 1 capital

- A minimum set of criteria for an instrument issued by the bank to meet or to exceed in order for its to be included in additional Tier-1 Capital and described in Annex # 3.

Additional Tier 1 capital consists of the sum of the following elements:

- Instruments issued by the bank that meet the criteria for inclusion in Additional Tier 1 capital (and are not included in Common Equity Tier 1);
- Stock surplus (share premium) resulting from the issue of instruments included in Additional Tier 1 capital;
- Instruments issued by consolidated subsidiaries of the bank and held by third parties that meet the criteria for inclusion in Additional Tier 1 capital and are not included in Common Equity Tier 1. Refer to Annex # 3 for the relevant criteria; and
- Regulatory adjustments applied in the calculation of Additional Tier 1 Capital are addressed in section 4 of this document.
- Tier-1 Capital instruments issued by consolidated subsidiaries are described in section 3 of this document.

**The following content has been added against certain assertions in the original paragraph above, these are highlighted in bold font – the rest of the original content remains “as is”:**

- Instruments issued by consolidated subsidiaries of the bank and held by third parties that meet the criteria for inclusion in Additional Tier 1 capital and are not included in Common Equity Tier 1. Refer to **Section 3** for the relevant criteria; and
- Refer to Paragraph 54, Additional Tier 1 capital, A global regulatory framework for more resilient banks and banking

## Positioning of the Paragraph in SAMA's Regulatory Documentation

systems - revised version (rev June 2011)

**Refer Page 78 Section A – Finalized guidance document concerning the implementation of Basel III, Annex 3, Instruments issued by the bank that meet the Additional Tier 1 criteria**

The original content was as follows:

### **Criteria for inclusion in Additional Tier 1 capital**

1. Issued and paid-in
2. Subordinated to depositors, general creditors and subordinated debt of the bank
3. Is neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis bank creditors
4. Is perpetual, ie there is no maturity date and there are no step-ups or other incentives to redeem
5. May be callable at the initiative of the issuer only after a minimum of five years
  - a. To exercise a call option a bank must receive prior supervisory approval; and
  - b. A bank must not do anything which creates an expectation that the call will be exercised; and

## Positioning of the Paragraph in SAMA's Regulatory Documentation

c. Banks must not exercise a call unless:

i. They replace the called instrument with capital of the same or better quality and the replacement of this capital is done at conditions which are sustainable for the income capacity of the bank<sup>15</sup>; or

ii. The bank demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised.<sup>16</sup>

6. Any repayment of principal (eg through repurchase or redemption) must be with prior supervisory approval and banks should not assume or create market expectations that supervisory approval will be given

7. Dividend/coupon discretion:

a. the bank must have full discretion at all times to cancel distributions/payments<sup>17</sup>

b. cancellation of discretionary payments must not be an event of default

c. banks must have full access to cancelled payments to meet obligations as they fall due

d. cancellation of distributions/payments must not impose restrictions on the bank except in relation to distributions to common stockholders.

8. Dividends/coupons must be paid out of distributable items

9. The instrument cannot have a credit sensitive dividend feature, that is a dividend/coupon that is reset periodically based in whole or in part on the banking organisation's credit standing.

## Positioning of the Paragraph in SAMA's Regulatory Documentation

10. The instrument cannot contribute to liabilities exceeding assets if such a balance sheet test forms part of national insolvency law.

11. Instruments classified as liabilities for accounting purposes must have principal loss absorption through either (i) conversion to common shares at an objective pre-specified trigger point or (ii) a write-down mechanism which allocates losses to the instrument at a pre-specified trigger point. The write-down will have the following effects:

- a. Reduce the claim of the instrument in liquidation;
- b. Reduce the amount re-paid when a call is exercised; and
- c. Partially or fully reduce coupon/dividend payments on the instrument.

12. Neither the bank nor a related party over which the bank exercises control or significant influence can have purchased the instrument, nor can the bank directly or indirectly have funded the purchase of the instrument

13. The instrument cannot have any features that hinder recapitalisation, such as provisions that require the issuer to compensate investors if a new instrument is issued at a lower price during a specified time frame

14. If the instrument is not issued out of an operating entity or the holding company in the consolidated group (eg a special purpose vehicle – “SPV”), proceeds must be immediately available without limitation to an operating entity<sup>18</sup> or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in Additional Tier 1 capital

## Positioning of the Paragraph in SAMA's Regulatory Documentation

*Stock surplus (share premium) resulting from the issue of instruments included in Additional Tier 1 capital;*

Stock surplus (ie share premium) that is not eligible for inclusion in Common Equity Tier 1, will only be permitted to be included in Additional Tier 1 capital if the shares giving rise to the stock surplus are permitted to be included in Additional Tier 1 capital.

**The following content has been added against certain assertions in the original paragraph above, these are highlighted in bold font – the rest of the original content remains “as is”:**

5. May be callable at the initiative of the issuer only after a minimum of five years:

a. To exercise a call option a bank must receive prior supervisory approval; and

b. A bank must not do anything which creates an expectation that the call will be exercised; and

c. Banks must not exercise a call unless:

i. They replace the called instrument with capital of the same or better quality and the replacement of this capital is done at conditions which are sustainable for the income capacity of the bank **(Replacement issues can be concurrent with but not after the instrument is called)**; or

ii. The bank demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised. **(Minimum refers to the regulator's prescribed minimum requirement, which may be higher than the Basel III Pillar 1 minimum requirement.)**<sup>16</sup>

7. Dividend/coupon discretion:

## Positioning of the Paragraph in SAMA's Regulatory Documentation

a. the bank must have full discretion at all times to cancel distributions/payments **(A consequence of full discretion at all times to cancel distributions/payments is that “dividend pushers” are prohibited. An instrument with a dividend pusher obliges the issuing bank to make a dividend/coupon payment on the instrument if it has made a payment on another (typically more junior) capital instrument or share. This obligation is inconsistent with the requirement for full discretion at all times. Furthermore, the term “cancel distributions/payments” means extinguish these payments. It does not permit features that require the bank to make distributions/payments in kind.)**<sup>17</sup>

14. If the instrument is not issued out of an operating entity or the holding company in the consolidated group (eg a special purpose vehicle – “SPV”), proceeds must be immediately available without limitation to an operating entity **(An operating entity is an entity set up to conduct business with clients with the intention of earning a profit in its own right.)** or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in Additional Tier 1 capital

Refer to Paragraph 54-56, A global regulatory framework for more resilient banks and banking systems - revised version (rev June 2011)

**Refer Page 80 Section A – Finalized guidance document concerning the implementation of Basel III, Annex 4, Instruments issued by the bank that meet the Tier 2 criteria**

The original content was as follows

**Annex-4**



## Positioning of the Paragraph in SAMA's Regulatory Documentation

### Criteria for inclusion in Tier 2 Capital

1. Issued and paid-in
2. Subordinated to depositors and general creditors of the bank
3. Is neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis depositors and general bank creditors
4. Maturity:
  - a. minimum original maturity of at least five years
  - b. recognition in regulatory capital in the remaining five years before maturity will be amortized on a straight line basis
  - c. there are no step-ups or other incentives to redeem
5. May be callable at the initiative of the issuer only after a minimum of five years:
  - a. To exercise a call option a bank must receive prior supervisory approval;
  - b. A bank must not do anything that creates an expectation that the call will be exercised; and
  - c. Banks must not exercise a call unless:
    - i. They replace the called instrument with capital of the same or better quality and the replacement of this capital is done

## Positioning of the Paragraph in SAMA's Regulatory Documentation

at conditions which are sustainable for the income capacity of the bank; or

ii. The bank demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised

6. The investor must have no rights to accelerate the repayment of future scheduled payments (coupon or principal), except in bankruptcy and liquidation.

7. The instrument cannot have a credit sensitive dividend feature, that is a dividend/coupon that is reset periodically based in whole or in part on the banking organisation's credit standing.

8. Neither the bank nor a related party over which the bank exercises control or significant influence can have purchased the instrument, nor can the bank directly or indirectly have funded the purchase of the instrument.

9. If the instrument is not issued out of an operating entity or the holding company in the consolidated group (eg a special purpose vehicle – —SPV), proceeds must be immediately available without limitation to an operating entity or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in Tier 2 Capital.

Stock surplus (ie share premium) that is not eligible for inclusion in Tier 1, will only be permitted to be included in Tier 2 capital if the shares giving rise to the stock surplus are permitted to be included in Tier 2 capital.

*General provisions/general loan-loss reserves (for banks using the Standardised Approach for credit risk)*

**The following content has been added against certain assertions in the original paragraph above, these are**

## Positioning of the Paragraph in SAMA's Regulatory Documentation

highlighted in bold font – the rest of the original content remains “as is”:

### Annex-4

Criteria for inclusion in Tier 2 Capital

5. May be callable at the initiative of the issuer only after a minimum of five years:

a. To exercise a call option a bank must receive prior supervisory approval;

b. A bank must not do anything that creates an expectation that the call will be exercised; **(An option to call the instrument after five years but prior to the start of the amortisation period will not be viewed as an incentive to redeem as long as the bank does not do anything that creates an expectation that the call will be exercised at this point.)** and

c. Banks must not exercise a call unless:

i. They replace the called instrument with capital of the same or better quality and the replacement of this capital is done at conditions which are sustainable for the income capacity of the bank; **(Replacement issues can be concurrent with but not after the instrument is called.)** or

ii. The bank demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised **(Minimum refers to the regulator's prescribed minimum requirement, which may be higher than the Basel III Pillar 1 minimum requirement.)**

9. If the instrument is not issued out of an operating entity or the holding company in the consolidated group (eg a special

## Positioning of the Paragraph in SAMA's Regulatory Documentation

purpose vehicle – —SPVII), proceeds must be immediately available without limitation to an operating entity **(An operating entity is an entity set up to conduct business with clients with the intention of earning a profit in its own right)** or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in Tier 2 Capital.

(Refer paragraph 57-59, A global regulatory framework for more resilient banks and banking systems - revised version (rev June 2011))

**Refer Page 80 Section A – Finalized guidance document concerning the implementation of Basel III, Minority interest (i.e. non-controlling interest) and other capital issued out of consolidated subsidiaries that is held by third parties**

The original content was as follows:

### **3.1 Common shares issued by consolidated subsidiaries**

Minority interest arising from the issue of common shares by a fully consolidated subsidiary of the bank may receive recognition in Common Equity Tier 1 only if:

- (1) the instrument giving rise to the minority interest would, if issued by the bank, meet all of the criteria for classification as common shares for regulatory capital purposes; and
- (2) the subsidiary that issued the instrument is itself a bank. The amount of minority interest meeting the criteria above that will be recognized in consolidated Common Equity Tier 1 will be calculated as follows:
  - Total minority interest meeting the two criteria above minus the amount of the surplus Common Equity Tier 1 of the

## Positioning of the Paragraph in SAMA's Regulatory Documentation

subsidiary attributable to the minority shareholders.

- Surplus Common Equity Tier 1 of the subsidiary is calculated as the Common Equity Tier 1 of the subsidiary minus the lower of: (1) the minimum Common Equity Tier 1 requirement of the subsidiary plus the capital conservation buffer (ie 7.0% of risk weighted assets) and (2) the portion of the consolidated minimum Common Equity Tier 1 requirement plus the capital conservation buffer (ie 7.0% of consolidated risk weighted assets) that relates to the subsidiary.
- The amount of the surplus Common Equity Tier 1 that is attributable to the minority shareholders is calculated by multiplying the surplus Common Equity Tier 1 by the percentage of Common Equity Tier 1 that is held by minority shareholders.

**The following content has been added against certain assertions in the original paragraph above, these are highlighted in bold font – the rest of the original content remains “as is”:**

### **3.1 Common shares issued by consolidated subsidiaries**

(2) the subsidiary that issued the instrument is itself a bank **(For the purposes of this paragraph, any institution that is subject to the same minimum prudential standards and level of supervision as a bank may be considered to be a bank.) & (Minority interest in a subsidiary that is a bank is strictly excluded from the parent bank's common equity if the parent bank or affiliate has entered into any arrangements to fund directly or indirectly minority investment in the subsidiary whether through an SPV or through another vehicle or arrangement. The treatment outlined above, thus, is strictly available where all minority investments in the bank subsidiary solely represent genuine third party common equity contributions to the subsidiary)**. The amount of minority interest meeting the criteria above that will be recognized in consolidated Common Equity Tier 1 will be calculated as follows:

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- Total minority interest meeting the two criteria above minus the amount of the surplus Common Equity Tier 1 of the subsidiary attributable to the minority shareholders.
- Surplus Common Equity Tier 1 of the subsidiary is calculated as the Common Equity Tier 1 of the subsidiary minus the lower of: (1) the minimum Common Equity Tier 1 requirement of the subsidiary plus the capital conservation buffer (ie 7.0% of risk weighted assets) and (2) the portion of the consolidated minimum Common Equity Tier 1 requirement plus the capital conservation buffer (ie 7.0% of consolidated risk weighted assets) that relates to the subsidiary.
- The amount of the surplus Common Equity Tier 1 that is attributable to the minority shareholders is calculated by multiplying the surplus Common Equity Tier 1 by the percentage of Common Equity Tier 1 that is held by minority shareholders.

(Refer paragraph 62, A global regulatory framework for more resilient banks and banking systems - revised version (rev June 2011))

### **Refer Page 11 Section A – Finalized guidance document concerning the implementation of Basel III, 3.3 Tier 1 and Tier 2 qualifying capital issued by consolidated subsidiaries**

The original paragraph was as follows:

#### **3.3 Tier 1 and Tier 2 qualifying capital issued by consolidated subsidiaries**

Total capital instruments (ie Tier 1 and Tier 2 capital instruments) issued by a fully consolidated subsidiary of the bank to third party investors (including amounts under paragraph 3.1 and 3.2) may receive recognition in Total Capital only if the

## Positioning of the Paragraph in SAMA's Regulatory Documentation

instruments would, if issued by the bank, meet all of the criteria for classification as Tier 1 or Tier 2 capital. The amount of this capital that will be recognized in consolidated Total Capital will be calculated as follows:

- Total capital instruments of the subsidiary issued to third parties minus the amount of the surplus Total Capital of the subsidiary attributable to the third party investors.
- Surplus Total Capital of the subsidiary is calculated as the Total Capital of the subsidiary minus the lower of: (1) the minimum Total Capital requirement of the subsidiary plus the capital conservation buffer (ie 10.5% of risk weighted assets) and (2) the portion of the consolidated minimum Total Capital requirement plus the capital conservation buffer (ie 10.5% of consolidated risk weighted assets) that relates to the subsidiary.
- The amount of the surplus Total Capital that is attributable to the third party investors is calculated by multiplying the surplus Total Capital by the percentage of Total Capital that is held by third party investors.

The amount of this Total Capital that will be recognized in Tier 2 will exclude amounts recognized in Common Equity Tier 1 under paragraph 3.1 and amounts recognized in Additional Tier 1 under paragraph 3.3.

Where capital has been issued to third parties out of a special purpose vehicle (SPV), none of this capital can be included in Common Equity Tier 1. However, such capital can be included in consolidated Additional Tier 1 or Tier 2 and treated as if the bank itself had issued the capital directly to the third parties only if it meets all the relevant entry criteria and the only asset of the SPV is its investment in the capital of the bank in a form that meets or exceeds all the relevant entry criteria (as required by criterion 14 for Additional Tier 1 and criterion 9 for Tier 2). In cases where the capital has been issued to third parties through an SPV via a fully consolidated subsidiary of the bank, such capital may, subject to the requirements of this paragraph, be treated as if the subsidiary itself had issued it directly to the third parties and may

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be included in the bank's consolidated Additional Tier 1 or Tier 2 in accordance with the treatment outlined in paragraphs 63 and 64 of the BCBS document of June 2011.

**The following content has been amended in the original paragraph above, these are highlighted in bold font – the rest of the original content remains “as is”:**

- The amount of the surplus Total Capital that is attributable to the third party investors is calculated by multiplying the surplus Total Capital by the percentage of Total Capital that is held by third party investors.

The amount of this Total Capital that will be recognized in Tier 2 will exclude amounts recognized in Common Equity Tier 1 under paragraph 3.1 and amounts recognized in Additional Tier 1 **under paragraph 3.2.**

Paragraphs 64-65: A global regulatory framework for more resilient banks and banking systems - revised version (rev June 2011)

**Refer, Page 13 of Section A – Finalized guidance document concerning the implementation of Basel III, Cumulative gains and losses due to changes in own credit risk on fair valued financial liabilities**

The original paragraph was as follows:

**Cumulative gains and losses due to changes in own credit risk on fair valued financial liabilities**

Derecognize in the calculation of Common Equity Tier 1, all unrealized gains and losses that have resulted from changes



## Positioning of the Paragraph in SAMA's Regulatory Documentation

in the fair value of liabilities that are due to changes in the bank's own credit risk.

### **The revised paragraph would read as follows**

Derecognize in the calculation of Common Equity Tier 1, all unrealized gains and losses that have resulted from changes in the fair value of liabilities that are due to changes in the bank's own credit risk.

In addition, with regard to derivative liabilities, derecognise all accounting valuation adjustments arising from the bank's own credit risk. The offsetting between valuation adjustments arising from the bank's own credit risk and those arising from its counterparties' credit risk is not allowed.”

(BIS has issued its final guidelines (July 2012) titled “Regulatory treatment of valuation adjustments to derivative liabilities - final rule issued by the Basel Committee”. Banks are advised to refer to the aforementioned, these would be regarded as binding by SAMA with respect to capital computation / capital adequacy under Basel III guidelines and consider these as binding.)

Refer to Paragraph 75, Cumulative gains and losses due to changes in own credit risk on fair valued financial liabilities (Updated in July 2012)

## Positioning of the Paragraph in SAMA's Regulatory Documentation

### Page 18 of Section A – Finalized guidance document concerning the implementation of Basel III, 4.4 Threshold Deduction

The original paragraph was as follows:

#### 4.4 Threshold deductions

Instead of a full deduction, the following items may each receive limited recognition when calculating Common Equity Tier 1, with recognition capped at 10% of the bank's common equity (after the application of all regulatory adjustments set out in paragraphs 4.1.1 to 4.3):

- Significant investments in the common shares of unconsolidated financial institutions (banks, insurance and other financial entities) as referred to in paragraph 84;
- Mortgage servicing rights (MSRs); and
- DTAs that arise from temporary differences.

On 1 January 2013, a bank must deduct the amount by which the aggregate of the three items above exceeds 15% of its common equity component of Tier 1 (calculated prior to the deduction of these items but after application of all other regulatory adjustments applied in the calculation of Common Equity Tier 1). The items included in the 15% aggregate limit are subject to full disclosure. As of 1 January 2018, the calculation of the 15% limit will be subject to the following treatment: the amount of the three items that remains recognized after the application of all regulatory adjustments must not exceed 15% of the Common Equity Tier 1 capital, calculated after all regulatory adjustments. See Annex 2 for an example.

## Positioning of the Paragraph in SAMA's Regulatory Documentation

The amount of the three items that are not deducted in the calculation of Common Equity Tier 1 will be risk weighted at 250%. (Refer to Prudential Return)

**The following content has been amended in the original paragraph above, these are highlighted in bold font – the rest of the original content remains “as is”:**

Instead of a full deduction, the following items may each receive limited recognition when calculating Common Equity Tier 1, with recognition capped at 10% of the bank's common equity (after the application of all regulatory adjustments set out in paragraphs 4.1.1 to 4.3):

- Significant investments in the common shares of unconsolidated financial institutions (banks, insurance and other financial entities) as referred to in **section 4.3 of this document;**

Refer to Paragraph 87-89, A global regulatory framework for more resilient banks and banking systems - revised version (rev June 2011)

### **Page 73 of Section A – Finalized guidance document concerning the implementation of Basel III, Disclosure requirements**

#### **Disclosure requirements**

The original paragraph was as follows:

91. To help improve transparency of regulatory capital and improve market discipline, banks are required to disclose the following:

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- a full reconciliation of all regulatory capital elements back to the balance sheet in the audited financial statements;
- separate disclosure of all regulatory adjustments and the items not deducted from Common Equity Tier 1 according to paragraphs 87 and 88;
- a description of all limits and minima, identifying the positive and negative elements of capital to which the limits and minima apply;
- a description of the main features of capital instruments issued;

banks which disclose ratios involving components of regulatory capital (eg —Equity Tier 1, —Core Tier 1 or —Tangible Common Equity ratios) must accompany such disclosures with a comprehensive explanation of how these ratios are calculated.

92. Banks are also required to make available on their websites the full terms and conditions of all instruments included in regulatory capital. The Basel Committee will issue more detailed Pillar 3 disclosure requirements in 2011.

93. During the transition phase banks are required to disclose the specific components of capital, including capital instruments and regulatory adjustments that are benefiting from the transitional provisions

**The following content has been amended in the original paragraph above, these are highlighted in bold font – the rest of the original content remains “as is”:**

## Positioning of the Paragraph in SAMA's Regulatory Documentation

91. To help improve transparency of regulatory capital and improve market discipline, banks are required to disclose the following:

- a full reconciliation of all regulatory capital elements back to the balance sheet in the audited financial statements;
- separate disclosure of all regulatory adjustments and the items not deducted from Common Equity Tier 1 according to **section 4.4.** of this SAMA guideline;
- a description of all limits and minima, identifying the positive and negative elements of capital to which the limits and minima apply;
- a description of the main features of capital instruments issued;
- banks which disclose ratios involving components of regulatory capital (eg —Equity Tier 1, —Core Tier 1 or —Tangible Common Equity ratios) must accompany such disclosures with a comprehensive explanation of how these ratios are calculated.

(Refer to Paragraphs 91-93: A global regulatory framework for more resilient banks and banking systems - revised version (rev June 2011))