Circular No.: 581
Date: 22 September 2008

From : Saudi Arabian Monetary Agency

To : All Banks

Attention : Managing Directors, Chief Executive Officers and General Managers

Subject : **Pillar 2: SAMA's Guideline Document on the Internal Capital Adequacy Assessment Plan (ICAAP)**

In December 2007, SAMA issued its first draft guidance document on preparation of ICAAP by Banks. In this respect, Banks have submitted to SAMA their initial Pilot Run ICAAP's for 2007 by 30 April 2008. The objective was for SAMA to review the methodology adopted by the Bank in establishing their Regulatory and Economic capital requirements.

Following a review of the Banks' ICAAP submissions, Bilateral Meetings were held in May and June of 2008 involving the SAMA Basel II Project Team and the Banks' Basel II Project Teams and other senior staff members including CRO's, CFO's, CCO's, etc. The objective of these meetings was to discuss SAMA's preliminary assessment of the Bank's ICAAP and provide comments and suggestions on enhancements and refinements.

These deliberations also pointed out the need for SAMA to refine its Draft Guidelines concerning the ICAAP. These have now been revised in the attached Draft No. 2 to further guide banks in constructing their annual ICAAP.

The most significant aspect of the Basel II Pillar II component is the Supervisory Review Process (SRP) and the review and assessment of the Internal Capital Adequacy Assessment Plan (ICAAP). ICAAP is derived from a formal internal process, whereby a bank estimate its capital requirements in relation to its risk profile, strategy, business plans, governance structures, internal risk management systems, etc. Consequently, the ICAAP process includes a strategic review of a bank's capital needs and how these are to be funded.

It is noteworthy that the ICAAP process involves an assessment of a bank's capital needs beyond its minimum capital requirements. Accordingly, it addresses both Pillar I and Pillar II risks. Pillar 2 risks include financial and non-financial risks such as strategic, reputational, liquidity, concentration, interest rate, etc. Consequently, ICAAP allows a bank to attribute and measure capital to cover the economic effects of all risk taking activities by aggregating Pillar 1 and Pillar 2 risks.

An essential feature of SAMA's Risk Based Supervision is the Annual Supervisory Visit where SAMA's staff meets with a bank's senior management to assess its risk profile, strategies, operational plans, internal control, risk management systems, and the quality of its senior management. Also included is an assessment whether the bank holds sufficient capital or it needs additional capital for risks that are not adequately covered. Consequently, going forward, SAMA will use a bank's annual ICAAP as the main document in the conduct of its risk based supervisory process during the supervisory visits.

The attached guidance document is in two components covering i) the process for constructing an ICAAP; ii) and the reporting format and the minimum content. This will assist the banks to document their ICAAP's in a manner that can be easily understood at the Board level and will also contain all relevant information to make an informed judgment about its internal risk assessment process and its capital requirements.

Further, the ICAAP should be approved by the Board of Directors, or by the Executive Committee of the Board before its submission to SAMA. Where appropriate, technical information on risk measurement methodologies, capital models and all other work carried out to validate models including other relevant information should be retained by the Bank for SAMA's on site work or validations.

Foreign Bank branches are not required to prepare an ICAAP document, although they would be expected to address relevant issues in their strategic and operational planning and risk management processes. These will be reviewed with the HO of the Branch in conjunction with the management of the branch.

The first formal ICAAP is to be submitted for year ended 31 December 2008 by 31 January 2009. This should be based on a Bank's strategic and operational plans for the next 12-24 months.

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Encl.: a/s