

Peer Review of Saudi Arabia
Review Report

5 November 2015

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Foreword

Financial Stability Board (FSB) member jurisdictions have committed, under the FSB Charter and in the *FSB Framework for Strengthening Adherence to International Standards*¹, to undergo periodic peer reviews. To fulfil this responsibility, the FSB has established a regular programme of country and thematic peer reviews of its member jurisdictions.

Country reviews focus on the implementation and effectiveness of regulatory, supervisory or other financial sector standards and policies agreed within the FSB, as well as their effectiveness in achieving desired outcomes. They examine the steps taken or planned by national authorities to address International Monetary Fund (IMF)–World Bank Financial Sector Assessment Program (FSAP) and Report on the Observance of Standards and Codes (ROSC) recommendations on financial regulation and supervision as well as on institutional and market infrastructure that are deemed most important and relevant to the FSB’s core mandate of promoting financial stability. Country reviews can also focus on regulatory, supervisory or other financial sector policy issues not covered in the FSAP that are timely and topical for the jurisdiction itself and for the broader FSB membership. Unlike the FSAP, a peer review does not comprehensively analyse a jurisdiction's financial system structure or policies, or its compliance with international financial standards.

FSB jurisdictions have committed to undergo an FSAP assessment every 5 years; peer reviews taking place 2-3 years following an FSAP will complement that cycle. As part of this commitment, Saudi Arabia volunteered to undergo a peer review in 2015.

This report describes the findings and conclusions of the Saudi Arabia peer review including the key elements of the discussion in the FSB’s Standing Committee on Standards Implementation (SCSI) on 7-8 September 2015. It is the fifteenth country peer review conducted by the FSB and it is based on the objectives and guidelines for the conduct of peer reviews set forth in the *Handbook for FSB Peer Reviews*.²

The analysis and conclusions of this peer review, which are based on the Saudi financial authorities’ responses to a questionnaire and the discussions held with various stakeholders during an onsite visit to Saudi Arabia, reflect information on the progress of relevant reforms as of August 2015. The review has also benefited from dialogue with the Saudi authorities as well as discussion in the FSB SCSI.

The draft report for discussion was prepared by a team chaired by Luigi Federico Signorini (Deputy Governor, Bank of Italy) and comprising Bahadır Çakmak (Central Bank of the Republic of Turkey), Carlos Eduardo de Almeida (Central Bank of Brazil), Rashid Naseem (Federal Reserve Bank of New York, United States) and Kumudini Hajra (Reserve Bank of India). Greta Mitchell Casselle, Costas Stephanou and Ruth Walters (all FSB Secretariat) provided support to the team and contributed to the preparation of the peer review report.

¹ See http://www.financialstabilityboard.org/publications/r_100109a.pdf.

² See http://www.financialstabilityboard.org/publications/r_140106.pdf.

Abbreviations

AP	Authorised Person (CMA)
BCBS	Basel Committee on Banking Supervision
BCL	Banking Control Law
BCP	Basel Core Principles for Effective Banking Supervision
BPSL	Bankruptcy Preventive Settlement Law
BSD	Banking Supervision Department (SAMA)
CAR	Capital adequacy ratio
CMA	Capital Market Authority
CML	Capital Market Law
DIS	Deposit insurance system
DPF	Depositor Protection Fund (SAMA)
DLR	Draft Law on the Resolution of Financial Institutions
D-SIBs	Domestic Systemically Important Banks
ETF	Exchange traded fund
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSC	Financial Stability Committee (SAMA)
FSD	Financial Stability Division (SAMA)
FSDD	Financial Sector Development Department (SAMA)
FSR	Financial Stability Report
GCC	Gulf Cooperation Council
GDP	Gross domestic product
GOSI	General Organization for Social Security
IADI	International Association of Deposit Insurers
KAs	Key Attributes of Effective Resolution Regimes
LTD	Loan-to-deposit
LTV	Loan-to-value
MoF	Ministry of Finance
MPC	Monetary Policy Committee (SAMA)
MPD	Monetary Policy Division (SAMA)
MPFSD	Monetary Policy and Financial Stability Department (SAMA)
NBFI	Nonbank financial institution
NFSC	National Financial Stability Committee
NSFR	Net Stable Funding Ratio
NPL	Nonperforming loan
PIF	Public Investment Fund
PPA	Public Pension Agency
QFI	Qualified Foreign Financial Institutions' Investment in Listed Shares
R&IA	Deputyship for Research and International Affairs (SAMA)
REDF	Real Estate Development Fund
ROA	Return on Assets
ROE	Return on Equity
SAMA	Saudi Arabian Monetary Agency
SCI	Specialized Credit Institution
SLA	Service Level Agreement
SME	Small- and medium-sized enterprises
SPAN	Saudi Payments Network
SAR	Saudi Arabian riyal
TADAWUL	Saudi Stock Exchange
USD	United States Dollar

Executive summary

Background and objectives

The main purpose of this peer review is to examine three topics that are relevant for financial stability and are important for Saudi Arabia: the macroprudential policy framework, bank resolution and deposit insurance. The peer review focuses on the steps taken to date by the authorities to implement reforms in these areas, including by following up on relevant FSAP and FSB recommendations.

Main findings

A fair amount of progress has been made on all three topics. In particular, SAMA has developed and started operationalising a macroprudential policy framework; a draft resolution law has been proposed; and an explicit deposit insurance system (DIS) will be introduced from 1 January 2016. However, there is additional work to be done. On the macroprudential side, SAMA needs to further strengthen institutional arrangements, enhance its analytical capacity for financial stability and publicly communicate macroprudential policy measures. On the bank resolution side, the authorities should proceed with the prompt adoption of the draft law and make it operational. On the DIS, further work is needed to address depositors' perception of an implicit deposit guarantee and clarify the implementing rules to ensure that it can function credibly and effectively.

Macroprudential policy framework

SAMA has taken significant steps to address the FSAP recommendations and develop a more formal macroprudential policy framework. In particular, it has included financial stability (in addition to financial system growth) as a key objective; established a high-level internal Financial Stability Committee (FSC) on macroprudential issues; created a financial stability department to undertake systemic risk analyses and support the work of the FSC; enhanced its analytical capacity via a macroprudential dashboard as part of an integrated early warning system; and recently issued its first Financial Stability Report (FSR). The FSC is already operational, has discussed a range of financial stability issues and made some policy decisions. In addition, SAMA has improved coordination and information-sharing mechanisms internally and with other authorities for financial stability purposes. The proposed establishment of a National Financial Stability Committee (NFSC) would further strengthen coordination with the Ministry of Finance (MoF) and Capital Markets Authority (CMA) on systemic risk analysis and the adoption of measures to promote financial stability.

As is common with many other countries, the macroprudential policy framework agenda remains work in progress. The authorities are aware that further steps to operationalise the framework are necessary and it would be useful to focus their efforts on the following issues:

- **Institutional arrangements**: Four sets of issues require attention. First, it is important for the NFSC to be created promptly given the close links between fiscal policy and economic/financial sector performance as well as the fact that an important part of the Saudi financial system is not regulated and supervised by SAMA (see below). Second, while bilateral cooperation mechanisms (both formal and informal) exist between the authorities, they may not be adequate or sufficiently targeted. In this

regard, the NFSC would benefit from setting up explicit mechanisms (e.g. a Memorandum of Understanding) between its members to facilitate the sharing of information solely for financial stability purposes. Third, the legal underpinnings for SAMA's financial stability work are rather indirect given its Charter. In order to further strengthen the formality, clarity and accountability of the framework, it would be useful to codify and reinforce SAMA's leading role in macroprudential matters by embedding its financial stability mandate in the NFSC's Charter. Finally, the resources required for SAMA to fulfil this task are limited at present. SAMA is aware of this challenge and is taking measures to further leverage existing capabilities as well as to hire and train more staff. As the macroprudential framework is rolled out, it would be useful for SAMA to enhance the resources and expertise of its financial stability function to be able to fulfil its broad macroprudential responsibilities.

- Scope of framework: A significant amount of credit (particularly real estate-related) in Saudi Arabia – equivalent to around 25% of that granted by the banking sector – is provided by state-owned specialized credit institutions (SCIs), and the scale and scope of their operations has grown in recent years. In addition, recent changes in their governance and the increased official sector focus on them (e.g. as a means to alleviate housing shortages) suggest that SCIs' footprint and their interactions with commercial banks are expected to increase in the future. The authorities are of the view that SCIs do not represent a financial stability concern at present given the fact that they complement (rather than compete with) banks by offering medium to long-term loans; that they are needed because the banking sector cannot support the economy's financing needs on its own; that they are mostly funded by direct budgetary support; and that SAMA already collects some data on SCI credit and reviews their interactions with commercial banks. However, available information on SCI operations and their performance remains limited, and it is important to ensure that these entities are monitored from a prudential standpoint given their financial system footprint and projected growth, their linkages and interactions with banks, and the fact that they often lend to the same borrowers.
- Data and risk assessments: SAMA has a broad range of tools at its disposal for macroprudential purposes. However, these tools have not generally been used in the past in a countercyclical way because they have been applied on a bilateral basis with individual banks. In order to support the decision-making process for the macroprudential use of these tools, more work may be needed on data collection and risk assessments. In terms of data collection, the dashboard's coverage of market indicators, business and confidence surveys as well as leverage trends for the corporate and household sectors is limited. Such data would provide useful information for better assessing risks, although it may require significant time and resource commitment to collect. Given its mandate, SAMA could initiate work with government agencies (as appropriate) to design suitable templates and methodologies to collect such data. In terms of risk assessments, early warning exercises are at an early stage of development, and further steps are needed to enhance modelling capabilities. In addition, SAMA could usefully expand the scope of its stress tests by, for example, incorporating second-round effects to facilitate a better understanding of interactions between the financial system and the real economy as well as of common

exposures, interconnectedness and contagion channels within the system. The results from these tests should not only be taken into consideration in the capital planning and Pillar 2 process for individual banks, but also feed into the decision-making process (e.g. assessing costs and benefits) for macroprudential policies.

Relatedly, understanding the interactions between micro-prudential, monetary and macroprudential policies on the one hand (which are under the purview of SAMA) and fiscal policies on the other hand is particularly important in Saudi Arabia, given the Riyal's peg to the US dollar, the economy's dependence on oil revenues and the use of fiscal policy as the principal countercyclical policy tool. The establishment of the NFSC is expected to create a venue for discussing the interaction of these policies. The FSR covers a broad set of risks, but it does not prioritise them, analyse their transmission channels or highlight the interactions between different policies. Going forward, the authorities will need to expand their analysis of transmission channels via which identified risks may be propagated to the financial system and economy at-large as well as examine the interactions between macroprudential and other types of policies. Finally, reconciling SAMA's dual objectives of promoting growth and ensuring soundness of the financial system is an important task of the FSC when determining the trade-offs of different macroprudential policy measures. In that respect, it would be helpful for SAMA to clarify and clearly communicate how it balances these objectives in its decision-making process.

- **Communication:** SAMA has not publicly explained its macroprudential framework or explicitly linked its policy actions to risk assessments, although it has used other mechanisms to communicate with market participants. The FSR will be SAMA's key mechanism for communicating financial stability assessments and macroprudential policy tools. The first FSR included a high level assessment of risks faced by the financial system and described SAMA's macroprudential toolkit for the banking sector. However, there was limited alignment between the assessment of risks and the policy tools available for macroprudential purposes. Given its annual frequency, it may also be useful to complement it with other forms of communication (e.g. speeches, policy statements, articles) from senior policymakers that describe the macroprudential policy stance and link financial stability assessments with policy actions to guide market expectations. The need for a clear public communication strategy may become even more relevant once the NFSC is established.

Bank resolution

Saudi Arabia does not have a specific insolvency or resolution framework for banks. Using its supervisory mandate, SAMA has historically interpreted its broadly-framed intervention powers under Article 22 of the Banking Control Law (BCL) to enable it to effect transactions such as mergers of a failing bank with a sound institution and shareholder recapitalisation in order to avoid bank failures. While SAMA believes that those powers are sufficiently broad to enable it to give effect to most resolution measures specified in the FSB's *Key Attributes*, it nevertheless sees advantages to formalising them to align the framework in Saudi Arabia more explicitly with international standards, enhance its predictability for market participants, and develop a regime that is 'future-proofed' for any possible developments in the banking sector. Accordingly, the authorities have drafted legislation to develop a formal general

resolution framework that specifies the powers and the conditions in which they can be exercised; enables losses to be absorbed by shareholders and creditors; and provides explicit safeguards in connection with the exercise of those powers.

Once approved and in force, that legislation will represent significant progress in addressing the FSAP recommendation and FSB commitments by putting in place a resolution framework that contains the elements described in the *Key Attributes*. In particular, the Draft Law on the Resolution of Financial Institutions (DLR) defines the role of SAMA as an independent administrative resolution authority with an extensive range of resolution powers for banks (and other financial institutions) that it can exercise directly through resolution orders. Furthermore, it expands the powers that SAMA considers are available under the current regime and introduces new powers for SAMA to write down and convert liabilities (bail-in); impose temporary stays on the exercise of early termination rights and moratoria on the enforcement of claims against a firm in resolution; and dispose of assets of that firm. The new law also introduces clear rights of appeal to judicial authorities for persons affected by resolution actions, coupled with restrictions on the scope of judicial review and the remedies available to prevent resolution actions from being suspended or reversed.

Notwithstanding this progress, further work is needed to ensure that the resolution framework is established on a timely basis and operates effectively.

- Prompt adoption of the DLR: The draft law is currently being revised by SAMA following comments from the Bureau of Experts. It is important that the authorities continue to commit the necessary resources to this process so as to expedite, as far as possible, the legislative process by early submission of a revised draft of DLR to the Bureau of Experts through the Council of Ministers. At the same time, SAMA should build the requisite internal expertise and organisational arrangements (i.e. establishment of resolution unit and development of cooperation and information-sharing protocols with supervision) to be in a position to assume the functions conferred under the new framework as soon as it is adopted.
- Implementing regulations: Given its high-level nature, the operational effectiveness of the DLR will depend on further detail about how the resolution powers will be exercised. Unless key elements of the framework set out in the DLR are elaborated in implementing regulations, the new resolution regime may not achieve the level of transparency, predictability and credibility that is aimed for. Two elements, in particular, on which the authorities should consider developing further detailed provision as a matter of priority include: (i) the conditions for entry into resolution; and (ii) specification of the creditor hierarchy for the purposes of loss allocation through the use of resolution tools and application of the ‘no creditor worse off’ safeguard. As regards (i), it would be desirable to provide further clarity through implementing regulations on the conditions for use of resolution tools and the transition from early intervention (with the objective of recovery) to resolution. As regards (ii), there are currently no clear rules under the legal framework in Saudi Arabia on the hierarchy of claims in insolvency. Clarity about the hierarchy of claims, for example by introducing provisions in implementing regulations, is a prerequisite for the allocation of losses in resolution through the use of powers in accordance with

the principles set out in the DLR. Such clarity also facilitates creditors and liability holders to assess their risk of loss in resolution and the pricing of debt.

- Recovery and resolution planning: SAMA considers that it currently has the necessary powers to require recovery and resolution plans as part of its general supervisory powers under the BCL, although it has not yet done so. Experience in other jurisdictions has shown that work on the development of resolution strategies and plans for individual firms can be of considerable value in helping authorities to identify the conditions – including legal provisions and rules – that should be in place to ensure that resolution powers can be exercised effectively. SAMA could therefore start developing resolution strategies and operational plans for those banks that have been identified as systemically important using its current powers under BCL, which can help inform the development of implementing regulations and identify detailed provisions that are needed to ensure that the new resolution regime is effective.

Deposit insurance

The introduction of an explicit DIS on 1 January 2016 as a “pay box” within SAMA indicates the authorities’ commitment to implement the internationally agreed standards. Once fully implemented, the scheme is expected to further enhance the financial safety net. SAMA has adopted a number of good international practices codified in the IADI Core Principles, such as explicit public policy objectives and mandate of the Depositor Protection Fund (DPF), compulsory membership and legal protection for the DPF.

In spite of these accomplishments, further work is needed to make the DIS operational and ensure that it is fully integrated in the financial safety net.

- Implicit deposit guarantee: An important issue that needs to be addressed is the Supreme Economic Council’s statement in 2008 that the authorities continue to ensure the safety of local banks and bank deposits. This is perceived to provide an implicit full coverage to all depositors and is inconsistent with the objective of setting up a limited deposit protection system that promotes market discipline and avoids moral hazard. In view of the entry into force of the DPF, the authorities need to decide how best to withdraw this implicit guarantee without any adverse impact on depositor confidence. Drawing on the experience of other countries, one option in this regard may be to adopt an explicit transition period that starts with higher coverage levels that could be reduced to the target level over time. Since the DPF is a new scheme, SAMA intends to undertake shortly a program to educate the public and stakeholders on its main features. This public awareness campaign, which would be undertaken in close cooperation with banks, should ideally address the issue of the implicit deposit guarantee as well as emphasise the advantages of a DIS in an international context and highlight its role in enhancing financial stability.
- Enhancing DPF Rules: It is important that implementing rules incorporate good international practices so that the DPF can function effectively if the need to invoke deposit insurance ever arises. Important issues that would need to be addressed in this context are reimbursement and governance arrangements as well as the integration of the DPF with the overall safety net. On reimbursement, the Core Principles establish a medium-term goal of ensuring that the depositors are reimbursed in no later than

seven days. This requires that supporting arrangements to ensure a quick pay-out, including a ‘single customer view’ of depositors, are maintained. SAMA will need to build up these capabilities and also ensure that depositors are aware of the timeframe in which pay-out will be made and the modes of reimbursement. On governance, the DPF is being established as a pay box, which seems appropriate for a start-up DIS. However, being a unit within SAMA requires that the DPF has a governance structure that ensures its operational independence and the ability to voice its views on financial stability issues. In keeping with good international practice, SAMA should ensure that the composition of the DPF’s governing committee is determined transparently, ensures its operational independence and minimises the potential for real or perceived conflicts of interest. Moreover, given the importance of rapid pay-out, information sharing arrangements with SAMA supervisory staff are needed so that the DPF learns expeditiously of impending bank failures. Finally, it is not clear under what conditions depositor pay-out would be activated in the current system or how the DPF scheme will integrate with the resolution framework once the DLR is implemented. As the current process may involve the corporate insolvency framework, the involvement of courts cannot be ruled out. The authorities therefore need to ensure that the DIS is aligned with the bank resolution framework.

- **Funding mechanisms:** The authorities are of the view that, given the soundness and stability of individual banks and the overall Saudi banking system, any initial funding or back-up support for the DPF are not necessary. SAMA aims to set up an *ex-ante* fund that will be built up gradually from the premiums charged from the industry. In that context, it may be helpful if the authorities provide seed capital to strengthen the fund, enhance public perceptions and contribute to its viability. In addition, as is the practice in most DISs, SAMA could establish a target size of the fund in relation to covered deposits by taking into account relevant factors. Furthermore, it is important that the fund is supported by a clearly laid-out back-up funding arrangement. The DPF Rules provide for borrowing and collection of additional premiums from banks, but collecting such premiums in the event of a bank failure may be pro-cyclical; borrowing from the market is another possibility, but it could be expensive. Emergency back-up funding – to supplement the deposit insurance funds when they are insufficient to meet depositor reimbursement – is a critical element of most DISs and is required for compliance with Core Principle 9. It is therefore important for the DPF Rules to explicitly provide for a line of credit from the government/central bank.

Recommendations

In response to the aforementioned findings and issues, the peer review has identified the following recommendations for consideration by the authorities:

Macprudential policy framework

1. In order to strengthen institutional arrangements for macroprudential policy: (1) the authorities should proceed promptly with the establishment of a NFSC, embed SAMA’s financial stability mandate within the NFSC’s Charter, and consider enhancing existing mechanisms between member agencies to facilitate information sharing for financial

stability purposes; and (2) SAMA should further enhance the resources and expertise of its financial stability function to be able to fulfil its macroprudential responsibilities.

2. The authorities should bring specialized credit institutions within the scope of the macroprudential policy framework – in terms of data collection, systemic risk analysis and (as needed) the adoption of policy measures.
3. SAMA should strengthen its analytical framework to support macroprudential decision-making by: (1) enhancing data collection (e.g. commodity and real estate price indices, business activity and confidence indicators, corporate and household sector leverage); (2) improving stress testing by incorporating second-round effects and enhancing modelling capabilities; (3) analysing transmission channels and interactions between policies; and (4) clarifying how to balance its dual mandate of financial system soundness and growth within the macroprudential framework.
4. In order to enhance transparency and accountability, SAMA should develop a clear communication policy for macroprudential measures.

Bank resolution

5. The authorities should proceed with the prompt adoption of the DLR to provide a general resolution framework that is aligned with the FSB's Key Attributes.
6. The authorities should develop implementing regulations detailing the operation of the resolution regime to take account of the specificities of the Saudi financial system and to ensure that the provisions in the framework law can be made operational. Priority should be given to implementing provisions that clarify the hierarchy of creditors and the conditions for entry in resolution.
7. The authorities should, in advance of the adoption of the DLR, initiate recovery and resolution planning for banks designated as systemically important to help inform the development of the implementing regulations.

Deposit insurance

8. In order to ensure the smooth adoption and effectiveness of the DPF, the authorities should address depositors' perception of an implicit guarantee provided by the Supreme Economic Council and adjust their public communication accordingly.
9. SAMA should: (i) establish and publicly communicate a timeframe for pay-out to depositors in order to enhance the credibility of the DPF, and make all necessary arrangements to meet that timeframe; (ii) ensure that the composition of the DPF's governing committee reflects the various safety net participants and stakeholders, and that appropriate safeguards are available to manage conflicts of interest and ensure its operational independence; (iii) establish information sharing arrangements between the DPF and supervisors; and (iv) elaborate on the process for invoking deposit insurance upon the failure of a bank at present as well as under the proposed draft law on resolution.
10. SAMA should consider enhancing the funding arrangements of the DPF by: (1) specifying a target fund size; and (2) establishing a back-up line of credit in order to ensure that DPF resources can meet deposit pay-out requirements in a timely manner.

1. Introduction

Saudi Arabia underwent an assessment update under the Financial Sector Assessment Program (FSAP) in 2011. The FSAP included assessments of the *Basel Core Principles for Effective Banking Supervision* (BCP), *IOSCO Principles and Objectives of Securities Regulation* and *CPSS Core Principles for Systemically Important Payment Systems*.³

The FSAP found that Saudi Arabia had confronted the global financial crisis from a position of strength and that it took decisive steps to manage the impact of the crisis. As a result, the financial system weathered the crisis relatively well; the banking sector as a whole was well capitalised and appeared able to withstand severe temporary shocks, but could be vulnerable to a large and prolonged oil price decline. The authorities had made progress implementing the recommendations of the 2004 FSAP, with many improvements to bank and securities supervision. However, the FSAP found that steps to further strengthen the bank resolution regime, macroprudential policies and the independence of bank supervision would be desirable. It welcomed measures to improve access to housing finance, but noted the need for them to be accompanied by strong prudential oversight to limit future financial stability risks.

The main purpose of the peer review report is to examine three topics that are relevant for financial stability and important for Saudi Arabia: its macroprudential policy framework, bank resolution and deposit insurance. The peer review focuses on the steps taken to date by the authorities to implement reforms in these areas, including by following up on relevant FSAP and FSB recommendations. In particular, the review evaluates progress with the reforms to draw conclusions and policy implications as well as identify remaining impediments and lessons that could be of benefit to Saudi Arabia and its FSB peers.

The report has three main sections, corresponding to the three topics being reviewed. Section 2 focuses on the macroprudential policy framework, Section 3 analyses the steps taken by the authorities to strengthen the bank resolution framework, while Section 4 covers deposit insurance. In addition to these sections, Annex 1 provides background information on the structure of the Saudi Arabian financial system and on recent regulatory developments, while Annex 2 presents the follow-up actions reported by the authorities to other key FSAP recommendations; these actions have not been analysed as part of the FSB peer review and are presented solely for purposes of transparency and completeness.

2. Macroprudential policy framework

Background

The FSAP noted that the Saudi Arabian Monetary Agency (SAMA) had, over the years, taken a large number of measures of a macroprudential nature that had helped to rein in credit

³ See “Saudi Arabia: Financial System Stability Assessment” (April 2012, IMF Country Report No. 12/92, available at <http://www.imf.org/external/pubs/ft/scr/2012/cr1292.pdf>). The BCP, IOSCO assessment and CPSS assessments have been published and are available on the IMF website (<http://www.imf.org/external/np/fsap/fsap.aspx>).

booms and equity bubbles and to mitigate their negative effects on financial and macroeconomic stability. It recommended that SAMA develops a more formal macroprudential policy framework, with clearly outlined objectives, in line with new practices being developed in international fora. It also noted that it would be desirable to implement a more transparent macroprudential framework that clearly outlines analytical methods and policy tools. In addition, the FSAP recommended that SAMA should refine coordination mechanisms with key agencies, including the Ministry of Finance (MoF) and Capital Markets Authority (CMA); and that SAMA should establish a formal early warning system, with information from multiple sources, to identify and address emerging financial sector risks and vulnerabilities. Finally, the FSAP noted that while Saudi banks' cross-border linkages appear to be small, there was limited detailed data around this issue; it recommended that developing better cross-border data on the financial activities of banks and corporates should be a priority for SAMA.

The IMF's 2013 Article IV report⁴ noted that under the exchange rate peg to the US dollar, SAMA relies primarily on macroprudential tools to manage demand and systemic financial sector risks. It concluded that the macroprudential framework had proven effective and served SAMA well during the global financial crisis, but suggested that a formal, clear and transparent framework would more explicitly codify SAMA's current practices. The appropriateness of macroprudential policy settings was confirmed in the IMF's 2014 Article IV report.⁵ However, IMF staff suggested that the use of the macroprudential toolkit – particularly those tools that are adjusted infrequently (loan-to-deposit ratio, loan-to-income ratio, debt-service-to-income ratio, limits on concentrated exposures) – be more clearly linked to overall macroeconomic and financial developments so as to signal SAMA's assessment of risks to the market. In its 2015 Article IV report, the IMF noted that formalising the macroprudential framework to clearly establish responsibilities and the way that countercyclical policy tools will be used would further enhance policy implementation.⁶

This section reviews the progress made to date and next steps vis-à-vis the FSAP recommendations on the development of a macroprudential policy framework in Saudi Arabia, drawing on international guidance and cross-country experiences in this area.⁷

⁴ See IMF Country Report No. 13/229 (<http://www.imf.org/external/pubs/ft/scr/2013/cr13229.pdf>).

⁵ See IMF Country Report No. 14/292 (<http://www.imf.org/external/pubs/ft/scr/2014/cr14292.pdf>).

⁶ See IMF Country Reports No. 15/251 (<http://www.imf.org/external/pubs/ft/scr/2015/cr15251.pdf>) and 15/286 (<http://www.imf.org/external/pubs/ft/scr/2015/cr15286.pdf>).

⁷ See the FSB peer reviews of China, Germany, Netherlands, Russia, UK and US (<http://www.financialstabilityboard.org/publications/peer-review-reports/>); “Macroprudential Policy Tools and Frameworks – Progress Report to the G20” by the FSB, IMF and BIS (October 2011, http://www.financialstabilityboard.org/wp-content/uploads/r_111027b.pdf); “Macroprudential Policy: An Organizing Framework” (March 2011, <http://www.imf.org/external/np/pp/eng/2011/031411.pdf>), “Institutional Models for Macroprudential Policy” (November 2011, <http://www.imf.org/external/pubs/ft/sdn/2011/sdn1118.pdf>), “Key aspects of macroprudential policy” (June 2013, <http://www.imf.org/external/np/pp/eng/2013/061013b.pdf>) and “Staff Guidance on Macroprudential Policy” (December 2014, <http://www.imf.org/external/np/pp/eng/2014/110614.pdf>) by IMF staff; and “Macroprudential instruments and frameworks: A stocktaking of issues and experiences” (May 2010, <http://www.bis.org/publ/cgfs38.pdf>) and “Operationalising the selection and application of macroprudential instruments” (December 2012, <http://www.bis.org/publ/cgfs48.pdf>) by the CGFS.

Steps taken and actions planned

Institutional arrangements: Financial stability is not explicitly mentioned in SAMA’s mandate, but SAMA has always recognized the importance of a stable financial system given its responsibility to regulate and supervise banks, insurance companies and finance companies whose assets account for the majority of the Saudi financial system (see Annex 1). Of note, SAMA now explicitly includes the growth and soundness of the financial system as two main policy objectives in its strategy.⁸

In line with its focus on financial stability, SAMA has changed its organizational structure in recent years.⁹ The Deputyship for Research and International Affairs (R&IA) is mandated to formulate SAMA’s macroprudential policy and ensure the stability of the financial system through the Monetary Policy and Financial Stability Department (MPFSD). The Department’s mandate, exercised primarily through the Financial Stability Division (FSD), is to monitor and assess systemic risk and to develop SAMA’s macroprudential framework.¹⁰ This work is complemented by the Deputyship for Supervision, which encompasses the various supervision departments and is responsible for formulating micro-prudential policies.

In the past, monetary and financial stability policies were discussed jointly by SAMA’s Riyal Committee. However, the Riyal Committee was disbanded in 2013-14 and replaced with the Monetary Policy Committee (MPC) and the Financial Stability Committee (FSC). The FSC is a high-level committee and the decision making body of SAMA on macroprudential policies. Its members include the Governor and Vice-Governor of SAMA; Deputy Governors from R&IA, Supervision and Investment Functions; General Managers from Banking, Insurance and Finance Companies Control Departments (under the Deputy Governor for Supervision); and the Heads of the Monetary Policy and Financial Stability Department, FSD and Monetary Policy Division (MPD) (under the Deputy Governor for R&IA). Its responsibilities are to:

- review risk analyses prepared by the FSD;
- monitor and analyse financial stability by evaluating macroprudential indicators and early warning signals;
- coordinate with external stakeholders, including the MoF and CMA;
- recommend to the Governor (who chairs the FSC) risk mitigation policies and measures;
- converge on recommended procedures to implement financial stability policies;
- investigate and recommend long-term changes to financial stability procedures;

⁸ SAMA has recently launched an initiative – “the 2020 banking vision” – to develop the banking sector in a way that ensures long-term, stable and sustainable growth. The initiative includes a broad range of actions on banking sector development, banking sector stability, macroprudential and micro-prudential regulations.

⁹ See <http://www.sama.gov.sa/en-US/About/Pages/OrganizationStructure.aspx>.

¹⁰ SAMA defines financial stability as “a state in which there are no, and there is confidence that there will be no, substantial discontinuities or disruptions in the functioning of the financial system. The system must have the ability to withstand shocks, process financial transactions and carry out its role of financial intermediation among all market participants smoothly.”

- review and assess global economic and financial developments and their implications for the Saudi financial system; and
- improve rules and regulations and contemplate additional macroprudential measures to enhance the resilience of the Saudi banking system.

The FSC held its first meeting in November 2014 and has met on a quarterly basis since then. It has discussed several issues in these meetings, including margin lending, loan-to-value (LTV) ratio for land, the impact of the recent fall in oil prices including the relationship between non-performing loans and oil prices, and banks' single counterparty exposure limits. In some cases, the FSC has made policy decisions as well, e.g. on the scope of the LTV ratio. The FSC coordinates with external stakeholders via the Banking Supervision Department (BSD) or the FSD, and its decisions do not need approval by SAMA's Board.

The FSD provides analytical support, including a quarterly risk assessment, to the FSC. It monitors and assesses systemic risks and vulnerabilities and is responsible for developing and enhancing the macroprudential framework, identifying key financial stability indicators, developing and running the stress testing model, and publishing the Financial Stability Report (FSR). If the FSD identifies a potential risk, it can request an FSC meeting to highlight and discuss systemic risk concerns. As the FSD is still in the early stages of institutional development, FSC meeting agendas and key issues for discussion to date have been largely guided by the Governor and senior SAMA officials. If the FSD identifies a risk which lies under the regulatory scope of another authority, the FSC decides whether the FSD should pursue the issue bilaterally at the staff level or whether to raise it at the principals' level.

Coordination within SAMA: Given SAMA's dual objectives of ensuring the soundness of the financial system and promoting its growth, representatives from FSD and the Financial Sector Development Department (FSDD) interact frequently and often conduct joint research (e.g. on competition and shadow banking) to ensure that both objectives are met.¹¹

The FSD also interacts with other SAMA departments – particularly the BSD that formulates SAMA's micro-prudential policies and ensures the safety and soundness of supervised institutions – to improve coordination and information sharing for financial stability purposes.¹² For example, the policy framework for domestic systemically important banks was discussed recently between the FSD and BSD ahead of a discussion on this topic at a future FSC meeting.¹³ Moreover, in order to supplement the work of the FSD, SAMA is considering setting up a Data Analytics Unit (possibly within BSD) to undertake detailed analysis of supervisory data and share results with the Deputyship of R&IA.

¹¹ For example, representatives from both departments take part in SAMA's annual Internal Capital Adequacy Assessment Program for banks. They have also jointly co-authored a paper with IMF staff on monetary and macroprudential policies, which was published in "Saudi Arabia: Tackling Emerging Economic Challenges to Sustain Growth" by the IMF (2015, <http://www.imf.org/external/pubs/ft/dp/2015/1501mcd.pdf>).

¹² In order to better coordinate the implementation of macroprudential policy tools with monetary policy, the head of FSD is a member of the MPC while the head of MPD is a member of the FSC.

¹³ Identifying D-SIBs is currently the responsibility of the BSD, which has already developed a framework (prior to the establishment of the FSC) and has sent a circular to all banks (see Table 1); implementation of the framework will be effective from 1 January 2016. Going forward, the responsibility with respect to policy measures for identified D-SIBs will be shared by the FSD and the BSD.

Under the direction of the FSC, a Micro-Macro Subcommittee has been set up initially for a period of one-year (though not yet activated) to establish formal channels of communication between SAMA's micro and macro supervisory departments and to ensure that systemic risk analysis feeds into the supervisory process. This Subcommittee will also provide a forum to discuss potential financial stability and macroprudential issues before they are raised with the FSC. The FSD is in the process of drafting a Service Level Agreement (SLA) with relevant supervisory departments to formalize this arrangement.¹⁴

Coordination with other authorities: While SAMA is responsible for regulating and supervising the majority of the financial system, it is worth noting that other authorities also regulate and supervise financial institutions. In particular, the CMA regulates the activities of securities market participants,¹⁵ while the MoF – at least until recently – supervised state-owned Specialized Credit Institutions (SCIs) (see Box 1).

In January 2012, SAMA and CMA signed a Memorandum of Cooperation (MoC) for improving coordination and data sharing, strengthening oversight of regulated entities and better understanding linkages between financial markets and institutions.¹⁶ Recent examples of coordination between the two agencies included discussions about the Qualified Foreign Investors framework to invest in Saudi capital markets, margin lending regulations between banks and broker-dealers, and the FSR.¹⁷ In addition, staff from SAMA's Monetary Policy and Financial Stability Department formally meets with the CMA on a quarterly basis to discuss financial stability issues relating to capital market developments. Coordination with the MoF takes place through frequent bilateral communication, although there is no formal data sharing arrangement between the two authorities.

Box 1: Specialised Credit Institutions in Saudi Arabia

Specialized credit institutions (SCIs) play an important role in credit intermediation in Saudi Arabia alongside the banking sector. In particular, the Saudi Industrial Development Fund (SIDF) finances industrial projects; the Public Investment Fund (PIF) finances large scale government and private industrial projects; the Real Estate Development Fund (REDF) finances individuals and corporate residential and commercial real estate; the Saudi Credit & Saving Bank (SCSB) provides interest-free loans for small and emerging businesses and professions; and the Saudi Agricultural Development Fund (SADF) finances farmers and agricultural projects.

¹⁴ The SLA covers data flows between the relevant micro-prudential divisions, the data center, and the Monetary Policy and Financial Stability Department. It specifies all data needed for macroprudential purposes, including for the macroprudential dashboard, specifies the timeline and deadlines for receiving the data and the role of each department in providing and using it.

¹⁵ The CMA was spun off from SAMA and assigned the responsibility in the 2004 Capital Market Law to regulate and develop capital markets activities, including the prudential supervision of so-called authorised persons (which include firms involved in dealing, custody, fund management, arranging and advisory).

¹⁶ The memorandum promotes coordination in the areas of supervision and oversight; regulation of corporate governance; selection of risk management and accounting standards; regulation of securities offering and their settlement; mergers, acquisitions and control; ownership limits; and exchange of information and data. The main focus of the MoC has been on improving data sharing protocols concerning enforcement.

¹⁷ The CMA recently created a risk analysis unit that helped draft the capital markets chapter in the FSR.

SCIs are unlevered non-deposit taking entities that rely upon direct budgetary support by the MoF and, on the margin, internally generated cash to fund credit activities. According to market participants, they do not directly compete with banks and in some instances complement banking sector activities.¹⁸ SCIs were established to direct credit to targeted areas of the economy including housing, critical industrial projects, and small and medium-sized enterprises; over time, the scale and scope of their operations has increased significantly. SCIs' loans outstanding have doubled since 2008 and are equivalent to around 25% of total bank credit (see Table below). The PIF and the REDF account for almost 75% of SCIs' loans outstanding.

Until recently, most SCIs were supervised and organisationally linked to the MoF which, along with their respective Boards of Directors (BoD), was responsible for overseeing their operations. However, the Saudi Council of Ministers recently announced major organisational changes aimed at aligning SCIs with appropriate line ministries, and as a result: (i) the SADF now reports to the Ministry of Agriculture, with the Minister as its Board Chair; (ii) the SCSB reports to the Ministry of Social Affairs, with the Minister as its Board Chair, and (iii) the SIDF reports to the Ministry of Commerce, with the Minister as its Board Chair.

The PIF now reports to the Council of Economic and Development Affairs, which is chaired by the Deputy Crown Prince who also chairs the PIF's BoD. The PIF has a broad mandate to make debt and equity investments in critical infrastructure and industrial projects with a view to maximizing total returns. As the second largest SCI by loan size, the PIF has SAR 105 billion in debt and nearly twice that amount in equity investments. The PIF recently received a capital injection of SAR 50 billion from the MoF to fund the railway project. While the PIF is still in the process of determining its future strategy, its scale and scope of operations are expected to increase in the future.

The REDF is the largest SCI and provides personal and investment loans for housing development. Given the shortage of housing stock in Saudi Arabia, real estate development is receiving significant official sector attention. This includes *inter alia* a SAR 250 billion allocation by the Saudi King in 2011 to build housing units (not yet utilised) and the use of REDF loans as down-payment to meet the 70% LTV requirement for mortgages that was introduced in 2014. Real estate lending has picked up significantly in recent years, with the outstanding volume at end-2014 reaching SAR 130 billion for REDF (compared to 79 billion in 2011) and SAR 149 billion (compared to 70 billion) for banks.

Table: SCI Loans Outstanding (SAR Billion)

	SADF	SCSB	PIF	SIDF	REDF	Total SCIs	Bank Credit	Total SCIs/ Bank Credit
2008	9.5	9.9	43.2	17.2	75.4	155	744.8	21%
2009	9.5	14.2	56.6	20.9	76.8	178	736.9	24%
2010	9.4	14.6	65.8	24.8	77.6	192	775.3	25%
2011	9.3	21.1	71.7	27.4	78.9	208	856.6	24%
2012	8.4	25.3	86.7	29.3	99.6	249	1,000.1	25%
2013	8.5	24.8	91.5	29.7	116.7	271	1,120.5	24%
2014	8.6	36.9	104.9	30.9	129.5	311	1,250.6	25%

Source: SAMA Quarterly Bulletin and Annual Report.

Note: Does not include Domestic Loans Program; Public Investment Fund includes SAR 14.5 billion in electricity loans; bank credit includes credit to private sector and public sector enterprises.

¹⁸ For example, banks offer bridge financing for construction deals financed by SIDF; an SCSB scheme will provide SME credit guarantees in collaboration with banks ("kafala" program); and the REDF is offering top-up financing for mortgage borrowers to meet the recent 70% LTV limit.

SAMA proposed in March 2014 the establishment of a National Financial Stability Committee (NFSC) comprising SAMA, MoF and CMA in order to improve coordination between these authorities around systemic risk analysis and the implementation of measures to promote financial stability. Once approved, the NFSC will be the highest authority in charge of financial stability given the ministerial level representation.¹⁹ SAMA is expected to play the lead role in organising and framing issues for the NFSC, with input from MoF and CMA. SAMA is proposed to be the secretariat of the NFSC and the main coordinator providing comprehensive assessments, raising issues regarding the interaction between different authorities, and recommending policy actions. The technical committee²⁰ of the NFSC met in June to prepare for the first NFSC meeting, which is scheduled for July 2015 and will decide on its charter and governance framework. The proposed responsibilities of the NFSC members include: coordinating financial sector policies; recommending laws and regulations to boost confidence and ensure financial stability; following up on implementation of measures to ensure soundness of the financial system; and identifying and communicating around risks and vulnerabilities in the financial system.

Analytical framework and risk assessments: Economic and financial developments are interwoven with the oil cycle in Saudi Arabia, with past episodes of large oil price declines been associated with a strong impact on macroeconomic and financial sector outcomes.²¹ Given the Riyal's peg to the US dollar as a monetary anchor, fiscal policy was often used in a countercyclical manner to shield the economy from oil price volatility and smooth the adjustment process, and has therefore been a key driver of short-term economic and financial sector performance. The systemic risk assessment framework in Saudi Arabia needs to take account of these factors and the interactions between different types of policies.

SAMA uses three main tools for systemic risk analysis: a macroprudential dashboard; an excel-based early warning model to monitor systemic risks across the financial system; and stress tests to evaluate firms' resilience to adverse shocks. The inputs used for the analysis include data collected by SAMA's supervisory departments; data from financial entities, which can be obtained on an *ad-hoc* basis to address emerging risk concerns; and the outcomes from stress testing. Other agencies contribute to the analysis through data and discussions on recent developments and financial stability issues.

SAMA's internal macroprudential dashboard, prepared by the FSD, is the principal tool for monitoring financial stability risks. The dashboard is shared with the FSC and includes measures of economic performance and credit growth; key financial metrics for banking and insurance sectors including credit, market, funding and liquidity risk metrics as well as capital adequacy and solvency ratios; international exposures; capital market metrics; and measures of interconnectedness for the financial sector. Each of these categories includes several indicators that can be used to assess the level of risk in the financial system. The

¹⁹ The NFSB is proposed to include the Minister and Vice-Minister of Finance, the Governor and Vice-Governor of SAMA and the Chairman and Vice-Chairman of CMA.

²⁰ This comprises the Vice-Minister of Finance, the Vice-Governor of SAMA, and the Vice-Chair of CMA.

²¹ See the 2015 IMF Article IV Report (*ibid*).

dashboard is complemented by the early warning model, which tracks short-term deviations from average trends in capital markets indices and the credit-to-gross domestic product (GDP) ratio to assess financial stability risks.

SAMA periodically performs top-down stress tests for the 12 domestic banks to evaluate the resilience of the banking sector. SAMA employs three macroeconomic scenarios (mild, moderate, and extreme) using a macroeconomic model, three expert scenarios based on expert judgment, and one empirical scenario based on stressed conditions observed during the global financial crisis. Model-based scenarios mostly cover major macroeconomic risks such as significant shrinkage in GDP or sharp decline in oil prices. Although the current stress testing framework depends on a top-down approach, it enables SAMA to observe the possible erosion in capital levels both at sectoral and bank levels.²² SAMA considers stress tests to be an early warning tool used to evaluate banks' resilience. In recent tests, SAMA has applied shocks to variables including oil prices, credit growth, interest rate, economic growth, government spending and equity market, and has used the results to assess bank capital and liquidity performance under stressed conditions. In addition, SAMA requires individual banks to semi-annually report their internal stress tests and compares the results with those from its own tests. Recently, SAMA asked all Saudi banks to complete a survey in order to assess the impact of a 1% rise in interest rates on banks' balance sheets.²³

In response to the FSAP recommendation to enhance data on cross-border financial activities of banks and corporates, SAMA has started collecting International Banking Statistics.²⁴ In the meantime, SAMA uses other metrics to monitor cross-border activities and their associated risks, including banks' net foreign assets and liabilities, their exposures related to foreign operations and overall capital flows.

As previously noted, recent FSC discussions about emerging vulnerabilities and risks have focused around margin lending; the scope and coverage of the LTV ratio; the interaction of oil prices, government spending and non-performing loans (NPLs); and insurance solvency ratios. In addition, the recently-published FSR²⁵ highlighted risks related to higher market volatility as a result of normalisation of US monetary policy; the growth in real estate lending during 2013-14; reliance of banking sector on short-term deposits; concentration of equity market capitalisation in the banking and petrochemical sectors; and corporate risk aversion. Separately, the FSC has requested FSD staff to establish regular outreach with risk managers at regulated banks, in coordination with BSD, and ascertain major risks at those firms. However, the FSC has not yet examined the interactions between macroprudential and fiscal policies in its deliberations.

²² The stress testing model is being further enhanced with technical assistance support from the IMF.

²³ While around half of the Saudi banking system operates on sharia principles, SAMA does not distinguish between Islamic and non-Islamic activities for regulatory purposes. However, SAMA takes into account special factors associated with such differences in products and structures when analysing risk indicators.

²⁴ See http://www.bis.org/statistics/about_banking_stats.htm.

²⁵ See <http://www.sama.gov.sa/en-US/EconomicReports/Financial%20Stability%20Report/FINANCIAL%20STABILITY%20REPORT-2015.pdf>.

Macroprudential tools: Similar to other commodity exporters in the Gulf Cooperation Council (GCC), SAMA has a broad set of tools at its disposal for macroprudential purposes (see Table 1).²⁶ According to SAMA, these tools were triggered in the past based on developments in the credit-to-GDP ratio, credit growth metrics, capital markets indices and credit concentration indicators. Instances where some of these tools have been deployed to mitigate financial stability risks include changes in reserve requirements on different types of deposits during the global financial crisis and at periods of high credit growth,²⁷ and the introduction of an LTV ratio in 2014 as part of the implementation of the finance laws promulgated in 2012 (see Annex 1) and in response to concerns about real estate lending.

Table 1: SAMA Tools for Macroprudential Purposes

Tools	Responsible department(s)	Description	Recent Use
Capital adequacy ratio	BSD	Minimum requirement of 10.5%	
Loan loss provisioning	BSD	General: 1% of total loans Specific: Minimum of 100% of NPLs	
Leverage ratio	BSD	Deposits/(capital + reserves) ≤ 15 times	
Reserve requirements ratio	MPFSD	7% for demand deposits 4% for time deposits	Reserve ratio on demand deposits reduced from 13% to 7% in October-November 2008
LTV ratio	BSD, MPFSD	Mortgage loans ≤ 70%	Adopted in November 2014 and extended to land loans
Debt service-to-income ratio	BSD	Monthly repayment: <ul style="list-style-type: none"> • ≤ 33% of income (personal loans & credit cards) • ≤ 25% for retirees 	
Loan-to-deposit ratio	BSD	85%	
Liquidity requirements <ul style="list-style-type: none"> • SLR • LCR (Basel III) • NSFR (Basel III) 	BSD	<ul style="list-style-type: none"> • Liquid assets/deposits ≥ 20% • 100% • 100% 	LCR and NSFR introduced since January 2012
Large exposures limit	BSD	Individual exposure/total capital ≤ 25%	To be reduced to 15% by 2019
Limits on foreign currency loans	BSD	SAMA approval needed for any lending to non-residents	
D-SIB capital buffer	BSD, MPFSD	Higher loss absorbency requirements (depending on bucket)	To be introduced in January 2016
Profit distribution limits	BSD	Profit distribution requires SAMA approval	

Source: SAMA.

The BSD has historically been responsible for applying those tools (with the exception of reserve requirements) to address identified (micro-prudential) risks. Currently, the FSD

²⁶ See “Macroprudential Policy in the GCC Countries” by Arvai, Prasad and Katayama (IMF Staff Discussion Note 14/01, March 2014, <http://www.imf.org/external/pubs/ft/sdn/2014/sdn1401.pdf>).

²⁷ See “The global financial crisis: impact on Saudi Arabia” by Abdulrahman Al-Hamidy (BIS Papers No 54, <http://www.bis.org/publ/bppdf/bispap54u.pdf>).

undertakes risk assessments and has the mandate, though not yet implemented, to review these tools and propose – through the aforementioned macroprudential framework structures and processes – their use where necessary for macroprudential purposes. SAMA considers the impact of macroprudential measures and interactions with different policies by involving relevant departments in the FSC decision making process and by commissioning research on these issues drawing on other countries’ experiences. In particular, the BSD is responsible for implementing such measures (given the fact that these involve the use of micro-prudential tools), while the FSD analyses its effectiveness and reports its assessment to the FSC.²⁸ According to the authorities, any interactions between fiscal and prudential policies are discussed bilaterally between SAMA and the MoF. The NFSC, once established, will provide an additional venue to discuss such interactions.

Communication: SAMA’s first annual FSR was published in June 2015, and is the key mechanism for communicating financial stability assessments and macroprudential policy tools. SAMA has also used working papers and the public issuance of circulars encompassing rules, regulations and guidance that are shared with financial entities to ensure proper understanding and full implementation.²⁹ In addition, the Deputyship for R&IA convenes quarterly seminars with market participants and academics to discuss financial and macroeconomic issues.³⁰ SAMA also uses more traditional ways of communicating changes in regulations via news releases on its website and in the press.

Lessons learned and issues to be addressed

SAMA has taken significant steps to address the FSAP recommendations and develop a more formal macroprudential policy framework. In particular, it has included financial stability (in addition to financial system growth) as a key objective; established a high-level FSC as the decision-making body on macroprudential issues; created a financial stability department to undertake systemic risk analyses and support the work of the FSC; enhanced its analytical capacity via a macroprudential dashboard as part of an integrated early warning system; and recently issued its first FSR. The FSC is already operational, has discussed a range of financial stability issues and made some policy decisions. In addition, SAMA has improved coordination and information-sharing mechanisms internally and with other authorities for financial stability purposes. The proposed establishment of a NFSC would further strengthen coordination with the MoF and CMA on systemic risk analysis and the adoption of measures to promote financial stability.

As is common with many other countries, the macroprudential policy framework agenda remains work in progress. The authorities are aware that further steps to operationalise the framework are necessary and, in this context, it would be useful to focus their efforts on the following issues: strengthening institutional arrangements; expanding the scope of the

²⁸ The FSC recently asked the BSD to analyse the impact of the 2014 mortgage law and the LTV ratio on real estate lending.

²⁹ For example, a working paper published on SAMA’s website (in Arabic) introduces the concept of an LTV ratio and the standards used in determining the maximum mortgage finance rate in the region and globally.

³⁰ See <http://www.sama.gov.sa/en-US/EconomicResearch/Pages/QuarterlyWorkShops.aspx>.

framework to cover the entire financial system; enhancing data and analytics underpinning systemic risk assessments; and communicating macroprudential policy measures.

Institutional arrangements: The authorities are currently in discussions about the establishment of a NFSC that will *inter alia* coordinate financial stability work. Given the close links between fiscal policy and economic/financial sector performance as well as the fact that an important part of the Saudi financial system is not regulated and supervised by SAMA (see below), it is important for such a body to be created promptly in order to ensure an integrated and comprehensive risk assessment framework that can effectively support macroprudential policy decision-making. Moreover, experience from other countries³¹ suggests that having a dedicated information gateway among agencies for financial stability purposes may be useful to clarify expectations and specify confidentiality arrangements. While bilateral cooperation mechanisms (both formal and informal) exist between SAMA, MoF and CMA, they may not be adequate or sufficiently targeted for this purpose. The NFSC would therefore benefit from setting up explicit mechanisms (e.g. MoU) between its members to facilitate the sharing of information solely for financial stability purposes.

The FSAP recommended that the authorities develop a more formal and transparent macroprudential policy framework in Saudi Arabia. A lot of work has recently taken place in this area by SAMA and financial stability now forms a key policy objective in its strategy. However, the legal underpinnings for such a mandate are rather indirect given SAMA's 1952 Charter.³² In order to further strengthen the formality, clarity and accountability of the framework, it would be useful to codify and reinforce SAMA's leading role in macroprudential matters by embedding its financial stability mandate in the NFSC's Charter.

SAMA has set up the FSD and given it broad responsibilities for monitoring, assessing and making proposals to respond to emerging financial stability risks and vulnerabilities. The resources required to fulfil such broad tasks are limited and the unit is currently operating with only a small staff of four experts. SAMA is aware of this challenge and is taking measures to further leverage existing capabilities (e.g. by setting up a Data Analytics Unit) as well as to hire and train more staff. As the macroprudential framework is rolled out, it would be useful for SAMA to enhance the resources and expertise of its financial stability function so as to be able to fulfil its macroprudential responsibilities.

- ***Recommendation 1: In order to strengthen institutional arrangements for macroprudential policy: (1) the authorities should proceed promptly with the establishment of a NFSC, embed SAMA's financial stability mandate within the NFSC's Charter, and consider enhancing existing mechanisms between member agencies to facilitate information sharing for financial stability purposes; and (2) SAMA should further enhance the resources and expertise of its financial stability function to be able to fulfil its macroprudential responsibilities.***

³¹ See, for example, the discussion of the Financial Stability Committee in the April 2014 FSB peer review of Germany (http://www.financialstabilityboard.org/wp-content/uploads/r_140409.pdf).

³² Article 1 of the Charter (Royal Decree No. 23) states that one of SAMA's objectives is to "regulate commercial banks and exchange dealers".

Scope of framework: While SAMA plays a critical role in monitoring, evaluating and mitigating threats to the financial system, risks could arise from parts of that system that are not under its purview. Of note, a significant amount of credit (particularly real estate-related) in Saudi Arabia is provided by SCIs, and the scale and scope of their operations has grown in recent years.³³ In addition, recent changes in their governance and the increased official sector focus on them (e.g. as a means to alleviate housing shortages) suggest that SCIs' footprint and their interactions with commercial banks are expected to increase in the future. The authorities are of the view that SCIs do not represent a financial stability concern at present given the fact that they complement (rather than compete with) banks by offering medium to long-term loans; that they are needed because the banking sector cannot support the economy's financing needs on its own; that they are mostly funded by direct budgetary support; and that SAMA already collects some data on SCI credit and reviews their interactions with commercial banks.³⁴ On the other hand, available information on SCI operations and their performance remains relatively limited, and it is important to ensure that these entities are monitored from a prudential standpoint given their financial system footprint and projected growth, their linkages and interactions with banks, and the fact that they often lend to the same (corporate or household) borrowers.

- ***Recommendation 2: The authorities should bring specialized credit institutions within the scope of the macroprudential policy framework – in terms of data collection, systemic risk analysis and (as needed) the adoption of policy measures.***

Data and risk assessments: SAMA has a broad range of tools at its disposal for macroprudential purposes. However, as noted by the IMF, these tools have not generally been used in the past in a countercyclical way because they have been part of the supervisory process and applied on a bilateral basis with individual banks based on their particular characteristics and concerns.³⁵ One of the FSD's tasks is to review these tools and propose their revision where necessary for macroprudential purposes. In order to support the decision-making process, more work may be needed on data collection and risk assessments.

In terms of data collection, the FSD can already access a broad range of sources (both within and outside SAMA) for its quarterly risk assessments, as reflected in the macroprudential dashboard. Work is also underway (as recommended by the FSAP) to enhance data collection on cross-border financial activities of banks and corporates. However, while the dashboard has comprehensive indicators for the banking and insurance sectors, its coverage of market indicators (e.g. foreign exchange, commodities and real estate), business and confidence surveys (which can serve as early warning indicators) and leverage trends for the corporate and household sectors is limited. Such data would provide useful information for better assessing risks, although it may require significant time and resource commitment to collect.

³³ SCIs' loans outstanding have doubled since 2008 and are equivalent to 25% of total banking sector credit.

³⁴ Senior SAMA management also participates in some of the Boards of Directors of SCIs.

³⁵ As noted in the 2014 Article IV report, "SAMA has encouraged banks to provision in a countercyclical way.... However, the bank-by-bank approach has made this more a micro- than macroprudential policy tool in the staff's view... Staff suggested that consideration could be given to using these [macroprudential] tools in a countercyclical way by linking them explicitly to macroeconomic and financial developments to signal SAMA's assessment of risks to the market."

Given its mandate, SAMA could initiate work with government agencies (as appropriate) to design suitable templates and methodologies to collect such data.

In terms of risk assessments, the FSD utilizes the dashboard and an excel-based early warning model as complementary mechanisms to monitor systemic risks. Early warning exercises are at an early stage of development,³⁶ and further steps are needed to enhance modelling capabilities.³⁷ In addition, SAMA employs stress tests to evaluate firms' resilience under a variety of scenarios generated by its macroeconomic model, expert judgment and historical events. SAMA could usefully expand the scope of these tests by, for example, incorporating second-round effects to facilitate a better understanding of interactions between the financial system and the real economy as well as of common exposures, interconnectedness and contagion channels within the system. The results from these tests should not only be taken into consideration in the capital planning and Pillar 2 process for individual banks, but also feed into the decision-making process (e.g. assessing costs and benefits) for macroprudential policies.

Relatedly, understanding the interactions between micro-prudential, monetary and macroprudential policies on the one hand (which are under the purview of SAMA) and fiscal policies on the other hand is particularly important in Saudi Arabia, given the Riyal's peg to the US dollar, the economy's dependence on oil revenues and the use of fiscal policy as the principal countercyclical policy tool. The establishment of the NFSC is expected to create a venue for discussing the interaction of these policies. The FSR covers a broad set of risks, but it does not prioritise them, analyse their transmission channels or highlight the interactions between different policies. Going forward, the authorities will need to expand their analysis of transmission channels via which identified risks may be propagated to the financial system and economy at-large as well as examine the interactions between macroprudential and other types of policies.

According to its recent strategy, SAMA has the dual objective of promoting growth and ensuring soundness of the financial system. The FSDD and the Monetary Policy and Financial Stability Department interact frequently to ensure that these objectives do not come into conflict with each other, although this may be particularly difficult during periods of financial stress or economic boom. Reconciling these objectives is also an important task of the FSC when determining the trade-offs of different macroprudential policy measures. Macroprudential bodies in other countries have taken different approaches to addressing this issue,³⁸ and it would be helpful for SAMA to clarify and clearly communicate how it balances these objectives in its macroprudential decision-making process.

³⁶ The early warning model currently depends on two major indicators: equity index and credit-to-GDP ratio. Although both indicators are sound and a well-established literature confirms their performance in indicating financial stress, they could usefully be complemented by (for example) domestic property prices, core and non-core funding ratios, and possibly household and corporate leverage ratios.

³⁷ The current approach adopted in the early warning exercise is based on predefined risk percentiles. In order to enhance its statistical properties, SAMA could consider developing a model-based approach.

³⁸ For example, the primary statutory objective of the Financial Policy Committee in the UK is to protect and enhance the resilience of the UK financial system, while the secondary objective is to support the economic policy of the government, including its objectives for growth and employment.

- ***Recommendation 3: SAMA should strengthen its analytical framework to support macroprudential decision-making by: (1) enhancing data collection (e.g. commodity and real estate price indices, business activity and confidence indicators, corporate and household sector leverage); (2) improving stress testing by incorporating second-round effects and enhancing modelling capabilities; (3) analysing transmission channels and interactions between policies; and (4) clarifying how to balance its dual mandate of financial system soundness and growth within the macroprudential framework.***

Communication: Formal communication channels are essential for establishing transparency and accountability of the macroprudential framework. Sharing policy decisions and actions with the public and explaining their underlying rationale may also allow authorities to receive more timely and effective results from macroprudential measures. To date, SAMA has not publicly explained its macroprudential framework or explicitly linked its policy actions to risk assessments, although it has used other mechanisms to communicate with market participants (e.g. academic papers and quarterly seminars around macroprudential and financial stability topics). Going forward, the FSR will be SAMA’s key mechanism for communicating financial stability assessments and macroprudential policy tools. The first FSR, which was published in June, included a high level assessment of risks faced by the Saudi financial system and described SAMA’s macroprudential toolkit for the banking sector. However, there was limited alignment between the assessment of risks and the policy tools available for macroprudential purposes. Given its annual frequency, it may also be useful to complement the FSR with other forms of communication (e.g. speeches, policy statements, articles) from senior policymakers that describe the current macroprudential policy stance and link financial stability assessments with policy actions to guide market expectations. The need for a clear public communication strategy may become even more relevant once the NFSC is established, particularly if it is given formal powers (e.g. public warnings or comply-or-explain recommendations) or intends to publish press releases and other reports.

- ***Recommendation 4: In order to enhance transparency and accountability, SAMA should develop a clear communication policy for macroprudential measures.***

3. Bank resolution

Background

Saudi Arabia does not currently have a specific insolvency or resolution framework for banks. To date, SAMA has relied on the powers of intervention set out in the 1966 Banking Control Law (BCL) that provide it, as the supervisory authority, with very broad and largely unspecified powers to require a bank to take any steps considered necessary to address threats to its solvency or liquidity. Using this power in pursuit of its supervisory objective to protect the functioning and stability of financial markets, SAMA intervened successfully in the past to prevent bank failure on a few occasions. The last such intervention took place in 1982 and there has never been an insolvency procedure for a failed bank in Saudi Arabia.

The lack of a specific insolvency or resolution framework for banks was noted both in the FSAP and in the FSB peer review on resolution regimes. The FSAP found that while SAMA

has strong supervisory powers to prevent bank failures, it has more limited powers to deal with an actual failure. In the absence of a specific resolution or insolvency regime for banks, the general corporate bankruptcy provisions apply,³⁹ meaning SAMA would not be in the lead if a bank is declared insolvent. The FSAP suggests that this lack of formal powers may have been a factor in motivating SAMA's forceful preventative approach. While shareholders and managers have suffered losses as a result of SAMA interventions, all depositors and other creditors have been fully protected and, indeed, the implicit guarantee for all bank deposits was made explicit in the wake of the financial crisis by official announcement. The FSAP recommended that the authorities initiate the preparation of a specific resolution framework for banks in line with international initiatives⁴⁰ and, to complement it, introduce an explicit deposit insurance scheme with limited coverage (see section 4).

Similarly, the FSB peer review⁴¹ found that a number of powers in the FSB's *Key Attributes of Effective Resolution Regimes for Financial Institutions (Key Attributes or KAs)*⁴² – such as, for example, bail-in within resolution, ability to impose temporary stay on early termination rights – were lacking in Saudi Arabia and that the circumstances in which shareholder and third party rights can be overridden were not set out explicitly in the legal framework or tested in court. It also noted that there were no requirements for recovery and resolution planning or for undertaking resolvability assessments.

This section reviews the progress made by the authorities to address the FSAP recommendation and develop a resolution framework for banks. Drawing on international guidance, it examines the proposed resolution regime and makes further recommendations to assist the ongoing work by the authorities to align that regime with the *Key Attributes*.

Steps taken and actions planned

Current regime: The framework reviewed in the FSAP and the FSB peer review of resolution regimes still remains in place, although reforms are underway (see below).

Under the current framework, SAMA's powers to intervene in a stressed or failing bank are part of its general supervisory powers under the BCL. Article 22 BCL gives SAMA very broad discretionary powers that are exercisable, subject to the approval of the Minister of Finance, when a bank fails to comply with the provisions of the BCL or any regulation issued under the BCL or adopts a policy that might seriously affect its solvency or liquidity. Measures permitted under Article 22 are, specifically, the appointment of advisors to advise a

³⁹ The general insolvency regime is set out in the Commercial Court Law of 1930, which applies generally to sole traders and companies. Proceedings under this Law are subject to court supervision. This is supplemented by the Bankruptcy Preventive Settlement Law of 1996, which provides a framework for companies in financial distress to reach a settlement with creditors under the control of the Board of Grievances. Neither procedure has ever been used for a bank.

⁴⁰ In particular, the FSAP noted that such a regime would empower the authorities to: continue temporarily the core operations of an institution; have shareholders absorb losses, pay off senior creditors only at estimated recovery value and change management so as to minimise moral hazard; and provide the conservator with adequate flexibility to minimise the damage to the economy and costs to taxpayers.

⁴¹ See http://www.financialstabilityboard.org/wp-content/uploads/r_130411a.pdf.

⁴² See http://www.financialstabilityboard.org/2014/10/r_141015/.

bank in the conduct of its business; the suspension or removal of any director or officer of a bank; and limiting or suspending the granting of credits and the acceptance of deposits, coupled with a general and uncircumscribed power for SAMA to require a bank to take other steps as it may consider necessary.

The latter power is interpreted by SAMA as the legal authority for it, in appropriate cases, to undertake resolution actions of the kind set out in the *Key Attributes*. However, the presumed scope of possible resolution measures under Article 22 BCL is based on SAMA's interpretation of its wide margin of discretion to take whatever action is needed in pursuit of its mandate to protect the functioning and stability of financial market. That interpretation is consistent with the Saudi legislative technique of high level framework legislation that confers broad powers, accompanied by a provision for adoption of implementing rules. At present, other than the generic Rules for enforcing Provisions of the BCL that were issued via Ministerial Decision No. 3/2149 in 1986, there are no detailed implementing rules that further specify the scope and operation of Article 22.

SAMA has historically pursued a zero-failure regime in its oversight of the banking sector, motivated by the perception that the failure of any banks could give rise to a broader crisis of confidence that would be detrimental to the stability of the sector as a whole. SAMA has used its powers to intervene and prevent a possible bank failure on at least three occasions during its existence. The measures included replacement of management, forced mergers with other banks and forcible dilution of shareholdings through recapitalisation. On each occasion shareholder rights were overridden but no losses were imposed on subordinated or senior creditors. None of these interventions has ever been the subject of a legal challenge, so the scope of the powers under Article 22 BCL and SAMA's margin of discretion in exercising them has never been the subject of any judicial review. The timeframe for those measures and the transactions involved typically took several months to be completed. SAMA interprets Article 22 as permitting, in appropriate cases, other resolution measures specified in the *Key Attributes*, such as transfer to a bridge bank or write down of liabilities. However, it has not hitherto taken such measures and has not been required to use its existing powers to make a rapid intervention to stabilise a failing bank over the short period that may be required in some circumstances.

Draft Law on the Resolution of Financial Institutions: In line with the FSAP recommendation, Saudi Arabia is in the process of adopting a formal bank resolution framework. To this end, SAMA has developed a Draft Law on the Resolution of Financial Institutions (DLR) that designates SAMA as the resolution authority for financial institutions⁴³ and formalises, broadens and clarifies the powers that SAMA interprets as already implicitly conferred by Article 22 BCL. The DLR gives SAMA, in its capacity as resolution authority, a range of explicit powers for the recovery or resolution of failing financial institutions. The DLR also gives SAMA explicit powers to disclose information⁴⁴ to other domestic and foreign authorities and to enter into non-binding cooperation

⁴³ This includes banks, insurance companies, finance companies (and domestic branches of such entities); and financial market infrastructure relating to payment systems, payments and cash transfers.

⁴⁴ The scope of this information will be set out in regulation.

arrangements with foreign authorities. Specific elements of the DLR are described further below, and additional features are summarised in Box 2.

The DLR has been submitted to the Bureau of Experts for discussion and SAMA has already received its feedback and observations. The next step is expected to be the submission of a revised draft of the DLR reflecting that feedback to the Bureau of Experts through the Council of Ministers. However, there is no clear timeframe for the finalisation and approval of the Law.

In line with other Saudi Arabian legislation, the provisions of the DLR are framed at a high level. In particular, the various features of the resolution powers, including the manner in which they may be exercised, are not elaborated in any detail. SAMA has indicated that implementing rules will be developed to elaborate on a number of elements and adopted once the Law is approved.

Objectives of resolution authority: The DLR sets out the objectives that SAMA must have regard to when exercising its powers in relation to recovery and resolution. These are closely aligned with the objectives for resolution authorities set out in KA 3 and include: ensuring the continuity of the critical functions; avoiding adverse effects on financial stability, including through the prevention of contagion and the maintenance of market discipline; the protection to the public funds by minimising reliance on public support; and the protection of deposits, client funds and client assets.

Conditions for intervention: The DLR sets out two sets of conditions for intervention. The first specifies that if an institution does not meet or is likely to breach any applicable capital adequacy and solvency requirements, SAMA may take all measures it sees fit to avoid, mitigate or cure the breach, including those measures that are available under Article 22 BCL (which will remain in force). The second allows SAMA to take resolution action in relation to an institution when it considers the institution is failing or likely to fail, or that resolution is in the public interest. When either of those conditions is met, the DLR gives SAMA unfettered discretion to take whatever resolution measures under that Law it considers appropriate. Further details on the second set of conditions will be set out by SAMA in implementing regulations.

Resolution powers: The DLR confers on SAMA a range of resolution powers that are intended to implement the powers specified in the *Key Attributes*. According to SAMA, this clarifies and gives explicit legal authority for many of the powers that it currently has implicitly under Article 22 BCL. It should be noted that, for the purposes of the application of the resolution powers, there is no special provision for banks designated as systemically important.

The DLR will enable SAMA, when the conditions for resolution are met, to issue resolution orders for any of the following:

- a sale of business (either by sale of shares or of assets, rights and liabilities) to a third party purchaser;
- a transfer of shares or assets, rights and liabilities to a bridge institution;
- asset separation through transfer to an asset manager;

- bail-in through write down of liabilities or conversion of debt into shares, either to recapitalise a failing institution or to provide capital for a bridge institution.

These resolution orders will not require the consent of the shareholders or of any third party. The DLR also confers on SAMA a range of powers necessary to enable it to implement resolution orders.

Box 2: Additional features of the DLR

Planning and early intervention

- a) Power for SAMA to require recovery and resolution plans;
- b) Power for SAMA to take measures to ensure an institution or financial group is resolvable;
- c) Power for SAMA to take early intervention measures when an institution is likely to breach capital adequacy or solvency requirements.

Resolution powers to facilitate implementation of resolution orders

- a) Require any person to provide any information required for any of the matters set out in law;
- b) Take control of an institution under resolution;
- c) Exercise all rights of shareholders or owners of the institution or to remove or replace, or enforce claims of any kind against, senior management;
- d) Amend the terms of, cancel, transfer or order the issuance of shares and other instruments of ownership, debt instruments, other capital instruments or any rights, assets or liabilities;
- e) Amend the terms of, write down or reduce amounts payable under, any liabilities or convert any liabilities into shares or other securities;
- f) Restrict or cancel termination, set-off or walk-away rights under contracts with an institution under resolution;
- g) Give effect to a transfer order, the power to: a) modify the terms of a contract to which the institution under resolution is a party or to cancel that contract or substitute a transferee as a party; b) modify the terms of a contract; c) enforce contracts and; d) impose information obligations or continuity arrangements to ensure that the business transferred may be operated by the recipient.

Resolution funding: The deposit insurance fund (see section 4), as currently constituted, will not be available to fund resolution actions. The DLR gives SAMA the power to establish a resolution fund funded by contributions from industry, but with no requirement for SAMA to use it and no specification of the timeframe for its establishment, how it should be constituted, governed and managed, or any target size. It is therefore currently unclear whether or how the power will be exercised and, pending the establishment of such a fund, what sources of funding for resolution – including provision of liquidity other than from the market – will be available.⁴⁵

⁴⁵ While the objective of minimising loss to taxpayers is not as relevant in Saudi Arabia, mechanisms for ensuring that excess losses to public funds, which are not borne by shareholders or creditors of the failing firm, can be passed on to other financial sector participants in appropriate cases may help address any moral hazard arising from an assumption of public support.

Safeguards: The DLR introduces a number of safeguards based on the *Key Attributes* that should confer appropriate protection for creditors and increase predictability about how losses will be allocated in resolution. These include the principles that: the shareholders of an institution under resolution should bear losses first, followed by creditors losses in accordance with the order of priority of their claim pursuant to the DLR;⁴⁶ creditors of the same class should generally be treated in an equitable manner and no creditors should incur greater losses that would be incurred if the institution had been wound down under normal insolvency proceedings; and senior management of the institution should be replaced and bear losses that are commensurate under civil or criminal law with their responsibility for the failure of the institution.

Recovery and resolution planning and resolvability assessments: There are currently no requirements for bank recovery and resolution planning in Saudi Arabia, although SAMA notes that the D-SIB framework that will come into force on 1 January 2016 may (in addition to higher loss absorbency) include such requirements. The DLR empowers SAMA to require financial institutions to prepare such plans. That power is complemented by a requirement for SAMA to assess the extent to which institutions and groups are resolvable without public financial support and a power for SAMA to take any measures it sees fit to ensure the resolvability and/or recoverability of an institution or a financial group.

Lessons learned and issues to be addressed

Saudi Arabia does not have a specific insolvency or resolution framework for banks. Using its supervisory mandate, SAMA has historically interpreted its broadly-framed intervention powers under the BCL to enable it to effect transactions such as mergers of a failing bank with a sound institution and shareholder recapitalisation in order to avoid bank failures. While SAMA believes that those powers are sufficiently broad to enable it to give effect to most resolution measures specified in the *Key Attributes*, it nevertheless sees advantages to formalising those powers in order to align the framework in Saudi Arabia more explicitly with international standards, enhance its predictability for market participants, and develop a regime that is ‘future-proofed’ for any possible developments in the banking sector. Accordingly, the authorities have drafted legislation to develop a formal general resolution framework that specifies the resolution powers and the conditions in which they can be exercised; enables losses to be absorbed by shareholders and creditors; and provides explicit safeguards in connection with the exercise of those powers.

Once approved and in force, that legislation will represent significant progress in addressing the FSAP recommendation and FSB commitments by putting in place a resolution framework that contains the elements described in the *Key Attributes*. In particular, the DLR defines the role of SAMA as an independent administrative resolution authority with an extensive range of resolution powers that it can exercise directly through resolution orders, without relying on directions to the failing firm. Furthermore, it expands the powers that SAMA considers are available under the current regime and introduces new powers for SAMA to write down and

⁴⁶ The hierarchy of creditor claims is not currently set out in Saudi law, and will need to be specified for the purposes of the operation of the resolution regime under the DLR.

convert liabilities (bail-in); impose temporary stays on the exercise of early termination rights and moratoria on the enforcement of claims against a firm in resolution; and dispose of assets of that firm. The new law also introduces clear rights of appeal to judicial authorities for persons affected by resolution actions, coupled with restrictions on the scope of judicial review and the remedies available to prevent resolution actions from being suspended or reversed.

Notwithstanding this progress, further work is needed to ensure that the resolution framework is established on a timely basis and operates effectively. This involves proceeding with the prompt adoption of the DLR; clarifying a number of important features in implementing regulations; and initiating, in advance of DLR adoption, recovery and resolution planning for banks to help inform the implementing regulations.

Prompt adoption of the DLR: As noted above, the DLR seeks to align the bank resolution regime in Saudi Arabia with international standards by comprehensively adopting the *Key Attributes* in a framework law. If implemented effectively, the DLR will offer SAMA the tools to intervene rapidly to manage failing banks in a way that minimises systemic impact while adding legal protections for affected stakeholders as well as transparency and predictability to the process by virtue of a more explicit regime (thereby avoiding the need to rely on implied powers through a broad interpretation of Art. 22 BCL).

The draft law is currently being revised by SAMA following comments from the Bureau of Experts. It is important that the authorities continue to commit the necessary resources to this process so as to expedite, as far as possible, the legislative process by early submission of a revised draft of DLR to the Bureau of Experts through the Council of Ministers. At the same time, SAMA should build the requisite internal expertise and organisational arrangements (i.e. establishment of resolution unit and development of cooperation and information-sharing protocols with supervision) to be in a position to assume the functions conferred under the new framework as soon as it is adopted.

- ***Recommendation 5:*** *The authorities should proceed with the prompt adoption of the DLR to provide a general resolution framework that is aligned with the FSB’s Key Attributes.*

Implementing regulations: Given its high-level nature, the operational effectiveness of the DLR will depend on further detail about how the resolution powers will be exercised. Unless key elements of the framework set out in the DLR are elaborated in implementing regulations, the new resolution regime may not achieve the level of transparency, predictability and credibility that is aimed for. Two elements, in particular, on which the Saudi authorities should consider developing further detailed provision as a matter of priority include: (i) the conditions for entry into resolution; and (ii) specification of the creditor hierarchy for the purposes of loss allocation through the use of resolution tools and application of the ‘no creditor worse off’ safeguard.

As regards (i), the DLR sets out two sets of conditions: one for early intervention (Article 8) and the other for resolution action (Article 10). Given the potential for overlap between those conditions as the DLR provides SAMA with unfettered discretion to take whatever resolution measures it considers appropriate in both cases, it would be desirable to provide further

clarity through implementing regulations on the conditions for use of resolution tools and the transition from early intervention (with the objective of recovery) to resolution.

As regards (ii), the principles of the DLR specify that creditors should bear losses (after shareholders) in accordance with the order of priority of their claims; and that no creditor should incur greater losses than would be incurred if the institution would have been wound down under normal insolvency proceedings. However, there are currently no clear rules under the legal framework in Saudi Arabia on the hierarchy of claims in insolvency. Clarity about the hierarchy of claims is a prerequisite for the allocation of losses in resolution through the use of resolution powers in accordance with the principles set out in the DLR. Such clarity also facilitates creditors and liability holders to assess their risk of loss in resolution and the pricing of debt. SAMA has indicated that provision on the hierarchy of creditors can be set out in implementing regulations, and it is highly desirable that such provision is adopted to support the use of resolution tools and the associated safeguards.

- ***Recommendation 6: The authorities should develop implementing regulations detailing the operation of the resolution regime to take account of the specificities of the Saudi financial system and to ensure that the provisions in the framework law can be made operational. Priority should be given to implementing provisions that clarify the hierarchy of creditors and the conditions for entry in resolution.***

Recovery and resolution planning: The DLR contains explicit powers for SAMA to require selected banks to develop recovery and resolution plans. However, SAMA considers that it currently has the necessary powers to require such planning as part of its general supervisory powers under the BCL, although it has not yet done so.

Experience in other jurisdictions has shown that work on the development of resolution strategies and plans for individual firms can be of considerable value in helping authorities to identify the conditions – including legal provisions and rules – that should be in place to ensure that resolution powers can be exercised effectively. Resolution planning also facilitates the identification of the main barriers to firm resolvability, whether arising from the legal framework or from the structure and business organisation of firms, so that measures can be taken to eliminate or mitigate them.

The practical experience of resolution planning could help to inform the development of implementing regulations and guide SAMA in identifying the detailed provisions that are needed to ensure that the new resolution regime is effective. Consistent with KA 11.1,⁴⁷ SAMA could therefore start developing resolution strategies and operational plans for those banks that have been identified as systemically important using its current powers under BCL, while the new regime is still being finalised and the implementing rules are being developed.

- ***Recommendation 7: The authorities should, in advance of the adoption of the DLR, initiate recovery and resolution planning for banks designated as systemically important to help inform the development of the implementing regulations.***

⁴⁷ “Jurisdictions should put in place an ongoing process for recovery and resolution planning, covering at a minimum domestically incorporated firms that could be systemically significant or critical if they fail.”

4. Deposit insurance

Background

The February 2012 FSB peer review on deposit insurance systems⁴⁸ found that Saudi Arabia was among a few FSB jurisdictions without an explicit deposit insurance system (DIS). Saudi Arabia had previously studied the establishment of an explicit DIS but decided not to adopt one as it believed that its framework of conservative prudential regulations and proactive supervision can provide depositors with sufficient protection.⁴⁹ However, the peer review noted that such a framework implicitly relied on government support in the event of bank failures and did not appear prima facie consistent with the G20 Leaders' call on national authorities to make feasible the resolution of financial institutions without severe systemic disruption and without exposing taxpayers to loss. The report recommended that Saudi Arabia consider the introduction of an explicit but limited DIS in order to enhance market discipline and to facilitate the adoption of an effective resolution regime for failing banks. The 2011 FSAP had also noted that the introduction of an explicit deposit insurance scheme with limited coverage would complement a formal resolution framework for banks in line with international initiatives.

This section reviews the progress made by the authorities to address the FSB recommendation. In particular, it examines the proposed objectives, scope, coverage and funding of the DIS drawing on available international guidance in this area, particularly the International Association of Deposit Insurers (IADI) *Core Principles for Effective Deposit Insurance Systems* (Core Principles).⁵⁰

Steps taken and actions planned

Introduction of deposit insurance system: The authorities remain of the view that the framework of conservative prudential regulations and proactive supervision provides depositors with strong protection. However, in order to better align with international standards and fulfil G20/FSB commitments, they have decided to introduce an explicit deposit insurance system. Following a consultation process with the banks to seek feedback on salient features of the proposed scheme, SAMA issued final Depositors Protection Fund (DPF) Rules⁵¹ on 14 April 2015. These Rules will come into effect on 1 January 2016. The

⁴⁸ See http://www.financialstabilityboard.org/wp-content/uploads/r_120208.pdf.

⁴⁹ Saudi Arabia did not introduce any extraordinary depositor protection measures during the crisis, although the Supreme Economic Council made an official announcement in October 2008 that deposits are safe. As noted in the FSAP, "the authorities consider that this announcement, which was incorrectly interpreted by some segments of the public as a blanket guarantee, contributed to the stability of the Saudi financial system during the crisis".

⁵⁰ See <http://www.iadi.org/docs/cprevised2014nov.pdf>. The Core Principles were developed by IADI in 2009 (jointly with the BCBS) and revised in November 2014 to incorporate the policy lessons for deposit insurance systems learnt from the global financial crisis of 2007-08.

⁵¹ DPF Rules were issued under Article 3(d) of SAMA Charter issued by Royal Decree No.23 dated 23-5-1377H (15 December 1957G) and Article 16(3) of the Banking Control Law issued by Royal Decree No. M/5 dated 22-2-1386H (11 June 1966 G).

study conducted by SAMA to assess the need for a DPF concluded that an explicit scheme will further strengthen financial system stability, protect small-scale depositors against any unlikely event of bank failure, create a formal mechanism of depositors' protection, help manage expectations of depositors, and provide a level playing field for all banks.

Design of scheme: The main objective of the DPF is to maintain financial stability by protecting depositors up to a certain limit. The DPF is being established as a simple “pay box”⁵² within SAMA based on the existing legal framework. The decision to introduce a pay box reflected the authorities' view that a pay box is an appropriate first step for a new deposit insurance system and would have greater credibility if maintained within SAMA. The authorities note that giving DPF a separate legal status would be considered at a later stage. Membership of DPF and the associated payment of the deposit insurance premium is mandatory for all banks that conduct banking business in Saudi Arabia, including the branches of foreign banks (see Box 3 for the main features).

Governance arrangements: The DPF is being established as an administrative unit in SAMA under the Deputy Governor for Supervision. The management and oversight of DPF will be done by a governing committee appointed by the Governor of SAMA, with the terms of reference approved by SAMA. The intention is to make the DPF operationally independent from the supervision function by ensuring separate reporting lines for the DPF unit. SAMA is in the process of deciding the composition of the governing committee, which is likely to comprise senior SAMA officials, industry representatives, asset managers and advisors. The governing committee can constitute one or more subcommittees and determine their terms of reference to ensure smooth functioning of the DPF.

Funding mechanisms: The DPF will be an *ex-ante* fund and the resources into the DPF will accrue from: a) initial and periodic premium payments from banks; b) return on the investment of DPF's resources; c) proceeds received from a bank's property in case of its sale or liquidation; and d) other sources of funding including loans and grants. The premium will initially be paid on a flat rate basis at an annual rate of 0.05% of the average amount of eligible deposits held by the bank.⁵³ This premium, which corresponds to around 1% of the banking sector's annual net income, will be collected on a quarterly basis. The resources of DPF will be managed by the governing committee according to the guidelines approved by SAMA; the investment policy of the fund will be formulated once the governing committee is formed and starts functioning. The fund adequacy will be assessed from time to time, and a target fund ratio will be specified in due course. The DPF Rules provide that banks will be required to fully indemnify the DPF for any payments made to the depositors until its liquidation. The position of DPF in the hierarchy of creditors in case of a bank failure is not explicitly defined under the general bankruptcy law.

⁵² In a “pay box” mandate, the deposit insurer is only responsible for the reimbursement of insured deposits and protecting the deposit insurance fund.

⁵³ A number of factors, such as the size of individual banks, eligible deposits, profitability of banks, premium rates in other countries etc. were taken into account while deciding the premium rate.

Box 3: Main Features of the DPF in Saudi Arabia

The deposit insurance system in Saudi Arabia will have the following features:

- Full protection to deposits of up to SAR 200,000⁵⁴ (equivalent to around USD 53,000 as on 30 April 2015) per depositor per member bank, including principal and accrued commission/return. This protection limit would fully insure 97% of bank depositors and 31% of the value of eligible deposits or 23% of the value of total deposits.⁵⁵
- Eligible depositors include individuals and other non-bank depositors (sole proprietorships, partnerships, companies, unincorporated entities etc.).⁵⁶ The following categories of individuals/institutions are not covered:
 - a) members of the board of directors and senior management of a bank and their family members;
 - b) other banks or financial institutions;
 - c) shareholders holding in excess of 5% shares in the bank;
 - d) Saudi government or quasi-government institutions; and
 - e) persons acting on behalf of any of the persons mentioned in a) through c) above.
- DPF covers all types of deposits in local or foreign currency with member banks including current accounts, savings accounts and time deposits. The following types of deposits are excluded:
 - a) a deposit that is not payable in Saudi Arabia;
 - b) an interbank deposit;
 - c) a negotiable instrument of deposit and any other bearer deposit;
 - d) a repurchase agreement; and
 - e) any other deposit or financial instrument as may be specified by SAMA.
- The DPF will perform all of the following functions:
 - i. Collect premiums and contributions;
 - ii. Manage resources of the DPF and conduct its operations;
 - iii. Evaluate the adequacy of the DPF's funding from time to time;
 - iv. Assess claims of eligible depositors for payments out of the DPF;
 - v. Make payments of accepted claims to eligible depositors within applicable protection limits;
 - vi. Other functions incidental or related to the DPF's affairs or required to achieve its objectives.

The DPF Rules provide that if at any time, the resources of the DPF fall short of its liabilities, such shortfall may be covered by requiring banks to make advance premium payments and/or increasing the rate and/or frequency of premium payments. The DPF is permitted to borrow

⁵⁴ In determining the coverage limit, the authorities took into account factors such as per capita GDP, number of small depositors, size and composition of deposits, availability of resources, size of individual banks etc.

⁵⁵ The relatively low level of coverage in terms of the value of deposits can be explained by the large presence of public sector and corporate deposits in the Saudi banking system that are not covered by the DPF.

⁵⁶ Islamic deposits are treated similarly to conventional deposits and are eligible for payment under the DPF.

and accept grants. There is at present no provision for back-up funding or line of credit from either SAMA or the government since the authorities are of the view that it is not needed.

Reimbursement arrangements: The DPF will assess claims of eligible depositors and make payments of accepted claims to eligible depositors within applicable protection limits, which will be inclusive of any return due or accrued on deposits up to the cut-off date determined by SAMA. The amount of protected deposits will be determined after deducting the money the bank is legally entitled to deduct by way of set-off.⁵⁷ The DPF Rules do not yet specify a timeframe for payments to depositors. Such a timeframe will be approved as part of the operating procedures of the DPF.

The DPF will provide details on how the compensation will be made. The depositor will not be required to file any claims. The DPF will make announcements for payment of compensation to eligible depositors through the public media and at the affected bank and its branches. If the deposit exceeds the compensation from the DPF, the depositors can file a separate claim with the liquidator of the affected bank for the difference, but one cannot claim what has already been compensated under the DPF.

Public awareness: SAMA intends to undertake a program for public awareness to educate the public and other stakeholders on the advantages of the DPF and highlight its role in enhancing financial stability. The public awareness strategy will be implemented once the detailed operating procedures of the DPF, which will outline critical design features of the insurance program, are finalised.

Lessons learned and issues to be addressed

The introduction of an explicit DIS on 1 January 2016 as a “pay box” within SAMA indicates the authorities’ commitment to implement the internationally agreed standards on deposit insurance. Once fully implemented, the scheme is expected to further enhance the safety net in the Saudi financial system. SAMA has adopted a number of good international practices codified in the IADI Core Principles, such as explicit public policy objectives and mandate of the DPF, compulsory membership and legal protection for the DPF.

In spite of these accomplishments, further work is needed to address depositors’ perception of an implicit deposit guarantee and to address certain shortfalls in the DPF Rules vis-à-vis the Core Principles so as to ensure that the DIS is fully integrated in the financial safety net.

Implicit deposit guarantee: An important issue that needs to be addressed is the Supreme Economic Council’s statement in 2008 that the authorities continue to ensure the safety of local banks and bank deposits. This is perceived to provide an implicit full coverage to all depositors and is inconsistent with the objective of setting up a limited deposit protection system that promotes market discipline and avoids moral hazard. The authorities need to decide how best to withdraw this implicit guarantee without any adverse impact on depositor

⁵⁷ “Set-off” refers to the practice where a depositor’s deposits at a failed bank are netted against the depositor’s liabilities owed to the failed bank before determining the depositor reimbursements. Set-off reduces the amount of total deposits in the bank and provides some protection to uncovered depositors.

confidence. Drawing on the experience of other countries,⁵⁸ one option in this regard may be to adopt an explicit transition period that starts with higher coverage levels that could be reduced to the target level over time. Such a phase-out needs to be supported by well-designed deposit insurance arrangements (see below), mechanisms for dealing with problem institutions (see section 3), and a strong public awareness campaign.

Since the DPF is a new scheme, SAMA intends to undertake shortly a program to educate the public and stakeholders on its main features. This public awareness campaign, which would be undertaken in close cooperation with banks, should ideally address the issue of the implicit deposit guarantee as well as emphasise the advantages of a DIS in an international context and highlight its role in enhancing financial stability.⁵⁹

- ***Recommendation 8: In order to ensure the smooth adoption and effectiveness of the DPF, the authorities should address depositors' perception of an implicit guarantee provided by the Supreme Economic Council and adjust their public communication accordingly.***

Enhancing DPF Rules: The DPF Rules do not provide sufficient details about certain important design features that are needed to make the DPF fully operational. SAMA is still in the process of finalising the implementing rules, and it is important that those rules incorporate good international practices so that the DPF can function effectively if the need to invoke deposit insurance ever arises. Important issues that would need to be addressed in this context are reimbursement and governance arrangements as well as the integration of the DPF with the overall safety net.⁶⁰

A prerequisite for a strong DIS is the speed with which depositors are reimbursed after a bank is closed. The Core Principles establish a medium-term goal of ensuring that the depositors are reimbursed in no later than seven days. This requires that supporting arrangements to ensure a quick pay-out, including a 'single customer view'⁶¹ of depositors, are maintained. Such a system requires capabilities to generate depositor balances quickly after taking care of set-off (which can impede fast disbursement of funds by requiring that data regarding amounts due from the depositor are netted) and funds-in-transit in the payments system (e.g. cheques issued and online transactions). SAMA will need to require banks to build up these

⁵⁸ See, for example, the IADI discussion paper on "Transitioning from a blanket guarantee or extended coverage to a limited coverage system" (March 2012, http://www.iadi.org/docs/transitioning_paper_29march2012_final_for_publication_1.pdf).

⁵⁹ As a reference, see "Public Awareness of Deposit Insurance Systems Guidance Paper" by IADI (November 2012, http://www.iadi.org/docs/IADI-Public_Awareness_Enhanced_Guidance_Paper.pdf).

⁶⁰ There are other good international practices that could also be usefully incorporated in the DPF Rules. For example, the coverage limit in Saudi Arabia should be reviewed periodically (e.g. every five years) in order to assess its role in minimising the risk of run on banks and maintain financial stability. See Core Principle 8 and "Deposit Insurance Coverage Guidance Paper" by IADI (March 2013, http://www.iadi.org/docs/IADI_Coverage_Enhanced_Guidance_Paper.pdf).

⁶¹ A single customer view is the total amount of deposits a single depositor holds in a bank, irrespective of the number of accounts the depositor holds in the bank. See "Reimbursement Systems and Processes Guidance Paper" by IADI (November 2012, http://www.iadi.org/docs/IADI-Reimbursement_Enhanced_Guidance_Paper.pdf).

capabilities and also ensure that depositors are aware of the timeframe in which pay-out will be made and the modes of reimbursement.

The DPF is being established as a pay box, which seems appropriate for a start-up DIS. However, being a unit within SAMA requires that the DPF has a governance structure that ensures its operational independence and the ability to voice its views on financial stability issues. The composition of the governing committee is not finalised yet. In keeping with good international practice (Core Principle 3 on Governance), SAMA should ensure that the composition of the committee is determined transparently, ensures its operational independence and minimises the potential for real or perceived conflicts of interest (e.g. by not having active bankers on the committee).⁶²

The Core Principles also suggest that the deposit insurer be fully integrated into the safety net. Given the importance of rapid pay-out, the DPF will need to be in a position to react quickly in the event of an unexpected failure. Information sharing arrangements with SAMA supervisory staff are needed so that that the DPF learns expeditiously of impending failures.

Finally, it is not clear under what conditions depositor pay-out would be activated in the current system or how the DPF scheme will integrate with the resolution framework once the DLR is implemented (see section 3). As the current process may involve the corporate insolvency framework, the involvement of courts cannot be ruled out. The authorities therefore need to ensure that the DIS is aligned with the bank resolution framework. This includes defining the place of DPF in creditor hierarchy, especially since DPF Rules envisage a share for the DPF in proceeds from the liquidation of the failed institution.

- ***Recommendation 9: SAMA should: (i) establish and publicly communicate a timeframe for pay-out to depositors in order to enhance the credibility of the DPF, and make all necessary arrangements to meet that timeframe; (ii) ensure that the composition of the DPF's governing committee reflects the various safety net participants and stakeholders, and that appropriate safeguards are available to manage conflicts of interest and ensure its operational independence; (iii) establish information sharing arrangements between the DPF and supervisors; and (iv) elaborate on the process for invoking deposit insurance upon the failure of a bank at present as well as under the proposed draft law on resolution.***

Funding mechanisms: The authorities are of the view that, given the soundness and stability of individual banks and the overall Saudi banking system, any initial funding of the DPF is not necessary. Similarly, back-up funding support is not considered necessary in view of other official sector buffers and implicit guarantees. SAMA aims to set up an *ex-ante* fund that will be built up gradually from the premiums charged from the industry. It is understood that it will take 8-10 years before the fund grows to a size sufficient to meet pay-out to depositors of a small to medium-sized bank. The Core Principles call for a robust funding arrangement to ensure public confidence in the DIS. For this purpose, it may be helpful if the

⁶² In case active bankers are taken on board, the DPF will need to ensure that adequate firewalls exist so no bank-specific information is discussed in their presence. In this case, the role of these individuals would be to advise on broad policy issues rather than operational activities of the DPF.

authorities provide seed capital⁶³ to strengthen the fund and contribute to its viability. Such a public perception may also facilitate the withdrawal of the guarantee issued by the Supreme Economic Council.

In addition, SAMA could establish a target size of the fund in relation to covered deposits while taking into account the likelihood of failure of banks and other factors. Most deposit insurance systems have adopted explicit target levels and Core Principle 9 (Sources and Uses of Funds) requires that a target ratio be established and achieved within a reasonable timeframe.⁶⁴ The DPF needs to be big enough to meet depositor liabilities in the event of any unexpected, idiosyncratic failure of banks operating in Saudi Arabia.

Furthermore, it is important that the fund is supported by a clearly laid-out back-up funding arrangement. Emergency back-up funding – to supplement the deposit insurance funds when they are insufficient to meet depositor reimbursement – is a critical element of most deposit insurance systems and is required for compliance with Core Principle 9. The DPF Rules provide for borrowing and collection of additional premiums from banks, but collecting such premiums in the event of a bank failure may be pro-cyclical and affect banks adversely; borrowing from the market is another possibility, but it could be expensive. It is therefore important for the DPF Rules to explicitly provide for a line of credit from the government/central bank.

- ***Recommendation 10: SAMA should consider enhancing the funding arrangements of the DPF by: (1) specifying a target fund size; and (2) establishing a back-up line of credit in order to ensure that DPF resources can meet deposit pay-out requirements in a timely manner.***

⁶³ Seed funding is sometimes received by a newly-established DIS in the form of initial contributions typically from financial institutions, government or the central bank.

⁶⁴ The target fund size of a deposit insurance fund, which is typically measured as a proportion of the assessment base (e.g. total or insured deposits), should be sufficient to meet the expected future obligations and cover the operational and related costs of the deposit insurer.

Annex 1: Structure of the financial system and recent developments⁶⁵

Financial system structure

Overview of the banking sector

Laws and regulations: Banks are regulated by SAMA, which is the central bank and the banking supervisory authority. SAMA is empowered by its 1957 charter and the 1966 Banking Control Law (BCL) to supervise and regulate all entities licensed as banks in Saudi Arabia. In 2003, SAMA was given powers to license and regulate insurance companies under the Cooperative Insurance Companies Control Law and in 2008, SAMA was granted powers to regulate and supervise real estate finance, leasing and finance companies. SAMA also has powers under its Charter to license and regulate the money exchange business.

The BCL gives SAMA significant powers and authority to issue regulations to the banking industry, including on solvency, liquidity, leverage, large exposures and related party lending. Over a period of more than half a century, SAMA has maintained financial stability through a prudent regulatory stance and no bank has ever failed in Saudi Arabia.

Banking sector: As of 31 December 2014, there were 24 licensed banks in the Kingdom, including 12 branches of foreign banks. The 12 Saudi banks have assets that account for approximately 96% of the assets of the banking system. The three largest banks have a share of 46% in assets and the next four banks each have a share exceeding 5%. The dominant shareholders of the three largest banks are government entities, although banks are run on a commercial basis. All domestic banks are listed on Tadawul, the Saudi Stock Exchange.

As at 31 December 2014, banks had extended loans in the amount of SR 1,295 billion. Their business is diversified, with credit extended largely to the corporate (62%) and retail (25%) sectors. In the last 5 years, Saudi banks have started funding residential real estate and SME sectors. As at end-2014, lending to these sectors remained small and represented 11% and 2% respectively of total credit. Saudi banks also have large investment portfolios since they are net placer of funds in the international financial markets.

As at end-2014, the banking sector had 47,588 employees, 1,912 branches, 15,516 automated teller machines and 138,779 point-of-sale terminals. Its capital adequacy ratio (CAR) was almost 18% on average; all banks have CARs above the regulatory minimum of 8%. The Tier 1 Capital Ratio was about 16%; the leverage ratio was around 12%; non-performing loans represented 1.1% of total assets; and the loan provisions coverage ratio was 170%.

The banks are highly liquid and have an average Basel liquidity coverage ratio of 217%. The regulatory liquidity ratio is 28%. The aggregate loan-to-deposit ratio is 76%, which is below the regulatory requirements of 85%. Banks have maintained strong profitability during 2014, with the average return on equity being 18.5% and return of assets being 2.5%. During the year, customer deposits grew by almost 10% and credit grew by 11.6%.

⁶⁵ Based on information provided by the Saudi authorities.

Basel standards: SAMA implemented Basel 1 in 1992, Basel II in 2008 and Basel III in 2013. In particular, SAMA has introduced all three Pillars of the Capital Adequacy Regime, Liquidity Coverage Ratio, Net Stable Funding Ratio and the Leverage Ratio. Saudi banks already meet the Basel III capital, liquidity and leverage standards that international banks are expected to meet by 2019.

Other features: Saudi Arabia established the Capital Market Authority (CMA) in 2004 to regulate the capital market, including by licensing and regulating securities firms such as broker-dealers, asset managers and custodians (referred to as Authorized Persons). It also oversees the Saudi Stock Exchange (Tadawul).

There are five government-owned specialized credit institutions that play a significant role in the financial sector. These institutions were designed to complement bank lending and to provide medium to long-term funds to industry, housing, SMEs and agriculture sectors. The assets of these institutions accounted for SAR 606 billion as at 30 September 2014, which was equivalent to about 28% of the assets of the banking sector.

The Saudi Arabia financial system has a fully functional credit bureau (SIMAH) that is licensed by SAMA and owned by the Saudi banks. The credit bureau collects data on retail and corporate customers and provides credit information to members for a fee. SIMAH also houses a national data pool where it collects information on the corporate sector to feed into a Probability of Default model, whose output is available to all member banks for use as benchmarking information for their own internal credit risk models.

Overview of the insurance sector

Background: The Saudi insurance industry, comprising 33 insurance companies, is supervised by SAMA under the 2003 Cooperative Insurance Companies Control Law. SAMA's Insurance Supervision Department licenses and supervises insurance companies in the Kingdom. The market remains among the largest and fastest-growing within the Gulf region, where premiums more than doubled between 2009 and 2014. This growth is expected to continue, driven mainly by compulsory insurance products.

Performance: Premiums in 2014 increased significantly across all lines of business and profitability recovered strongly compared to 2013, achieving a compound annual growth rate in excess of 16% over 2010-2014. Though still young, as indicated by low premium penetration relative to non-oil GDP (1.1% in 2014), the Saudi insurance market is on track to becoming the largest market in the region in terms of Gross Written Premium. The insurance premiums density was SAR 880 per capita in 2014, almost unchanged from 2013.

Growth in recent years was mainly driven by compulsory insurance products in the 'motor' and 'medical' sectors, which allowed the market participants to develop a profile in the market and led to increasing competition. In the short to medium term, the 'property & casualty' and 'protection and saving' sectors of the market are expected to grow mainly because of the implementation of the new Mortgage Law.

The insurance sector recorded a net profit of SAR 937 million in 2014, compared to a loss of SAR 1,272 million in 2013 (before zakat and income tax). Most of the reported premiums and profits in 2014 – as well as losses in 2013 – stemmed from three large insurers that dominate the market. In 2014, twenty one companies reported positive pre-zakat earnings compared to twelve companies in 2013. However, the market is still burdened with large

accumulated retained losses. The consolidated insurance sector indicators show lower loss levels and improved underwriting performance. The average net combined operating ratio for the sector stood at approximately 98% for 2014, compared to 111% for the previous year.

Overview of the finance, leasing and real estate finance sector

Three finance laws (Real Estate Finance Law, Financial Lease Law, Finance Companies Control Law) were issued in July 2012, and their implementing regulations were issued in February 2013. The laws and their implementing regulations establish the regulatory framework for the real estate finance sector and non-bank finance companies sector, and entrust SAMA with the responsibilities of regulating and supervising those two sectors. The regulatory framework for the real estate finance sector aims at maintaining the stability of the finance sector as well as fostering development and sustainable growth of the sector as well.

The Law on Supervision of Finance Companies provided a grace period of two years for existing finance companies to fully comply with the finance laws and their implementing regulations. The grace period ended in November 2014. As of end-2014, SAMA had issued licenses to 12 banks to carry out real estate and/or finance lease activities based on the new laws, in addition to licenses to 5 finance companies (with total capital of SAR 3 billion) to carry out real estate finance, and to other 13 finance companies (with total capital of SAR 4.5 billion) to carry out one or more of the other finance activities under the Law on Supervision of Finance Companies.⁶⁶ As of end-2014 SAMA had also granted preliminary approvals on 13 additional license applications, and required those applicants to complete remaining requirements with the Ministry of Commerce and Industry to receive their licenses.

The Saudi authorities are in the process of developing a set of prudential reporting forms and systems, which are expected to be finalized during the first half of 2015. They estimate that the total assets of non-bank finance companies at end of 2013 were around USD 6.5 billion.

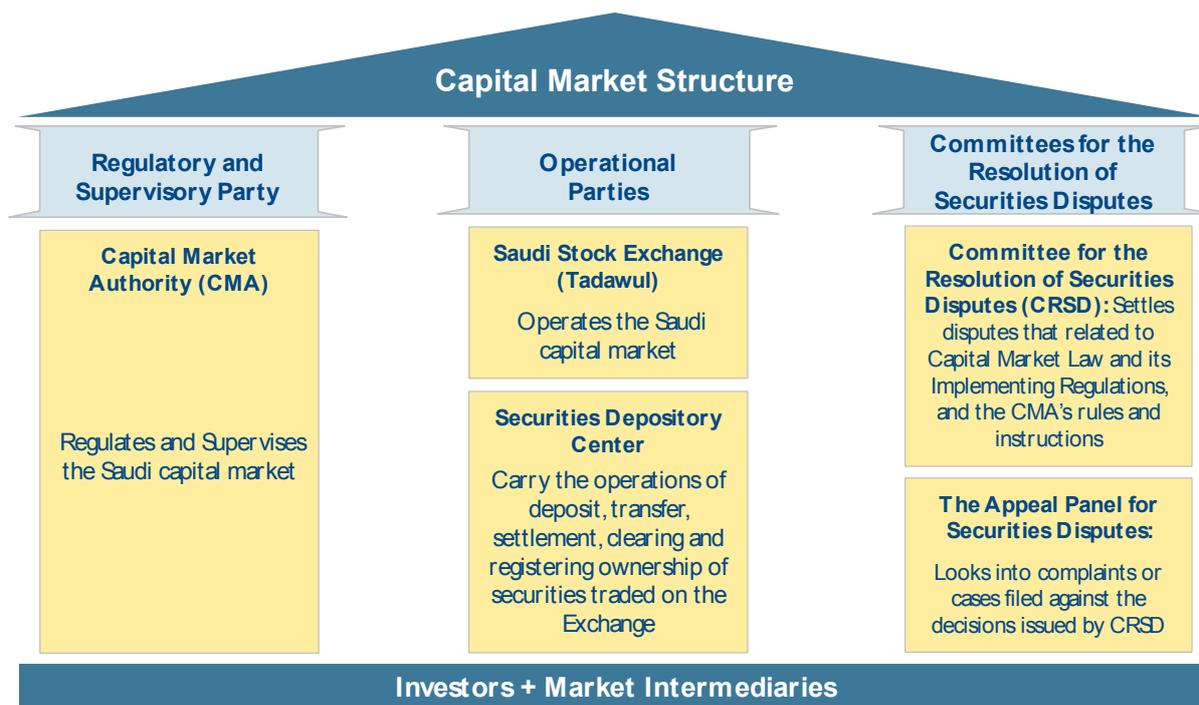
Overview of the capital market sector

Background: SAMA was charged with operating and regulating the stock market's daily activities in Saudi Arabia until the CMA was established in July 2003 under the Capital Market Law (CML).⁶⁷ By mid-2004, the CMA started its role as the sole regulator and supervisor of the capital market.

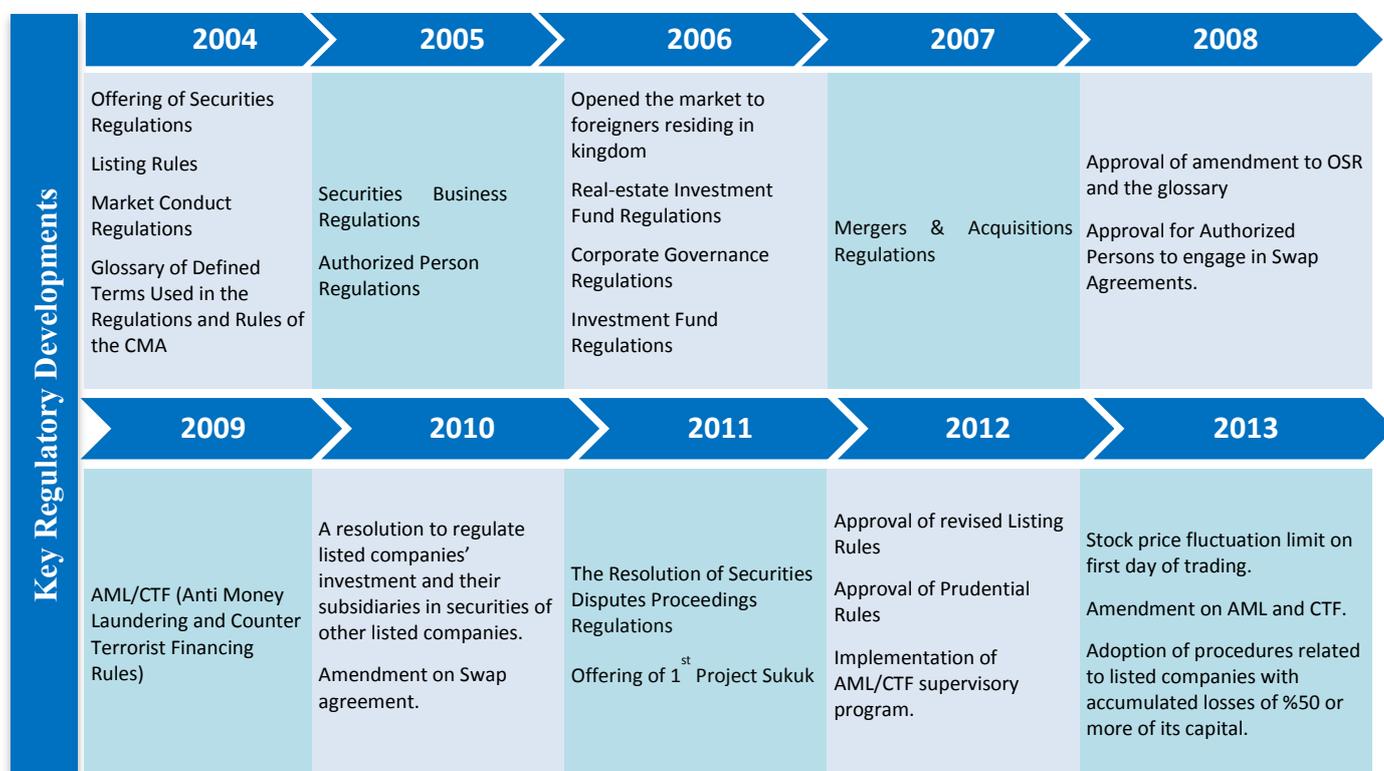
Institutional structure: The CML was declared by a Royal Decree in July 2003, which brought the CMA into existence as an authority with full financial, legal and administrative independence, with direct links with the President of the Council of Ministers. The CML promulgated the capital market structure to be organized as shown by the figure below.

⁶⁶ These include the following: real estate finance; productive asset finance; SME finance; financial leasing; credit card finance; consumer finance; and microfinance (no such companies have been licensed yet).

⁶⁷ In 1984, a ministerial committee was set up by the Ministry of Finance, the Ministry of Commerce and Industry and SAMA for regulating and developing the stock market. In the same year, the banks operating in the Kingdom, on SAMA's initiative, established a Saudi company for registering shares and related transactions (see <http://www.sama.gov.sa/en-us/about/pages/samahistory.aspx>). The responsibility of regulating and developing the stock market was assigned to the ministerial committee.



Regulatory developments: Since its establishment, the CMA has issued 15 implementing regulations and rules aimed at enhancing investor protection and promoting market development. The diagram below illustrates the main regulatory developments in recent years (including CMA board resolutions).



In addition to the above regulations, the CMA is working on a number of other regulations, including: Credit Rating Agencies Regulations (approved in 2014 and will be effective on September 2015); Special Purpose Entities Regulations (under drafting); Authorized Persons Regulations (under revision); and Investment Funds Regulations (under revision).

Securities offerings and developments: Currently, equities, sukuk, bonds, exchange traded funds (ETFs) and investment funds are the main products in the Saudi capital market. The total value of securities offerings reached USD 103.9 billion by end-2014. The number of public funds rose to 263 by 2014 and accumulated more than USD 29.5 billion of assets under management. The number of private placement funds reached 315, with assets under management standing at USD 13.7 billion. The ETF industry's development is expected to grow after the opening of the market to foreign investors (see below).

Market intermediaries: The number of APs surged from 8 in 2005 to 88 at the end of 2014. Their paid-up capital at the end of 2014 amounted to USD 4.2 billion, with revenues of USD 1.9 billion. In its efforts to maintain capital market stability, the CMA approved Prudential Rules, based on the three-pillar Basel framework, which require APs to maintain adequate financial resources. The CMA supervises the capital adequacy of APs as per the requirements of the Prudential Rules. In 2014, the industry's capital adequacy ratio stood at 29.1%.

Foreign investors in Saudi capital market: The CMA has now finalised and implemented the Rules for Qualified Foreign Financial Institutions Investment in Listed Shares. These Rules set out the procedures, requirements and conditions for the registration of qualified foreign investors with the CMA, and specify the obligations of authorized persons in their dealings with qualified foreign investors.

Market performance: The number of stock market listed companies increased from 72 in 2004 to 169 by end-2014, with market capitalization exceeding USD 483 billion. The total value of shares traded in 2014 reached USD 572 billion, compared to USD 365 billion in 2013. The trading volume reached almost 71 billion shares, compared to around 53 billion shares for the previous year.

Since 2004, the number of public investment fund rose by 40% to reach 263 funds in 2014, while assets under management increased by 83% to almost USD 30 billion in 2014. The assets under management of private investment funds rose by 40% to USD 13.7 billion in 2014, compared to USD 10 billion at the end of 2013.

Annex 2: Follow-up of other key FSAP recommendations

This Annex presents the follow-up actions reported by the Saudi authorities to key FSAP recommendations that are not covered in sections 2, 3 and 4. The actions mentioned below have not been evaluated as part of the peer review and are presented solely for purposes of transparency and completeness.

Recommendations	Steps taken to date and actions planned (including timeframes)
Bank and securities regulation	
Update the BCL and remove need for ministerial approval of certain SAMA decisions.	SAMA has studied the need for updating BCL and concluded that the existing law is serving the purpose well. This issue may be revisited in due course.
No longer allow large exposures up to 50 percent of banks' own fund	SAMA has issued the new rules on large exposures after consultation with the banking industry. These rules are in line with the BCBS standard on monitoring and controlling large exposures.
Broaden the definition of related parties in bank lending.	SAMA has finalized the new rules on large exposures which also include a broadened definition of related parties. These rules are under approval process and will soon be issued to banks. Furthermore, the scope of work for SAMA on-site inspection has also been broadened to include the review of exposures to related and connected parties.
Strengthen the CMA's regulatory transparency by fully disclosing all enforcement actions, interpretations, and funding rules.	Starting in 2014, the CMA has published its Financial Statements in its Annual Report. See http://cma.org.sa/cma/AnnualReportFB/2013-en/ .
Systemic stability	
Introduce a formal liquidity forecasting framework.	
Maintain a stable stock of government securities and regular issues to help anchor a robust yield curve.	<p>Saudi Arabia is a highly cyclical economy, and this largely influences the fiscal position of the government. By way of background information, Saudi Arabia's government debt/GDP was more than 100% in 1999 and now it is less than 2%. This acute rise and fall in the stock of government securities has to do with cumulative budget deficits and surpluses.</p> <p>Technically, even when the government was regularly issuing bonds during 1988 to 2007, the "buy and hold to maturity" culture of the narrow investor base diluted the significance of the yield curve for secondary market transactions. This is in addition to the bank-centric culture restraining issuance of corporate bonds.</p> <p>As for the anchoring role of the government bond yield curve, it should be seen in the context of government bond pricing linked to US Treasuries. If corporate bonds were to be priced off</p>

	<p>government bonds, this would tantamount to pricing off US Treasuries indirectly. Currently, corporate bonds are priced off US Treasuries. In short, the issue is not the yield curve, but it is the willingness of the corporate sector to balance its financing needs between banks and the market.</p>
<p>Introduce a payment systems law.</p>	<p>SAMA has been working to identify the best means of explicitly removing any potential conflict for our payment systems with other laws and regulations.</p> <p>SAMA has drafted a legal covering note based on the powers included in the SAMA Charter (Royal Decree No. 23 dated 23-05-1377h) which refers to the rules and regulations in place. This legal covering note is in the final stages of approval. This action will provide more explicit legal support to SAMA as owner, operator and regulator of these payment systems regarding the variety of rules and regulations already in place, i.e.:</p> <ol style="list-style-type: none"> 1. Saudi Payments Network (SPAN) Operating Rules 2. Regulatory Rules for the Prepaid Payment Services in the Kingdom of Saudi Arabia 3. SARIE Operating Rules and Regulations 4. SADAD (payment system) SLA with Billers 5. SADAD SLA with Banks 6. SPAN SLA with Banks 7. SPAN Operating Procedures and Standards 8. Cheque Clearing House Regulations 9. Cheque Issuance and Standards Manual 10. Direct Debit Scheme Manual
<p>Conduct stress tests with a wider range of shocks, including liquidity shocks, on a regular basis and incorporate lessons into supervision.</p>	<p>SAMA built its own top-down stress testing model in 2010. The model covers credit, liquidity, and contagion tests with three different macro scenarios and three expert-based scenarios. The model was built with consultation with an IMF team during a TA mission.</p> <p>Banks are required to conduct their own bottom-up stress tests which are reviewed on annual basis as part of the ICAAP process.</p> <p>Significant development and enhancements of SAMA's current ST model is in progress. The development is undertaken in a joint work with the IMF through the recent Stress Test TA mission. The mission kicked-off in February and the model is expected to be finalised by end of May 2015.</p>
<p>Expanding access to finance and preserving financial stability</p>	
<p>As housing finance expands in the future, ensure loan soundness through strong prudential measures, notably lowering permissible loan-to-value and debt service ratios.</p>	<p>The Finance Laws and their implementing regulations provide strong prudential measures that aim at ensuring the stability and soundness of the real estate finance sector, including a maximum LTV of 70% for residential real estate finance provided by banks and finance companies. In addition, the Finance Companies Control Law and its implementing regulation provide prudential measures for finance companies, including a cap on total financing assets at 5 times capital and reserves (which can be increased up to 7 times capital and reserves with SAMA's</p>

	<p>permission).</p> <p>As to debt service ratios, SAMA is in the process of engaging an external consulting firm to support the development of responsible lending principles, including debt burden ratios. The principles will be finalised soon.</p>						
Contract banks to manage both the existing and the new Real estate Development Fund (REDF) portfolios.	The Ministry of Housing and the Real Estate Development Fund are working closely with Saudi Banks to develop and explore various funding schemes for encouraging consumers to acquire residential real estate. In this regard, a number of alternative proposals that would help meet the national objectives are currently under consideration.						
Complement mortgage reform by establishing a housing market observatory, developing consumer guidance options and strengthening the developer industry.	SAMA is coordinating with related government entities in regard to facilitating the process of collecting and publishing relevant housing market data. On developing consumer guidance options, SAMA has issued the Consumer Protection Principles for banking and insurance, emphasizing fair treatment, honesty and financial inclusiveness. SAMA has also drafted Consumer Protection Principles for finance companies which are now under public consultation.						
Prepare long-term funding solutions for mortgage finance, starting with a refinance facility.	Public Investment Fund (PIF) is currently in the process of establishing the Saudi Real Estate Refinance Company, which will be fully owned by PIF and supervised by SAMA. The Saudi Real Estate Refinance Company is expected to provide necessary long-term funding solutions for mortgage finance.						
Create a modern, electronic, and unified registry for movable collateral.	SAMA has engaged a consulting firm to assess the feasibility of establishing a financial lease registry in the form of a company owned by licensed lessors, in accordance with the Financial Lease Law and its implementing regulation. The study has been finalized, and SAMA is now coordinating with Ministry of Justice to ensure that registration certificates issued by the financial lease registry will be admissible by courts and enforceable.						
Enact and implement the draft Enforcement Law that introduces specialized enforcement courts operating with strict time-bound procedures.	The Enforcement Law and its implementing regulation have been issued and implemented by Ministry of Justice and courts.						
Closely supervise the quality of SME units in the banks, including the robustness of their internal rating systems and automated procedures.	SAMA has started monitoring the exposures of banks to SMEs.						
Insurance, institutional investors, and capital markets							
Finalize and issue the outstanding functional regulations for insurance.	<table border="1"> <thead> <tr> <th>No.</th> <th>Regulation</th> <th>Status</th> </tr> </thead> <tbody> <tr> <td> </td> <td> </td> <td> </td> </tr> </tbody> </table>	No.	Regulation	Status			
No.	Regulation	Status					

	1	Insurance Intermediaries Regulation	Issued in 2011
	2	Investment Regulation	Issued in 2012
	3	Outsourcing Regulation for Insurance and Reinsurance Companies and Insurance Service Providers	Issued in 2012
	4	Anti-money Laundering & Combating Terrorism Financing Rules have been updated	Updated in 2012
	5	Surplus Distribution Policy	Issued in 2015
	6	Insurance Corporate Governance Regulations	In Progress (Expected by March, 2015)
	7	Audit Committee Regulations	In Progress (Expected by March, 2015)
	8	Actuarial Work Regulations	In Progress (Expected by June, 2015)
Improve enforcement of mandatory motor third party liability insurance.	The Kingdom has taken several initiatives since 2011 to improve the enforcement of motor TPL insurance by requiring the availability of insurance as follow:		
	No.	Procedure	Status
	1	Upload insurance data electronically to National Information Centre and reject any policies that do not exist in the system	Achieved in 2010
	2	Restrict processing new vehicle registration to Insurance availability in the system	Achieved in 2011
	3	Restrict processing the renewal of vehicle registration to Insurance availability in the system	Achieved in 2012
4	Suspend uploading the insurance data through agencies (Tam Gate) and consider Najm as the only	Achieved in 2012	

		uploading channel	
	5	Restrict processing vehicles ownership transfer to insurance availability in the system	Achieved in 2012
	6	Restrict processing the issuance of the permit for the international driving to insurance availability in the system	Achieved in 2012
	7	Restrict issuance of the repair permission to availability of insurance	Achieved / Manually in 2012
	8	Linking the insurance policy within the buyer identity upon ownership transfer	Achieved 2014
Disclose the investment policies, portfolios, and portfolio performance of the Public Pension Agency (PPA) and General Organization for Social Insurance (GOSI).	<p>PPA discloses full information regarding investment policy, performance, and portfolios to regulatory authorities such as “Shura Council” (the Parliament). Additionally, PPA provides partial disclosure to the public through its Annual Statistical Report, which is available on PPA’s website. More information has been added to the PPA’s Annual Statistical Report such as total return, details of the local equity portfolio, and general information about the investment.</p> <p>PPA intends to include more information about Asset Allocation and performance in the next Annual Statistical Report for 2015. The GOSI board of Director has recently approved a more active disclosure policy by which GOSI will commit to disclosing certain elements of its investment policy and performance in 2015. The ultimate goal of this policy is to have growing disclosures over time.</p>		
Further outsource the management of the portfolios of the PPA and GOSI.	<p>More than 50% of PPA’s assets are outsourced, which suits with PPA’s investment policies and objectives.</p> <p>GOSI’s investments are managed by a company called Hasanah which is wholly owned and captive by GOSI. Hasanah's board is comprised of seven experienced individuals, 5 are also sitting on GOSI's board representing employers, employees and the government, with two members being independent. Hasanah aims to implement best practice investment management by partnering with some of the world leading asset managers and advisors. Thus, GOSI has met its objective of outsourcing the management of its foreign investments.</p>		
Permit foreign institutional investors to invest directly in domestic equities.	<p>Based on the Council of Ministers’ Resolution No. (388) dated 24/9/1435H (corresponding to 21/7/2014G) that permitted the CMA to allow foreign financial institutions to trade shares listed on the Saudi Stock Exchange in accordance with the time the</p>		

CMA deems appropriate and pursuant to regulations it issues, the CMA published the draft Rules for Qualified Foreign Financial Institutions investment in Listed Shares Rules for (90) days on its website on 25/10/1435H (corresponding to 21/8/2014G) to enable concerned and interested parties to provide their comments and observations. The CMA has reviewed comments and observations received in this regard, coordinated with concerned governmental parties, and received the Saudi Stock Exchange (Tadawul)'s confirmation of its readiness, based on which the CMA Board has adopted on 27/6/1436H (corresponding to 16/4/2015G) a timeline to implement the Council of Ministers' Resolution referred to above. Based on the Capital Market Law issued by Royal Decree Number (M/30) Dated 2/6/1424H, the CMA Board of Commissioners has issued its resolution Number 1-42-2015 Dated 15/7/1436H corresponding to 4/5/2015G including the following:

- a) Adopting the Rules for Qualified Foreign Financial Institutions Investment in Listed Shares (the "QFIs Rules").
- b) Adopting the following forms:
 - (1) Qualified Foreign Investor Application for Registration Form.
 - (2) Qualified Foreign Investor Client Application for Approval Form.
 - (3) The Minimum Requirements that must be included in the QFI Assessment Agreement Form as per Article 12 of the QFIs Rules.
 - (4) The Assessing Authorised Person's Acceptance Determination Template (to Register a QFI or to Approve a QFI Client).
 - (5) The Assessing Authorised Person's Rejection Determination Template (to Register QFI or to Approve QFI Client).

The CMA Board of Commissioners has also issued its resolution Number 3-42-2015 Dated 15/7/1436H corresponding to 4/5/2015G adopting the Frequently Asked Questions document in relation to the Rules and publishing it on the CMA's and the Saudi Stock Exchange's (Tadawul) websites. The QFIs Rules can be viewed on CMA's website on the following link:
http://www.cma.org.sa/En/Pages/Implementing_Regulations.aspx
 The forms referred to above and the Frequently Asked Questions document in relation to the QFIs Rules can be viewed on CMA's website on the following link:
<http://www.cma.org.sa/en/Pages/QFI.aspx>.