The roll-out of Basel III financial reforms

On 1 January 2023, SAMA published a circular for the implementation of Basel III final reforms, which covered the full adaptation measures for credit risk, market risk, operational risk, credit value adjustment (CVA) and leverage ratio by banks in Saudi Arabia.

SAMA has also set out the final prudential framework for Saudi banks' capital requirements to align with those Basel III final reforms and risk weights which are to be applied across all domains. These reforms conclude Basel III implementation from a regulatory standpoint, in line with the internationally agreed timeline set by the Basel Committee on Banking Supervision (BCBS), the global standard-setter for the prudential regulation of banks.

Launch objectives

Saudi Arabia is one of the few jurisdictions — and the leading country in the Middle East — that have met the official Basel III implementation date and are commencing implementing of the reforms. Under the regulatory direction and guidance of SAMA, Saudi's banks are required to start the official implementation of the Basel III final reforms starting from January 1, 2023, in line with the BCBS timelines and expectations from G20 member countries.

The Basel III final reforms aim to restore creditability in the calculation of risk-weighted assets (RWAs) by improving the sensitivity of the standardized approach used in calculating them and reducing reliance on the internal ratings-based approach, and setting a framework for comparison of the banks' capital ratios. Expanded risk coverage as a result of revised methods of the calculation are likely to have a wider impact on business models and capital allocation strategies.

The reforms also aim to complement the risk-weighted capital ratio with a revised leverage framework, which includes an uprated leverage ratio, as well as minimum outputs for calculating risk-weighted assets (output floors) which will be phased in from 1 January 2023 through 1 January 2028.

Key changes and enhancements

These are the six key focus areas affected by the reforms and the expected implications for banks:

1. Introduction of output floors
A capital floor has been set to sequentially constrain the extent to which banks can use internal models to bring capital requirements for credit and market risk below the requirements set by the standardized approaches for these types of risks. The floor will be phased in over five years, starting from 2023 at 50 percent and reaching 72.5 percent by 2028 and will apply to all Pillar 1 risk types: credit risk, market risk and operational risk.

2. Leverage ratio
An additional leverage ratio buffer has been introduced for global systemically important banks (G-SIBs) to mitigate the systemic risk to capital adequacy and is set at 50 percent of a G-SIB's higher loss-absorbency risk-based requirements. Additionally, there is a revision to the exposure definition for calculating the leverage ratio to align it with the revised credit risk framework and ensure consistency across accounting standards.

Evolution of Basel reforms

1999
Basel I
- Focused on credit risk.
- Defined capital and structure of risk weights.
- Minimum capital requirement was fixed at 8 percent.

2004
Basel II
Based on the three pillars
- Capital adequacy requirements.
- Supervisory review.
- Market discipline.

2008
Basel II.5
- Impact on the definition of the capital as well as the risk-weighting rules for credit, market risk and concentration risk.
- Market risk included stressed VaR and incremental VaR for instruments relying on credit correlation.

2010
Basel III
- Aimed to promote a more resilient banking system by focusing on four vital banking parameters; capital, leverage, funding and liquidity.
- Introduction of liquidity risk framework and interest risk rate in the banking book (IRRBB).

2017
Basel III final reforms
- Introduction of output floor.
- Reform in risk weights for SA-CR, introduction of input floors for IRB, quantification of CVA risk.
- Changes in operational risk approaches and enhancements to leverage ratio framework.

Basel III Final final reform implementation

Full implementation of measures for credit risk, market risk, operational risk, CVA and leverage ratio is 1 January 2023. Output floor phased-in from 1 January 2023 to 1 January 2028.

In line with BCBS guidelines and G20 implementation expectations, SAMA circular for implementation of Basel III Final Reforms commencing 1 Jan 2023.

3. Changes to a standardized approach to credit risk
Revisions include making the standardized approach more risk sensitive; removing the option for banks to use internal models to calculate RWAs for some types of exposures constraining the internal models that can still be used e.g., input floors.

4. FRTB for market risk
A revised fundamental review of the trading book (FRTB) framework will bring structural change in all processes and calculation of risk-based capital requirements and market exposure for trading activities. The FRTB will require banks to make frequent holdings data available to measure fund risk using a look through (LT) approach, which assesses positions based on their underlying constituents.

5. A new approach to operational risk
The introduction of a single standardized measurement approach (SMA) for assessing operational risk replaces the use of internal models and will provide more simplicity, comparability across banks, and greater risk sensitivity compared with previous approaches. SMA is based on a combination of a simple financial statement proxy for operational risk exposure called the business indicator (BI) and bank-specific loss data.

6. CVA risk
The existing credit valuation adjustment (CVA) method has been designed to calculate the capital charge for credit risk associated with derivatives and securities financing transactions and in its place are two alternative standard approaches: a basic approach (BA-CVA) and a standardised approach (SA-CVA). The Basel reforms introduce more risk sensitivity, recalibrated risk weights, different treatment of certain hedges, and a revised boundary between the banking book and the trading book.

Potential implementation challenges

Benchmarking against global learnings, banks may face several challenges in migrating to the new Basel standards, the most significant challenges are detailed below:

- Given the official implementation timeline starts January 1, 2023, one of the most significant risks is related to inadequate readiness of all banks in the current volatile environment with respect to timely implementation and reporting of Basel III final requirements across all risk dimensions. This including carrying out the requisite changes in policies and procedures, system configurations/ enhancements, data governance as well as adopting to additional reporting complexities.

- Limited functional knowledge of implementation approaches and development of detailed methodology for implementation of enhanced Basel requirements covering all scenarios and asset classes.

- Data availability, quality and accuracy, a potential roadblock to implementation of revised methodologies under various risk areas, will require review and reconfiguration in most cases. In a few cases, a full data architecture review may be required.

- Revised requirements under standardized approaches add to system and data implementation complexities. There will be a requirement to assess the impact on banks' business and adjust business models and risk strategies accordingly.

SAMA has been instrumental in supporting banks in initiating implementation of Basel III final reforms, resulting in Saudi Arabia being the leading country in the Middle East to meet the implementation deadline in line with BCBS expectations.

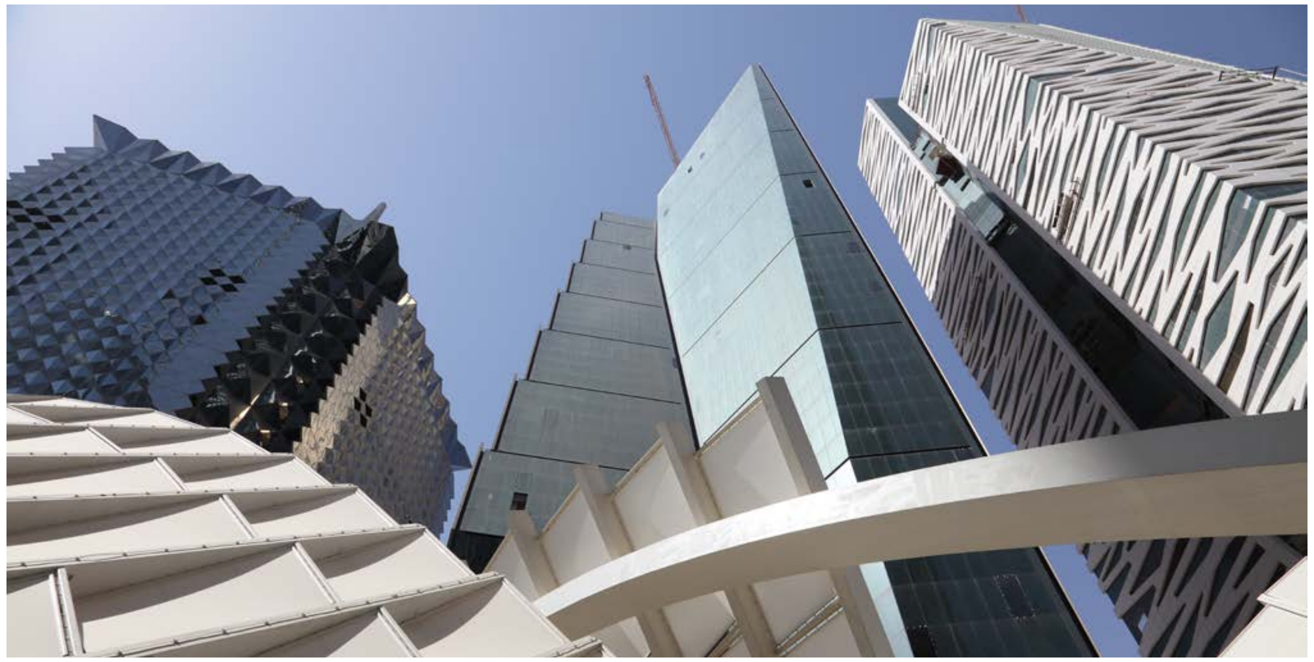
- Differences in regulatory requirements of central banks across various jurisdictions with SAMA regulations, especially for banks with a high degree of interconnectedness and cross border banking operations may add to implementation reporting complexity.

- Finally, banks relying on internal models for credit and market risk will additionally have to compute capital as per the standardized approach for output floor implementation.

Implementation pathway

Recommended steps for implementation of revised standards should be supported with a structured approach, well-defined program management for knowledge transfer, and capacity enhancement.

The initial phase should involve a thorough current state assessment and evaluation to include each bank's policies and practices in identifying areas for improvement or that fall short in compliance with the new guidelines. Once completed, a roadmap to a target



state can be defined for implementation.
The second phase is implementation, which can be segmented into two streams – functional and system implementation. Functional implementation involves the development of programs that install tools and processes that align with the new standards. Additionally, existing policies should be revised, enhanced, and updated. System implementation involves the creation and roll out of a roadmap for the systematic reconfiguration of the bank's systems. Further, a clean and centralized data repository across all risk types is essential for banks to make accurate risk weights, capital estimations, liquidity and leverage ratio computations and report to the regulators in the required format. Robust data architecture and reporting framework are essential for ensuring compliance with enhanced Basel requirements while keeping compliance costs in check.

Following implementation, a review stage commences which will require a periodic review and monitoring of the implementation status with respect to the revised guidelines, tools and new procedures implemented. Throughout the implementation lifecycle, the bank will need to provide ongoing support across project management, functional and technical teams to ensure that compliance with the new reforms is met.

Going forward

The additional regulatory requirements place an imperative on banks to implement and comply with all the requirements, commencing 2023. This is expected to have significant implications across strategy, capital management, risk as well as business operations.
Early adopters with a structured approach have benefitted from leveraging global learnings; banks globally are following a variety of strategies and approaches in implementing the reforms, from allocating additional responsibility onto existing staff, to the formation of new functions and departments, to the setting up of dedicated project management offices. Regardless of the approach, a structured approach incorporating technical, functional and resourcing considerations during the entire lifecycle is key to a timely and successful Basel III Final Reforms implementation.

Saudi Arabia's banks are expected to ensure full compliance and timely implementation of these reforms in line with BCBS timelines. Prior to roll-out, SAMA has also undertaken a parallel run in the second half of 2022 to ensure the initial readiness of the banking sector for official implementation while ensuring adequate and stable capital levels.

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