

Saudi Arabia
Financial Sector
Assessment Program
Update—Detailed
Assessment of Observance
of the Basel Core Principles
for Effective Banking
Supervision

Saudi Arabia: Financial Sector Assessment Program Update—Detailed Assessment of Observance of the Basel Core Principles for Effective Banking Supervision

This paper on Saudi Arabia was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed in September 2011. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of Saudi Arabia or the Executive Board of the IMF.

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FINANCIAL SECTOR ASSESSMENT PROGRAM UPDATE

SAUDI ARABIA

BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING
SUPERVISION

DETAILED ASSESSMENT OF OBSERVANCE

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GLOSSARY

AML/CFT	Anti-Money Laundering and Combating the Financing of Terrorism
AMLS	Anti-Money Laundering Statute
BCBS	Basel Committee on Banking Supervision
BCL	Banking Control Law
BID	Banking Inspection Department
BSD	Banking Supervision Department
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CMA	Capital Market Authority
CP	Core Principle
CRO	Chief Risk Officer
ELA	Emergency Liquidity Assistance
ERMS	Electronic Return Management System
FATF	Financial Action Task Force
FIU	Financial Intelligence Unit
FSAP	Financial Sector Assessment Program
GCC	Gulf Cooperation Council
ICAAP	Internal Capital Adequacy Assessment Process
IFRS	International Financial Reporting Standards
IRB	Internal Ratings Based
ISA	International Standards of Auditing
IT	Information Technology
KYC	Know your customer
LCR	Liquidity Coverage Ratio
MENA FATF	Middle East and North Africa Financial Action Task Force
MOF	Ministry of Finance
MOU	Memorandum of Understanding
NPL	Nonperforming loan
RBA	Risk-based approach
SAMA	Saudi Arabia Monetary Agency
SCSB	Saudi Credit & Saving Bank
SIMAH	Saudi Credit Bureau
SR	Saudi Riyal
STR	Suspicious transaction reporting
VaR	Value at risk

I. SUMMARY, KEY FINDINGS, AND RECOMMENDATIONS

A. Introduction

1. **This assessment of Saudi Arabian Monetary Agency’s (SAMA) compliance with the Basel Committee’s Core Principles for Effective Banking Supervision was conducted by a mission to Saudi Arabia during April 9–20, 2011.** The assessment was carried out as part of a Financial Sector Assessment Program (FSAP) Update undertaken by the IMF and the World Bank at the request of the Saudi authorities. The authorities requested that the assessment of compliance be conducted using only the essential criteria in the methodology. The assessment was conducted by Peter Hayward (IMF consultant) and Cédric Mousset (World Bank).

B. Information and Methodology Used for Assessment

2. **This assessment was based on a review of laws, regulations, policies and practices in place at the time.** It was based on the 1966 Banking Control Law (BCL) and its implementing ministerial decision, the 1957 SAMA Charter, circulars issued by SAMA, as well as the Code of Corporate Governance issued by the Capital Markets Authority (CMA). Other sources included a self-assessment, detailed interviews with staff from SAMA and internal reports, as well as external meetings with banks, external audit firms and a lawyer. All interlocutors responded freely to the mission. Material included reports and assessments where they were prepared in English, such as full-scope examinations, prepared by external audit firms, but not other reports prepared in Arabic and not available to non-Arabic speakers. The assessment was conducted using the 2006 methodology published by the Basel Committee for Banking Supervision.¹

C. Institutional and Macroeconomic Setting and Market Structure—Overview

3. **Saudi Arabia confronted the global financial crisis from a position of strength.** In the years before the crisis, the authorities strengthened the balance sheet of the government and enhanced the financial sector’s resilience. A strong policy response moderated the impact of the crisis.

4. **Commercial banks are the largest sector of the financial system.** As of December 2010, there were 23 licensed banks, but only 20 are “active.” Of these, 12 are Saudi incorporated banks, whose assets account for 98 percent of the banking system assets, or more than half of total financial system assets and 85 percent of GDP. As a percentage of GDP, bank assets and credit are comparable to those in other countries with similar characteristics. However, as in the case of other Gulf Cooperation Council countries, loan portfolios are concentrated, reflecting limited lending to sectors such as small- and medium-

¹ See <http://www.bis.org/publ/bcbs130.htm>

scale enterprises (SMEs) and housing. Credit concentration risk has been mitigated by high capital requirements. Sharia-compliant products are offered by commercial banks based on a single license for commercial banks. Products offered are mainly “plain vanilla” (for example installment sales) and primarily involve credit risk, and do not require sophisticated supervisory approaches.

5. **The banking sector is fairly concentrated around a few banks.** The seven largest banks have a combined share of assets of 85 percent. The three largest have a combined share of about 45 percent, and the next four each have market shares exceeding 5 percent. The dominant shareholders of the three largest banks are government entities, the fourth largest is linked to a family business group, and the next three have ties to major international banks. All banks with government participations appear to be run on a commercial basis. In addition, all banks but the largest (state-owned) are listed. This reflects a policy designed to ensure arm’s-length relationships between banks and the large family-owned groups, and to promote Saudi citizen investments in banks. The market shares of the long established institutions have not been significantly affected by the entry of new banks in recent years. SAMA licensed two domestic banks in the mid-2000s, as well as several branches of foreign banks. The two new banks only account for 3 percent of banking assets, and foreign branches remain niche players with a 2 percent market share.

6. **The banking sector overall is well capitalized and profitable.** The solvency ratio for the sector as a whole was above 17 percent in December 2010, having declined from about 21 percent in December 2007. The main causes of the sharp decline in capital adequacy ratios between 2007 and 2008 (16 percent) are a new operational risk charge due to the implementation of Basel 2 and rapid asset growth coupled with slower growth of own funds. The Tier 1 capital ratio is about 15 percent (end-2010). After a credit squeeze in 2009, credit growth picked up in 2010, thus far without any deterioration in asset quality. Credit declined by 1 percent over the 12 months to December 2009, but increased by 5 percent in the following 12 months. The nonperforming loan (NPL) ratio has remained broadly at 3 percent, with provisions covering 116 percent of NPLs in December 2010.² Loans are the largest bank asset class (54 percent of banks’ aggregate balance sheet at end-2010). Liquidity appears to be adequate. Profitability weakened during the crisis, but appears to be recovering in 2010. Return on assets was nearly 2 percent and return on equity 13.6 percent in December 2010, compared with 2.8 percent and 22.3 percent in December 2007.

D. Preconditions for Effective Banking Supervision

7. **The financial system is subject to risks reflecting the openness of the economy and dependence on the hydrocarbon sector, as well as the size of the market.** A relatively simple banking system centered on core banking activities makes supervision

² Raw data received from SAMA shows a provisioning ratio of 90 percent.

relatively straightforward. Any growth in the use of more sophisticated products and forms of intermediation will require a more elaborate and formal supervisory approach.

8. **The financial infrastructure is being strengthened.** The old and ineffective collateral regime is progressively being improved, especially for real estate. Enforcement of real estate collateral remains difficult and lengthy. The situation is worse in the case of movables. A package of five draft laws recently approved by the Shura Council and submitted to the Council of Ministers includes an Enforcement Law that is expected to improve the effectiveness of enforcement procedures for all types of collateral.³ Saudi Arabia's credit reporting system has improved in recent years thanks to the modern private Saudi Credit Bureau (SIMAH).

9. **Saudi Arabia implements International Financial Reporting Standards (IFRS) for banks and insurance companies and is served by the major accounting firms.** Listed companies apply local generally accepted accounting principles and auditing standards set by Saudi Organization for Certified Public Accountants, which are not as comprehensive and detailed as IFRS and International Standards of Auditing (ISA).

10. **Saudi Arabia does not have a formal deposit insurance scheme.** There has been no need to provide emergency liquidity assistance (ELA) to any bank in recent years. The conditions in which SAMA would provide ELA would be determined on a case-by-case basis, as would the terms on which such ELA would be provided.

E. Main Findings

11. **There have been significant improvements in banking regulation and supervision since the 2004 FSAP.** SAMA made efforts to introduce Basel II, and used the Pillar 2 requirements to foster improvements in banks' risk management and capital planning. In supervision, risk-based approaches (RBAs) have been introduced and large resources allocated to supervision, with overall staffing now around 200 people (a doubling over the past five years). SAMA has also initiated the introduction of Basel III requirements.

12. **The assessment can be summarized as follows:**

- *Objectives, independence, powers, transparency, and cooperation (CP1).* The legal framework is old; the BCL has hardly been changed since enactment in 1966. It should be updated, especially as it provides for much less formal independence and authority for SAMA than is exercised in practice. SAMA, however, considers that the BCL has served it well and believes that there would be more risk than benefits in amending it. The planned codification of the numerous circulars and other communications with banks will help. The

³ Saudi Arabia is a monarchy and legislation is by resolution, ratified by the King (royal decree).

framework has not been an impediment to effective supervision, as SAMA has been able to take adequate actions without using formal legal powers (a situation explained by its standing and credibility as well as the limited number of banks). The BCL could be updated to remove the need for government approval to license banks and impose sanctions, issue regulations, conduct inspections, and put SAMA's present autonomy in practice on a statutory basis to ensure it remains effective. Provisions could also be added to provide legal protection to supervisors, require SAMA's approval in case of transfer of significant ownership, create a bank resolution framework, and provide a clear mandate to exercise consolidated supervision and share information for supervisory purposes.

- *Licensing and structure (CPs 2–5)*. The prudent licensing approach implemented by SAMA could benefit from a legal definition of SAMA's objectives and improved disclosure of its expectations for new banks. There are no published objectives for supervision, an omission that should be addressed in the law. Only two banks have been licensed in the last decade (one state-owned, one resulting from the merger of money changers), and new foreign bank branches remain marginal players. To make clear that the market is contestable, SAMA should publish its detailed criteria for licensing new banks, fully align them with objectives focused on safety and soundness, and withdraw the requirement that new licensees should "add value." Similarly, legal requirements for SAMA to approve any new bank outlet (i.e., branch or automated teller machine) could usefully be removed so that such risks can be covered within the risk-based process (i.e., ex post rather than ex ante). Although SAMA has effectively controlled changes in ownership, the legal basis for doing so is not robust and this should be remedied.
- *Prudential regulation and requirements (CPs 6–18)*. SAMA has made substantial efforts to introduce Basel II. It should complement recent strides in banks' risk management by an improved regime for large exposures and connected parties. Much of the risk management guidance appears in the various Basel II documents (which do not apply to foreign branches). A framework circular should be issued bringing all aspects of risk management into one document, and updating requirements on market risk and internal controls to reflect developments in the last decade. Widespread bank losses caused by the 2009 failure of Al-Gossaibi & Bros. Co. and the Saad Group, two large well-established family groups, suggest that there may have been weaknesses in credit risk management.⁴ SAMA has responded to this default, including by ensuring that losses were fully provisioned and by spearheading a dialogue with the banking industry to identify relevant lessons. In a system characterized by high single-name concentration, attention to individual large exposures should be intensified, in particular during on-site inspections. The possibility for SAMA to allow large exposures of as much as 50 percent of capital, which was recently used, should also be removed (with the maximum exposure capped at, for example,

⁴ Both Saudi and foreign banks, including large international banks, were significantly exposed to these groups.

25 percent of capital). The definition of related parties needs to be strengthened to ensure that close family relationships are taken into account.

- *Methods of ongoing banking supervision (CPs 19–21).* SAMA has made progress in implementing RBA approach and should complete this transition. The supervisory regime still includes broad requirements for banks to obtain SAMA’s ex ante approval (for example, before opening branches, before lending to a nonresident, before releasing financial statements, before launching new products). In recent years, the introduction of the RBA triggered a welcome intensification of contacts with banks as part of off-site supervision. SAMA has maintained an intrusive on-site process, which relies primarily on full-scope examinations and, to a growing extent, on focused ones. The schedule for full-scope examinations should be better defined to avoid crowding effects (that is, most banks were covered in 2007 and 2008, but only one in 2009 and 2010); examinations should focus more on actual risks and banks’ ability to manage them; and increased attention should be paid to branches of foreign banks. More systematic on-site verification of prudential reporting may also be needed.
- *Accounting and disclosure (CP 22).* SAMA has for a long time encouraged banks to build prudent capital and provisioning buffers, based on reliable financial statements. Such buffers have proved valuable in recent years in allowing the impact of the global crisis and the default of two large groups to be absorbed without threatening any bank. Capital buffers are now defined as part of the Internal Capital Adequacy Assessment Process (ICAAP), while provisioning buffers result from pragmatic decisions from SAMA’s senior management. The latter would benefit from being more formalized. SAMA has successfully introduced international accounting and auditing standards (IFRS and ISA) for banks and their auditors. It also introduced Pillar 3 disclosure requirements in 2008 as part of the implementation of Basel II.
- *Corrective and remedial powers of supervisors (CP 23).* SAMA’s proactive style of supervision has meant that formal enforcement action has rarely been needed, but removal of the statutory need for government approval of the exercise of its powers would safeguard its independence. SAMA should take the opportunity, already taken by many other countries, to establish a specific bankruptcy regime for banks, and ideally a specific resolution regime.
- *Consolidated and cross-border banking supervision (CPs 24–25).* While SAMA’s exercise of its consolidated supervision authority has been effective, some banks are beginning to expand across border quite aggressively and this could prove a challenge to group managements and boards, and thus to supervisors. SAMA has good contacts with the CMA and with foreign supervisors. The draft memorandum of understanding (MOU) with the CMA should be finalized and exchange of inspection reports and common on-site work initiated. SAMA should also give thought to the advantages of having written agreements with foreign supervisors so that cooperation can be effective in any unforeseen emergency.

Table 1. Saudi Arabia: Summary Compliance with the Basel Core Principles—Report on Standards and Codes

Core Principle	Comments
1. Objectives, independence, powers, transparency, and cooperation	
1.1 Responsibilities and objectives	SAMA's objectives are not defined.
1.2 Independence, accountability and transparency	The approval/action of the Ministry of Finance (MOF) or Council of Ministers is needed for key regulatory and supervisory actions.
1.3 Legal framework	The BCL has not been updated, nor are all circulars easily and publicly available.
1.4 Legal powers	The approval/action of the MOF or Council of Ministers is needed for key regulatory and supervisory actions.
1.5 Legal protection	Supervisors (agency and staff) do not benefit from clear legal protection.
1.6 Cooperation	A draft MOU between the CMA and SAMA is being finalized.
2. Permissible activities	Activities effectively controlled and term 'bank' protected.
3. Licensing criteria	Core criteria used by SAMA to review licensing applications are not made public. Core licensing criteria include a need for a new bank to "add value," which is unrelated to safety and soundness.
4. Transfer of significant ownership	There are no legal provisions on the transfer of significant ownership.
5. Major acquisitions	Limits on investments are applied and acquisitions subjected to supervisory approval.
6. Capital adequacy	Minimum capital ratios well exceed Basel requirements.
7. Risk management process	Key risk management requirements can be only indirectly imposed on banks and branches of foreign banks.
8. Credit risk	Recent large corporate failures may require some strengthening of credit risk regulation.
9. Problem assets, provisions, and reserves	Portfolio approach may need to be supplemented by more on-site assessment of individual risks.
10. Large exposure limits	The large exposure limit can be raised to 50 percent (a possibility sometimes used by SAMA). Supervision is not implemented systematically during full scope on-site inspections (definition of connected parties).
11. Exposure to related parties	The definition of related parties is not comprehensive (for example, senior management, close family members). Supervision is not implemented systematically during full scope on-site inspections (definition of related parties).
12. Country and transfer risks	Risks are extensively reported and are low.

Core Principle	Comments
13. Market risks	Existing guidance does not cover all derivative activities, nor incorporate recent best practices. Some core requirements are not binding.
14. Liquidity risk	Basel III approach is to be implemented.
15. Operational risk	A capital charge is applied and operational risk management policies are discussed with supervisors.
16. Interest rate risk in the banking book	Risk levels are low but are considered in the internal capital adequacy assessment process.
17. Internal control and audit	Framework is comprehensive but could be updated.
18. Abuse of financial services	On-site inspection plan generates concentration on a few years (see CP 20).
19. Supervisory approach	Supervisory risk ratings are not differentiated. Risk profiles are sometimes not updated at least annually.
20. Supervisory techniques	The on-site full scope examination plan generates a concentration on a few years (and a lack of such examinations during others). Limited scope examinations remain primarily compliance oriented. Full-scope examinations do not always pay attention to assessing adequacy of provisioning of individual exposures. Meetings with the full Board are not organized.
21. Supervisory reporting	Full-scope on-site inspections do not always assess the reliability of electronic return management system (ERMS) returns.
22. Accounting and disclosure	The process followed to set provisioning buffers which banks should hold is not formalized.
23. Corrective and remedial powers of supervisors	The exercise of formal supervisory action requires an approval outside SAMA (for example, MOF). There is no specific bankruptcy regime for banks.
24. Consolidated supervision	SAMA does not have a clearly defined power to conduct consolidated supervision. Banks' group internal control/risk management frameworks are not always assessed during full-scope on-site inspections.
25. Home-host relationships	The BCL does not contemplate a lifting of its confidentiality requirements when necessary. There are no MOU with foreign supervisors.

Table 2. Saudi Arabia: Summary Compliance with the Basel Core Principles—Detailed Assessments

Core Principle	Grading	Comments
1. Objectives, independence, powers, transparency, and cooperation		
1.1 Responsibilities and objectives	LC	SAMA's objectives are not defined.
1.2 Independence, accountability and transparency	LC	The approval/action of the MOF or Council of Ministers is needed for key regulatory and supervisory actions.
1.3 Legal framework	LC	The BCL is not updated, nor are all circulars easily and publicly available.
1.4 Legal powers	LC	The approval/action of the MOF or Council of Ministers is needed for key regulatory and supervisory actions.
1.5 Legal protection	NC	Supervisors (agency and staff) do not benefit from clear legal protection.
1.6 Cooperation	C	A draft MOU between the CMA and SAMA is being finalized.
2. Permissible activities	C	
3. Licensing criteria	LC	Core criteria used by SAMA to review licensing applications are not made public. Core licensing criteria include a need for a new bank to "add value," which is unrelated to safety and soundness.
4. Transfer of significant ownership	MNC	There are no legal provisions on the transfer of significant ownership.
5. Major acquisitions	C	
6. Capital adequacy	C	
7. Risk management process	LC	Key risk management requirements can be only indirectly imposed on banks and branches of foreign banks.
8. Credit risk	LC	Credit risk regulation should be strengthened building on the lessons of recent large corporate failure
9. Problem assets, provisions, and reserves	C	
10. Large exposure limits	MNC	The large exposure limit can be raised to 50 percent (a possibility sometimes used by SAMA). Supervision is not implemented systematically during full scope on-site inspections (definition of connected parties).
11. Exposure to related parties	MNC	The definition of related parties is not comprehensive (e.g., senior management, close family members). Supervision is not implemented systematically during full scope on-site inspections (e.g., definition of related parties)
12. Country and transfer risks	C	
13. Market risks	LC	Existing guidance does not cover all derivative activities, nor incorporate recent best practices. Some core requirements are not binding.

Core Principle	Grading	Comments
14. Liquidity risk	C	
15. Operational risk	C	
16. Interest rate risk in the banking book	C	
17. Internal control and audit	LC	Some internal control requirements are too old.
18. Abuse of financial services	LC	On-site inspection plan generates concentration on a few years (see CP 20).
19. Supervisory approach	LC	Supervisory risk ratings are not differentiated Risk profiles are sometimes not updated at least annually.
20. Supervisory techniques	LC	The on-site full scope examination plan generates a concentration on a few years (and a lack of such examinations during others). Limited scope examinations remain primarily compliance oriented. Full-scope examinations do not always pay attention to assessing adequacy of provisioning of individual exposures. Meetings with the full Board are not organized.
21. Supervisory reporting	LC	Full-scope on-site inspections do not always assess the reliability of ERMS returns.
22. Accounting and disclosure	LC	The process followed to set provisioning buffers which banks should hold is not formalized.
23. Corrective and remedial powers of supervisors	LC	The exercise of formal supervisory action requires an approval outside SAMA (e.g., MOF). There is no specific bankruptcy regime for banks.
24. Consolidated supervision	LC	SAMA does not have a clearly defined power to conduct consolidated supervision. Banks' group internal control /risk management frameworks are not always assessed during full-scope on-site inspections.
25. Home-host relationships	C	The BCL does not contemplate a lifting of its confidentiality requirements when necessary. There are no MOU with foreign supervisors
<i>Aggregate: Compliant (C) – #; Largely compliant (LC) – #; Materially noncompliant (MNC) – #; Noncompliant (NC) – #; Not applicable (N/A) – #</i>		

F. Recommended Action Plan and Authorities' Response

Recommended action plan

Table 3. Saudi Arabia: Recommended Action Plan to Improve Compliance with the Basel Core Principles

Reference Principle	Recommended Action
1.1 Responsibilities and objectives	Introduce better definition of SAMA's objectives (public statements in the short term, revised law in the medium term).
1.2 Independence, accountability and transparency	Revise legal requirements to remove the need that the MOF or Council of Ministers approve or take action to exercise key regulatory and supervisory powers.
1.3 Legal framework	Update the BCL (see details under other CPs), codify all circulars and make them publicly available.
1.4 Legal powers	Revise legal requirements to remove the need that the MOF or Council of Ministers approve or take action to exercise key regulatory and supervisory powers.
1.5 Legal protection	Introduce clear legal protection for supervisors.
1.6 Cooperation	Finalize the draft MOU between the CMA and SAMA.
2. Permissible activities	
3. Licensing criteria	Make SAMA core criteria for reviewing license applications public and remove the need for a new bank to "add value."
4. Transfer of significant ownership	Introduce legal provisions on the transfer of significant ownership.
5. Major acquisitions	
6. Capital adequacy	
7. Risk management process	Issue circular covering key risk management requirements.
8. Credit risk	Strengthen further credit risk regulation.
9. Problem assets, provisions, and reserves	
10. Large exposure limits	Update the large exposure regulation (for example, remove possibility to raise limit to 50 percent, derivatives risk weighting). Implement supervision more systematically (for example, definition of connected parties).
11. Exposure to related parties	Broaden the definition of related parties to include close family members and key staff. Implement supervision more systematically (for example, definition of related parties).
12. Country and transfer risks	

Reference Principle	Recommended Action
13. Market risks	Update requirements to cover all derivative activities, incorporate recent best practices, and make core requirements binding.
14. Liquidity risk	
15. Operational risk	
16. Interest rate risk in the banking book	
17. Internal control and audit	Internal control requirement should be updated.
18. Abuse of financial services	Better define the examination program to avoid crowding effects.
19. Supervisory approach	Differentiate banks' risk ratings more and update risk profiles at least annually.
20. Supervisory techniques	<p>Better define the full-scope examination program to avoid crowding effects.</p> <p>Focus limited scope examinations more on actual risks and banks' ability to manage them.</p> <p>Pay more attention on-site to assessing large exposures and the adequacy of provisioning of individual exposures.</p> <p>Consider introducing meetings with the full Board as part of the off-site process.</p>
21. Supervisory reporting	Ensure that the reliability of ERMS returns is systematically assessed on-site.
22. Accounting and disclosure	Formalize the process followed to set provisioning buffers which banks should hold.
23. Corrective and remedial powers of supervisors	<p>Remove the need for any approval/action outside SAMA to exercise formal supervisory action (for example, MOF).</p> <p>Establish a specific bankruptcy regime for banks, and consider introducing a special resolution regime.</p>
24. Consolidated supervision	<p>Revise legal requirements to give SAMA a stronger legal basis to conduct consolidated supervision.</p> <p>Review more systematically banks' group internal control/risk management frameworks during on-site inspections.</p>
25. Home-host relationships	<p>Update the BCL to lift confidentiality requirements when necessary (for example, to share information for supervisory purposes).</p> <p>Establish MOUs with relevant foreign supervisors.</p>

G. Authorities' Response to the Assessment

13. **Saudi Arabia supports the FSAP, which intends to promote stability of the financial systems and best supervisory practices.** The authorities appreciate the efforts and commitment of the FSAP team for timely completion of this assessment. The authorities are broadly in agreement with the overall findings, but have reservations on certain aspects of the assessment. The assessment has rightly acknowledged that Saudi Arabia confronted the global financial crisis from a position of strength and that there have been significant improvements in banking regulation and supervision since the 2004 FSAP. However, the assessment has somehow not fully reflected several actions taken by Saudi Arabia to strengthen the supervisory framework. The authorities were expecting the assessment to focus more on qualitative aspects of Saudi Arabia's regulatory and supervisory framework, keeping in view the local and regional context and taking into account the ground realities.

14. **The authorities believe that the grading of certain Core Principles (CP) is not reflecting the substantial progress made in strengthening the supervisory oversight.** For example, all the requirements of CP 1(3) and 1(4) are fully met, and the assessment does not identify any material deficiencies. Regarding CP 1(5), legal protection of SAMA or its staff has never been an issue given that there is adequate protection available in the general laws and no supervisory action has ever been challenged in a court of law. Similarly, the grading of CP 4, 10 and 11 is not justified and, based on the comments conveyed earlier, should have been upgraded. In fact, CP 10 (large exposure limits) was downgraded from an initially higher rating without any explanation. The authorities also believe that the existing BCL of Saudi Arabia is serving the purpose well and provides the necessary legal framework for implementing international standards and for taking all the required supervisory actions. For example, in exercise of powers under this law, SAMA has already implemented Basel-II / Basel-III and all other relevant international standards. As was explained elaborately to the FSAP team, legal systems vary in their approaches. Hence, appreciation for such diversity in legal cultures was in order. However, the authorities will review the other FSAP recommendations and take appropriate actions in line with the existing legal and regulatory framework.

II. DETAILED ASSESSMENT

15. **The assessment of compliance of each principle should be made based on the following four-grade scale: *compliant, largely compliant, materially noncompliant, and noncompliant.*** A "not applicable" grading can be used under certain circumstances.

- *Compliant* – A country will be considered compliant with a Principle when all essential criteria applicable for this country are met without any significant deficiencies. There may be instances, of course, where a country can demonstrate that the Principle has been achieved by other means. Conversely, due to the specific conditions in individual countries, the essential criteria may not always be sufficient

to achieve the objective of the Principle, and therefore other measures may also be needed in order for the aspect of banking supervision addressed by the Principle to be considered effective.

- *Largely compliant* – A country will be considered largely compliant with a Principle whenever only minor shortcomings are observed which do not raise any concerns about the authority’s ability and clear intent to achieve full compliance with the Principle within a prescribed period of time. The assessment “largely compliant” can be used when the system does not meet all essential criteria, but the overall effectiveness is sufficiently good, and no material risks are left unaddressed.
- *Materially noncompliant* – A country will be considered materially non-compliant with a Principle whenever there are severe shortcomings, despite the existence of formal rules, regulations and procedures, and there is evidence that supervision has clearly not been effective, that practical implementation is weak, or that the shortcomings are sufficient to raise doubts about the authority’s ability to achieve compliance. It is acknowledged that the “gap” between “largely compliant” and “materially noncompliant” is wide, and that the choice may be difficult. On the other hand, the intention has been to force the assessors to make a clear statement.
- *Noncompliant* – A country will be considered non-compliant with a Principle whenever there has been no substantive implementation of the Principle, several essential criteria are not complied with or supervision is manifestly ineffective.

Table 4. Saudi Arabia: Detailed Assessment of Compliance with the Basel Core Principles

Principle 1.	Objectives, autonomy, powers, and resources. An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks. Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.
Principle 1(1).	Responsibilities and objectives. An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks.
Description	<p>SAMA’s Charter, issued by Royal Decree in 1957, clearly establishes that the sole responsibility for the regulation of banks lies with the agency. Article 1(c) of the Charter states that an “objective” of the agency is “to regulate commercial banks and exchange dealers.” Perhaps more appropriately, the regulation of banks is described as a function of SAMA in Article 3 (d).</p> <p>The legal framework for the process is set out in the BCL of 1966. This contains some of the basic prudential requirements such as a leverage requirement in Article 6 (deposit liabilities shall not exceed 15 times capital and reserves), a liquid asset requirement (see CP 15 below) in Article 7, a limit on large exposures of 25 percent of capital and reserves (see CP 10) in Article 8, and limitations on investments (CP 5) in Article 10. BCL also contains other limitations on the activities of banks.</p> <p>The BCL has only been amended once since 1966, but regulations and guidance (much of which is considered by SAMA as mandatory) issued by SAMA are frequently updated.</p> <p>Banks are required to observe Basel II pillar 3 disclosure requirements as well as to publish financial statements according to IFRS. SAMA also publishes in its annual report and elsewhere data on the financial soundness of the sector as whole. SAMA uses its risk profile of banks as a basis for determining the allocation of resources to the supervision of individual banks.</p>
Assessment	LC
Comments	SAMA’s objectives should be better defined by amendment to the Charter or the BCL. Until this happens, SAMA should at least publish objectives for supervision, (e.g., in its annual report or other suitable publication). Its report should then give an account of the extent to which it meets those objectives. This would be a useful example to the entities it supervises of effective corporate governance. SAMA is considering preparing a periodic financial stability report and if this were done it could help identify and promote its objectives.
Principle 1(2).	Independence, accountability, and transparency. Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties.
Description	<p>Although the law does not state that SAMA is independent, and although exercise of many of the powers in BCL is subject to approval by the Minister of Finance and National Economy (the Minister) and the Council of Ministers, in practice it appears to have operational autonomy in respect of the supervision of banks.</p> <p>The governance structure (Article 7 of the Charter) makes clear that the governor is accountable to the agency’s Board of Directors the members of which are appointed by the Council of Ministers for fixed five-year terms as is the governor. None can be removed except by the Council. None of the governors or directors has in fact ever been removed. There is no specific provision in the law to disclose the reasons for such a removal.</p> <p>Although SAMA has not published its objectives for supervision, it is accountable to the government, and publishes its annual report and financial statements. SAMA decided to have the latter independently audited by two commercial audit firms part of the network of the big four global auditing firms.</p> <p>The core staff of SAMA has earned a high degree of credibility and respect according to commercial</p>

	<p>banks supervised by them.</p> <p>The Board of SAMA approves its budget which is not subject to government approval. There are no specific fees levied on banks for their supervision, the cost of which is defrayed from SAMA's own resources, which to some extent rely on the employment of the cash reserves the banks are required to maintain with SAMA under Article 7 of the BCL. The budget appears to provide amply for the recruitment and maintenance of sufficient staff with the skills needed. SAMA also has authority to hire outside experts to help conduct supervisory tasks and makes extensive use of this power. SAMA also has a very extensive training program for staff and a generous travel budget which, inter alia, allows for extensive visits to home and host supervisory authorities (see CP 25).</p>
Assessment	LC
Comments	<p>Although the BCL appear to subject many supervisory decisions, e. g., the licensing of banks and the revocation of their licenses, and other sanctions on banks, to approval by government, in practice SAMA has very full operational autonomy.</p> <p>The Council of Ministers has the right (BCL Article 3) to impose conditions on any license granted to a foreign bank to establish a branch in Saudi Arabia, but the assessors were informed that this has never been exercised. Nor has the Minister exercised his powers under Article 21 to exempt a bank from any of the provisions of the law.</p> <p>Nonetheless, it would be in keeping with best practice if provisions subjecting the exercise of key regulatory and supervisory powers to the approval of the Minister or the Council of Ministers would be removed, preventing any possible difficulty in a different environment (especially as the public sector plays a key role in the banking sector as shareholder, depositor etc.).</p>
Principle 1(3).	Legal framework. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking establishments and their ongoing supervision.
Description	<p>BCL (Article 3) clearly identifies SAMA as the sole supervisory authority for the licensing of banks. Although the CMA is now responsible for investment subsidiaries of banks, there is no doubt that SAMA has overall supervisory authority over the banks and their subsidiaries on a consolidated basis (see CP 24 and associated recommendations).</p> <p>All applications for banking licenses have to be submitted to SAMA. Although decisions to grant licenses are subject to approval by the Minister and the Council of Ministers, the assessors were informed that on no occasion has the Minister or the Council questioned or delayed the recommendation of SAMA.</p> <p>Subject to the prudential limitation in the BCL, SAMA has authority, under Article 7 of the Charter, to make rules as necessary. Article 7 appears to give the government some residual power over SAMA's rule making authority ("In the event that changes are found necessary the Board of Directors shall recommend them to the government through the minister of finance").</p> <p>Normally, SAMA does consult banks extensively before applying new rules or guidelines to banks. SAMA usually circulates Basel Committee on Banking Supervision (BCBS) guidelines to the industry shortly after they are issued to ensure Saudi banks comply with the best international standards. SAMA expects banks to comply with them and sometimes request them to assess their compliance, take corrective actions where necessary and report to SAMA.</p> <p>BCL, Article 17, empowers SAMA to obtain any information from banks that is necessary for the realization of the purposes of the law.</p>
Assessment	LC
Comments	<p>The basic law is now 45 years old and must be one of the oldest banking laws still in existence. While so far the law has allowed SAMA to do what it has wanted to do, SAMA's formal powers have not been tested as the validity of its circulars was never formally challenged and it was able to have banks implement corrective actions where needed without using such formal powers. This reflects SAMA's authority as well as the limited number of players in the Saudi banking system (which have for most of them been active for decades). The Saudi financial system is likely to change considerably in coming years (including additional competition for banks coming from other domestic or international financial institutions or banks' expansion abroad and in other financial sectors) and opportunity should be taken now to initiate a banking law reform project better formalizing SAMA's powers (thereby making them more robust and less prone to challenges), as this project is likely to take time.</p>

	The numerous circulars (often old) and other directives and guidelines issued by SAMA are difficult to locate and navigate. Beyond its ongoing efforts to gather all its circulars in a single place, SAMA should initiate a codification project (not only the collection of all existing circulars and guidelines, but also their integration into a single body of texts which can be easily accessed, modified and which is fully consistent) and this would do much to help make the rule book more comprehensible and accessible. Most circulars defining prudential standards (e.g., Basel 2, large exposures etc.) are not yet available online and could usefully be posted on SAMA's website.
Principle 1(4).	Legal powers. A suitable legal framework for banking supervision is also necessary, including powers to address compliance with laws as well as safety and soundness concerns.
Description	BCL, Article 22, empowers SAMA to enforce any of the provisions of the law or regulations made under it. It also empowers SAMA to take enforcement action where there is a threat to the solvency or liquidity of a bank. The range of sanctions available is wide and includes revocation of the license. Article 18 authorizes SAMA, with the approval of the Minister, to conduct on-site examinations of banks and requires banks to make available all books and accounts and provides such information as the examiners require. Article 17 empowers SAMA to obtain any information it needs from a bank.
Assessment	LC
Comments	The Minister has in practice given authority for examinations so obviating the need to obtain authorization on each occasion, but this has not been formalized. Although sanctions may be subject to Ministerial approval it has never been denied. As recommended under CP 1 (2), the removal of the need for Ministerial approval to exercise key supervisory powers would be desirable. Please also see recommendations under CP 1 (3) to initiate the modernization of the banking law.
Principle 1(5).	Legal protection. A suitable legal framework for banking supervision is also necessary, including legal protection for supervisors.
Description	There is no specific protection for SAMA or its staff from legal action that might be taken against it or its employees for actions taken, or omission of actions, by SAMA. SAMA legal department considers that, in application of general principles applicable in Saudi Arabia, public employees cannot be held responsible for their activities while discharging their duties, although there appears to be no protection for SAMA itself. There is provision for the Board of Grievances to hear complaints against SAMA. No such action has ever been taken and the possibility of such action is regarded as extremely remote. As a result there has been no need to make provision to reimburse staff of the agency for any costs incurred in defending any such action. The assessors were informed that there is little doubt that if such cases did occur, then SAMA would cover such costs if the act or omission was regarded as having been taken in good faith.
Assessment	NC
Comments	Legal action against a governmental authority is extremely rare in Saudi Arabia. The assessors were also informed that in a case involving a customs officer, the case was dismissed as it was considered that only the customs office could be sued. The absence of legal protection has not infringed the ability of SAMA to carry out its mandate free from undue pressure. As mentioned under CP 1 (3), a reform of the banking law would be desirable and could usefully include a specific provision granting legal protection to SAMA and its staff.
Principle 1(6).	Cooperation. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.
Description	An MOU between SAMA and the CMA, the only other agency responsible for the supervision of financial institutions, is under preparation. Meanwhile cooperation and information sharing is done on an informal and need basis. There are a wide range of informal arrangements to share information and cooperate with foreign supervisory authorities and they are extensively used. There are no formal written agreements authorizing such cooperation but this has not proved to be a drawback in practice. There are no legal barriers to SAMA assisting other supervisory authorities who need information for supervisory purposes. When SAMA does provide such information it takes steps to ensure that the information remains confidential. Similarly it protects the confidentiality of information it receives. SAMA is able to deny any request for information if it does not believe its confidentiality will be protected.
Assessment	C
Comments	Although the absence of MOU or other written agreements has not hindered cooperation, SAMA should

	<p>consider whether the advantages of expressing understandings in written form, which can draw attention at an early stage to any problems that might arise when time is critical, are not greater than any potential loss in flexibility.</p> <p>The MOU between SAMA and the CMA should be rapidly completed, especially as SAMA relies on the CMA for some supervisory aspects (e.g., bank ownership and corporate governance). It could usefully contemplate detailed exchange of information after on-site examinations (e.g., risk management issues should be of common interest) and make joint inspections possible.</p> <p>Confidentiality requirements set by the BCL (art. 19) should be clarified to explicitly authorize the sharing of information for supervisory purposes (see CP 25 for more details).</p>
Principle 2.	Permissible activities. The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined and the use of the word “bank” in names should be controlled as far as possible.
Description	<p>BCL, Article 1 defines “bank” as any person practicing “banking business” and that concept as the business of taking deposits and performing some other services (including foreign exchange transactions), but not the lending of money. Thus the definition effectively includes all deposit-taking businesses, but not nondeposit taking lenders, such as finance companies and leasing companies funded by other means.</p> <p>BCL Article 2 permits money changers to undertake foreign exchange business, but no other banking business. They are licensed under separate legislation and also supervised by SAMA.</p> <p>Article 2 also allows other persons licensed under other legislation to carry on banking business, but at present none are authorized to take deposits.</p> <p>BCL contains no list of permissible activities, but certain activities that are not permissible are specified, e.g., commercial activities (BCL Article 10). BCL Article 5 prohibits any person not licensed as a bank from using the word “bank” or synonyms or any similar expression. The effect of BCL Article 1 is to prohibit any nonbank from taking deposits.</p> <p>SAMA’s website and its annual report lists currently licensed banks.</p>
Assessment	C
Comments	<p>Although there is no exhaustive list of activities permissible to banks, the law does enforce the limit on activities that banks can perform and SAMA has not been impeded in policing the perimeter.</p> <p>The Saudi Credit & Saving Bank (SCSB), a state-owned specialized institution, is allowed by a specific law to use the term bank and collect deposits. That same law empowers SAMA to regulate and supervise it. The SCSB has not yet started collecting deposits, but plans to do so in coming years. The assessors were informed that SAMA intends then to start supervising it.</p>
Principle 3.	Licensing criteria. The licensing authority must have the power to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the ownership structure and governance of the bank and its wider group, including the fitness and propriety of Board members and senior management, its strategic and operating plan, internal controls and risk management, and its projected financial condition, including its capital base. Where the proposed owner or parent organization is a foreign bank, the prior consent of its home country supervisor should be obtained.
Description	<p>Relevant laws and regulations: BCL Article 3, Article 12 and Circular of April 2005 (fit and proper criteria); circular on large exposures covering conflicts of interest (360 of June 2008); SAMA’s list of minimum requirements to be considered in assessing a domestic application for a bank license, 2005.</p> <p>BCL, Article 3 empowers the Minister to issue licenses on applications submitted through SAMA and after approval by the Council of Ministers. In practice the Minister and the Council have always accepted SAMA’s recommendations, nor have they ever issued license to persons other than those recommended by SAMA.</p> <p>Although Article 3 permits the Council to set conditions in respect of branches of foreign banks, none has ever been imposed.</p> <p>Article 3 stipulates that founders and directors should be “of good reputation” and that the memorandum and articles of association should be acceptable to the Minister of Finance.</p> <p>Article 3 also empowers SAMA to obtain all necessary information (and implicitly not consider any</p>

	<p>application where such information is not forthcoming); but does not list other criteria or empower SAMA to determine criteria. In practice SAMA has compiled a list of criteria although this list is not public. The criteria include adequate capital, ownership and management structure not hindering supervision, appropriate corporate governance, risk management, compliance, effective systems and internal controls, suitability of shareholders, directors and management that satisfy ‘fit and proper’ tests, a suitable business plan and reasonable financial projections.</p> <p>Licensing criteria also require that the proposed bank should add value to the financial sector (through new approach, business strategy, innovative products and services, delivery channels, employment opportunities etc.). SAMA can also add any other requirement it may deem appropriate.</p> <p>There is a public list of criteria in respect of licenses of banks from other Gulf Cooperation Council (GCC) member states (as agreed by the different GCC governments to promote regional integration). All these criteria are consistent with those applied in ongoing supervision</p> <p>All new banks must satisfy the CMA’s listing requirements (other than the track record requirement) as the SAMA licensing process in practice includes a requirement that banks are listed as soon as they start their activities (only the largest -government controlled- bank is not currently listed).</p> <p>SAMA satisfies itself in respect of the management and ownership structure, including satisfying itself that the structure does not hinder supervision. There are no specific criteria or supervisory methodologies to review beneficial ownership.</p> <p>Article 12 and a circular of April 2005 prescribe minimum requirements for directors and senior managers (fit and proper tests). Circular 360 on large exposures (June 2008) deals with conflict of interest cases. SAMA verifies the source of capital and ensures that it is familiar with the ownership and considers the applicant’s business plans and projected financials. Article 3 specifies a minimum capital of SR 2.5 million although in practice the minimum figure that would be acceptable to SAMA is now much higher. The assessors were informed that SAMA also considers the financial strength of shareholders and their ability to supply additional financial support if necessary. In the case of branches of foreign banks, SAMA verifies that the home supervisor has no objection and that the home supervisor is in a position to exercise effective supervision.</p> <p>There is no specific provision enabling SAMA to revoke the license if it is based on false information but the general power available in Article 22 would enable such action. New licensees are subject to continuous supervision to monitor progress in meeting their business plans.</p>
Assessment	LC
Comments	<p>Only two new licenses have been issued in the last decade for commercial banks incorporated in Saudi Arabia. In one case the controlling shareholders were government agencies with very substantial resources. In the other the shareholders were well known to SAMA as they owned licensed money changers subject to SAMA supervision. It has not therefore been possible to assess standard licensing practices.</p> <p>SAMA stated that in any future cases they would follow practices used in the licensing of insurance companies of which there have been several, and that these provisions follow those envisaged in the principle. These could usefully be set out in formal regulation, including the elements considered in applying the “fit and proper” test to managers, directors, and shareholders.</p> <p>SAMA should publish its detailed criteria for licensing new banks, fully align them with objectives focused on safety and soundness and withdraw the requirement that new licensees should “add value” so as not to unduly restrict. Similarly, additional criteria should only be contemplated in line with recommended detailed definition of SAMA’s defined objectives.</p> <p>SAMA could usefully develop a methodology to assess beneficial ownership, which could also be used after a bank has been licensed to identify and collect information on the different persons associated to a beneficial owner.</p>
Principle 4.	Transfer of significant ownership. The supervisor has the power to review and reject any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties.

Description	<p>There is no definition of a “significant” or “controlling” shareholder in the BCL or regulation. There is a requirement that companies notify the CMA of transfers leading to the direct acquisition of ownership stakes of more than 5 percent. The CMA approval is also required for changes of control of any listed company. All banks are listed except NCB which is the largest bank in the system and government controlled.</p> <p>Although there is no statutory basis the assessors were informed that SAMA expects to be informed of changes of control and its non-objection issued before completion.</p> <p>There have been very few such transactions and in most cases, SAMA was itself involved in their facilitation. Changes of indirect ownership have been rare. Although SAMA does not have a rigorous process in place to assess the beneficial ownership of direct shareholders of banks (e.g., when a succession occurs in a domestic family owned group which has a significant stake in a bank), it considers it is able to keep a good understanding on the beneficial ownership of the few significant private domestic and international investors in Saudi banks.</p>
Assessment	MNC
Comments	<p>In practice SAMA has been able to exercise its authority in cases of changes of ownership, but there is no legal basis for ensuring that such a state of affairs continues in the future. Legal authority should be obtained so as to ensure that future decisions cannot be challenged and that indirect changes in ownership can be effectively controlled.</p> <p>SAMA should also prepare and implement a methodology to regularly collect relevant information and review beneficial ownership of significant banks’ shareholders and set out the criteria by which applications would be judged. It will be particularly important if new entrants are allowed.</p>
Principle 5.	Major acquisitions. The supervisor has the power to review major acquisitions or investments by a bank, against prescribed criteria, including the establishment of cross-border operations, and confirming that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.
Description	<p>Relevant laws and regulations: BCL Article 10 and 11. Circular on criteria for investments of March 2011.</p> <p>BCL, Article 10(4) limits investments in any company incorporated in Saudi Arabia to 10 percent of its capital subject to the total of all such investments not exceeding 20 percent of the bank’s paid-up capital and statutory reserves. These limits may be increased but the assessors were informed that they never have been, although SAMA has approved acquisitions of more than 10 percent of other financial companies but always subject to the 20 percent limit.</p> <p>Article 10(3) subjects any purchase of shares in another bank in Saudi Arabia to SAMA approval. SAMA’s circular of March 2011 lists the criteria by which applications will be considered. Any shares acquired as a result of default by a borrower must be disposed of within three years or within such other period approved by SAMA. Article 11 bans investments in companies incorporated outside Saudi Arabia without approval of SAMA, which has mainly been given in respect of the trading book activities of banks.</p>
Assessment	C
Comments	Because Saudi banks are very straight forward operations, there have been no acquisitions and investments that have challenged the basic supervisory approach relied on so far.
Principle 6.	Capital adequacy. Supervisors must set prudent and appropriate minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the applicable Basel requirement.
Description	<p>Relevant laws and regulations: SAMA Charter, Article 7, BCL Article 6 & 22, letter to banks (April 1990); Basel II, – Detailed Guidance Note, Draft No. 2 (June 2006); Basel I – Introduction of market risk amendment (circular of May 2003); Basel II – Pillar 2 – ICAAP guideline of September 2008, Basel II; Advanced approaches – draft guidelines (April 2008).</p> <p>Although the BCL is silent on capital adequacy (apart from Article 6 which limits deposits to 15 times paid-up capital and reserves), SAMA has used general powers under Article 7 of the SAMA charter to issue regulations.</p> <p>When the requirements of the first Basel Capital Accord were applied to banks in 1990 (letter to banks of</p>

	<p>April 14, 1990), SAMA imposed a minimum capital requirement of 8 percent of risk-weighted assets. Since January 2008 banks have been required to observe the so-called Basel II capital requirements. At this stage all banks are on the standardized approach.</p> <p>The current guidance for the standardized approach followed by all Saudi banks is in the Detailed Guidance Note – Draft 2, of June 2, 2006. Although termed ‘draft’ SAMA requires its content to be observed and the banks have complied with its provisions since 2008. The content follows strictly the Basel II documents issued by the BCBS and is applied to all Saudi banks. In addition to the Pillar 1 requirements for credit and operational risk, SAMA introduced the market risk amendment to Basel I in 2004 (circular of May 14, 2003).</p> <p>SAMA also applies Pillar 2 requirements in respect of other risks (section 11 of the guidance note) including liquidity, interest rate, reputational, and strategic risk. Banks are expected to hold additional capital in respect of these risks. This required capital is designed to meet the specific risk profile of the individual bank. The pillar 1 requirement includes all off-balance sheet exposures.</p> <p>Although the minimum requirement remained at 8 percent, following the move to Basel II, banks are expected to, and do observe a minimum ratio of 12 percent. In practice all banks have complied with the 12 percent minimum since it was set. SAMA has authority under BCL Article 22 to take any steps necessary, including revocation of the license, if a bank failed to comply (see CP 23).</p> <p>At this stage, no bank has been allowed to use internal ratings for the calculation of its capital adequacy provision although some banks do use VaR models to assess market risk for internal management purposes.</p> <p>SAMA has now developed the ICAAP in Basel II, pillar 2, to ensure that banks have a forward-looking approach to capital planning. (Basel II guideline on ICAAP Draft No. 2 of September 2008). Since 2008, banks have been required to develop, and have reviewed by SAMA, an ICAAP. This process is designed to ensure that banks have adequate capital to support their business projections, taking account of the bank’s risk appetite, going forward. The ICAAP is subject to annual review. This process also ensures that banks have adequately capitalized their subsidiaries and affiliates, although the amount of risk carried on outside the bank itself is in most cases still quite small. As part of this process banks are given an individual target capital ratio which they are expected to achieve. This target is always above the 12 percent minimum referred to above.</p> <p>The average target ratio is currently about 14 percent. Guidance has been issued to banks (see draft guidelines of April 8, 2008) for banks wishing to move to the advanced methods in Basel II. One application has been received, but not yet approved, and a number of other banks are expected to submit applications in the years ahead.</p>
Assessment	C
Comments	<p>SAMA has been very active in recent years to introduce Basel II three pillars in Saudi Arabia thereby promoting significant improvements in banks’ abilities to identify and manage all their risks. Beyond detailed guidelines, it maintained an ongoing dialogue with the industry to guide the introduction of Basel II (including the ongoing preparation by some banks for internal ratings based (IRB) approaches), respond to questions and ensure the successful implementation of Basel II in Saudi Arabia. As a member of the Basel Committee, SAMA plans to introduce Basel III in the coming years.</p> <p>The ICAAP is a new tool which helps strengthen banks’ approaches to capital adequacy as well as supervisory approaches. This is still a recent initiative and banks still need to make some progress in their implementation of this new and demanding approach (e.g., insufficient understanding of methodological limits, insufficient understanding of models used to measure concentration risk in some cases etc.)</p> <p>Under the standardized approach, SAMA has so far adopted a 100 percent risk weight for mortgage loans (rather than the 35 percent baseline risk weight suggested in the Basel II international framework). The opportunity to revisit this risk weight for sound mortgage loans (i.e. owner occupied, conservative loan to value ratio etc.) could be contemplated taking into account the loss experience for such exposures and, when it is adopted, the new mortgage law.</p>
Principle 7.	Risk management process. Supervisors must be satisfied that banks and banking groups have in place a comprehensive risk management process (including Board and senior management oversight) to identify,

	<p>evaluate, monitor and control or mitigate all material risks and to assess their overall capital adequacy in relation to their risk profile. These processes should be commensurate with the size and complexity of the institution.</p>
Description	<p>Relevant laws and regulations: (i) Rules for enforcing the provisions of the BCL, 1986,;(ii) Basel II – SAMA detailed guidance document consultative draft no 2, 2006; (iii) Pillar 2, SAMA’s guideline document on the ICAAP, Draft 2, September 2008.</p> <p>SAMA ensures through its supervisory process (especially on-site visits) that banks have in place comprehensive and updated risk management policies and procedures to identify, evaluate, monitor and control or mitigate material risks and that they are adequate to banking groups’ risk profiles. It also requires banks to have a dedicated unit responsible for risk evaluation, monitoring and control or mitigation for material risk areas. Exceptions are reviewed during on-site inspections, with some having to be regularly reported through ERMS.</p> <p>SAMA can and has required banks to take corrective actions when shortcomings were identified in these areas (e.g., after on-site inspections).</p> <p>Overall, SAMA verifies that banks and banking groups have appropriate risk management strategies approved by the Board (See CP 20). It also confirms that the Board ensures that policies and procedures for risk-taking are developed, appropriate limits are established and senior management takes the steps necessary to monitor and control all material risks consistent with the approved strategies.</p> <p>Since 2008, SAMA requires Saudi banks to prepare annually an ICAAP. It has to be derived from a formal internal process through which a bank estimate its capital requirements in relation to its risk profile, strategy, business plans, governance structures, internal risk management systems etc. The ICAAP process needs to cover all risks (including Pillar 2 risks such as concentration risk, interest rate in the banking group risk, reputation risk and strategic risk) as well as risk management strategies and risk appetite. Forward-looking stress testing is fully integrated in the ICAAP process.</p> <p>The ICAAP has to be approved by the Board (or its Executive committee) before being submitted to SAMA by end-January. A two hour meeting is organized with each bank’s senior management (chief executive officer (CEO) in some cases, chief financial officer (CFO) and /or chief risk officer (CRO) in most cases) during the first semester to review their ICAAP (on the basis of which the bank and SAMA agree on a capital ratio target to be met during the upcoming year). Branches of foreign banks are not covered by this process. The ICAAP process is still recent in Saudi Arabia, with a heterogeneous quality among banks (but improvements across the board according to SAMA). In the documents the assessors could review, banks had not clearly addressed the limitations of such approaches (despite requests from SAMA to do so).</p> <p>SAMA ensures that banks have policies and procedures in place for new products and major risk management initiatives and independent validation of the models used. On-site inspections verify that management information system and information technology (IT) systems are adequate to manage risks faced by the bank. In practice, banks have to submit contemplated new products to SAMA for approval (based on article 1-i of the Rules for enforcing the provisions of the BCL).</p> <p>SAMA verifies that a strict segregation of duties is practiced. At the highest level, the Heads of internal audit and compliance have to report directly to the Board (while the CRO reports to senior management).</p> <p>SAMA issued standards and guidelines related to credit risk, market risk, liquidity risk, interest rate risk in the banking book, and operational risk. As a standard practice, it circulates new standards issues by the BCBS to all Saudi banks and, for the most significant, requires banks to assess their compliance (sometimes by performing internal audits) and take corrective actions where necessary.</p> <p>SAMA holds regular meetings with the Chairman of the Board and of the Audit Committee as well as senior management to discuss issues of supervisory interests as well as their role in the governance of the bank. This allows SAMA to determine that senior management and the Board understand the nature and level of risk being taken by the bank and how this risk relates to adequate capital levels.</p> <p>The assessors were informed that on-site inspection teams ensure that relevant policies and procedures are approved by the Board, and review the composition of the Board and its Committees, as well as minutes of their meetings, to ensure they can effectively fulfill their role.</p>

Assessment	LC
Comments	<p>In recent years, SAMA has adequately placed increased focus on risk management in its supervisory process, while retaining thorough examinations, and maintained an ongoing dialogue on this topic with banks. It appropriately leveraged on the introduction of Basel II in Saudi Arabia (2008) to foster improvements in banks' risk management frameworks. Additional improvements are ongoing, with many large banks actively preparing the transition towards IRB approaches which require that detailed risk management criteria be met.</p> <p>To complement its detailed guidelines and supervisory process (and adequately cover branches of foreign banks), SAMA should consider introducing key risk management requirements in a specific circular (in particular specific requirements for banks and banking groups to have in place comprehensive risk management policies and procedures to identify, evaluate, monitor and control or motivate material risks, as such requirement does not appear in the internal control circular and only indirectly in Basel II requirements).</p>
Principle 8.	Credit risk. Supervisors must be satisfied that banks have a credit risk management process that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control credit risk (including counterparty risk). This would include the granting of loans and making of investments, the evaluation of the quality of such loans and investments, and the ongoing management of the loan and investment portfolios.
Description	<p>Relevant laws and regulations: (i) BCL; (ii) SAMA, Internal control guidelines for commercial banks operating in Saudi Arabia, 1988; (iii) SAMA, Framework for the evaluation of internal control system, 1998; (iv) Pillar 2, SAMA's guideline document on the ICAAP, Draft 2, September 2008; (v) SAMA, Basel Committee papers on sound practices for backtesting counterparty credit risk models and capitalization of bank exposures to central counterparties, 2010; (vi) SAMA Circular, Credit bureau, 2009; and (vii) SAMA circular, Credit bureau report, 2009</p> <p>SAMA ensures (i) that a bank's Board approves and periodically reviews the credit risk management strategy and significant policies and processes for assuming, identifying, measuring, controlling and reporting on credit risk and (ii) that senior management implements the credit risk strategy approved by the Board and develops the aforementioned policies and processes. Such expectations appear in the internal control circular as well as the more recent structured ICAAP requirements, which are used as a key element of the off-site supervisory process. Banks' credit risk framework is in particular discussed during annual ICAAP meetings.</p> <p>It is reviewed in details during on-site inspections which ensures in particular that banks have (i) a well-documented strategy and sound policies and procedures for assuming risk, (ii) well-defined criteria and policies and processes for assuming new exposures as well as renewing and refinancing existing exposures, (iii) effective credit administration and processes, (iv) comprehensive policies and processes for reporting exposures on an ongoing basis, (v) comprehensive policies for identifying problem assets and (vi) prudent lending controls and limits.</p> <p>The internal control circular mentions that large lines of credit should be approved by the Board itself (or by the Executive Committee if necessary).</p> <p>Regarding counterparty credit risk, SAMA circulated in 2010 new BCBS documents on sound practices for back testing counterparty credit risk models indicating that it expected "banks that are planning to move to the IRB approaches to credit risk to be fully familiar with this paper and to ensure that is used in developing models related to counterparty credit risk". Most Saudi banks are developing their IRB systems, with a first one expected to shortly seek supervisory validation of its IRB framework.</p> <p>Beyond connected party regulations, there are no requirements for credit to be extended at arm's length.</p> <p>SAMA Circulars require banks to monitor customers' total indebtedness and consult the credit bureau SIMAH before extending new loans.</p>
Assessment	LC
Comments	The default in 2009 of the large Saudi groups Al Gossaibi and Saad highlighted weaknesses in Saudi (and foreign) banks' credit processes. After this default, SAMA took prompt action to (i) assess Saudi banks' exposures (including through on-site inspections), (ii) ensure that the provisioning of such exposures was

	<p>rapidly brought to 100 percent (which affected the profitability of banks to a manageable extent, but not the stability of the system) and (iii) then organized and led a working group with Saudi banks CRO to draw lessons from this case. At the time of the mission, its key conclusions were not yet available and SAMA has not yet decided what detailed changes should be made to the regulatory framework and to supervisory practice. It intends to take into account lessons learnt from this working group to strengthen its on-site examination practices. After this case, SAMA should (i) revisit the opportunity to make some key requirements compulsory rather than guidelines (collection and analysis of financial statements, lending at arm's length etc.); (ii) prepare specific guidelines for dealing with large non listed private groups with a view to promote a level playing field and avoid competition leading to a lowering of origination standard; and (iii) step up its verification of large exposures during on-site inspections (appropriate capture of all counterparts, collection of relevant documentation, proper credit approval process etc.). SAMA could also usefully build its internal capacity to assess the transparency of the main non listed private groups, identify their members and assess their creditworthiness. This would provide rich and independent information to its RBA, help identify situations where insufficient transparency exist and provide a strong basis to verify proper implementation of the large exposure regime.</p> <p>The welcome inclusion of corporate exposures in the Saudi credit bureau (SIMAH) which is expected to be fully effective in 2011 (Pilot phase at the time of the mission) will also improve Saudi banks' ability to manage their corporate credit risk.</p>
<p>Principle 9.</p>	<p>Problem assets, provisions and reserves. Supervisors must be satisfied that banks establish and adhere to adequate policies and processes for managing problem assets and evaluating the adequacy of provisions and reserves.</p>
<p>Description</p>	<p>Relevant laws and regulations: (i) SAMA Circular on loan classification, provisioning and credit review, January 2004; (ii) SAMA, rules governing loan classification, provisioning and credit review, 2003; (iii) BCL.</p> <p>The 2003 rules governing loan classification, provisioning and credit review mentions that all Saudi banks are expected to establish a system of independent, ongoing credit review and that the results of such reviews should be communicated directly to senior management, the Board of Directors and the Audit Committee. Key objectives of an independent credit review system include the following:</p> <ul style="list-style-type: none"> • ensure that credits are appropriately classified, • ensure that problem credits are promptly identified and remedial actions taken, • review the adequacy of allowances for credit losses, • assess the adequacy of adherence to internal credit policies and administrative procedures, • provide senior management, the Board of Directors and the Audit Committee with an objective and timely assessment of the overall quality of the credit portfolio. <p>The 2003 circular further indicates that large loans should be reviewed and assessed on an individual basis. It also calls for proper procedures to value collateral using external appraisers or external reliable information and applying appropriate haircuts (at a minimum on a yearly basis).</p> <p>The 2003 circular contains detailed classification and provisioning requirements, including the following categories:</p> <ul style="list-style-type: none"> • Standard and special mention loans for which a 1 percent general provision has to be constituted, • Substandard (including loans with arrears > 90 days) with a 25 percent provisioning requirement, • Doubtful (including loans with arrears > 180 days) with a 50 percent provisioning requirement, • Loss (including loans with arrears > 360 days) with a 100 percent provisioning requirement, <p>These detailed requirements apply for the assessment of supervisory provisions. IFRS standards are applied for the preparation of financial statements and cover all assets and off-balance sheet exposures as well as detailed impairment test criteria (See CP 22). Where they exist, differences between supervisory and accounting provisions are deducted from accumulated retained earnings for the purposes of calculating</p>

	<p>regulatory capital.</p> <p>SAMA ensures strict adherence to its guidelines through on-site inspections and also covers this issue as part of its off-site supervisory process. It pays particular attention to the content and implementation of banks' classification and provisioning policies and processes during on-site examination (which usually involve one of the Big four accounting firms), as well as the effectiveness of the credit review system.</p> <p>SAMA regularly receives detailed information on the classification of credits and assets, as well as their provisioning (specific and general) through ERMS.</p> <p>Although the BCL does not specifically empower SAMA to require a bank to increase its level of provisions, SAMA has effectively used its broader supervisory powers to do so when necessary. In the past two years, it intervened to ensure all banks were fully provisioning exposures on a large group and to require banks to build up a larger provisioning buffer (dynamic provisioning, see CP 22 for more details).</p>
Assessment	C
Comments	SAMA should consider devoting greater on-site examination resources to detailed inspection of large exposures and other problem assets and question banks' classification item by item.
Principle 10.	Large exposure limits. Supervisors must be satisfied that banks have policies and processes that enable management to identify and manage concentrations within the portfolio, and supervisors must set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties.
Description	<p>Relevant laws and regulations: (i) BCL (Art. 8), (ii) SAMA Circular, Limits on credit exposures to non bank counterparties and banks and financial institutions, June 1994, (iii) SAMA Circular, Further clarifications concerning lending to connected parties covered in SAMA's circular on limits on credit exposures dated June 1994, June 2008, (iv) Pillar 2, SAMA's guideline document on the ICAAP, Draft 2, September 2008, (v) Clarifying memo on powers and responsibilities of members of the Board of directors of Saudi banks, 1981.</p> <p>In its 1994 circular, SAMA adopted a broad definition of connected parties. The definition primarily covers two or more persons mutually associated in that (i) one of them holds directly or indirectly power of control over the other through common ownership, common directors, cross-guarantees or direct commercial dependencies which cannot be substituted in the short term and (ii) they are so interconnected that if one was to experience problems, it is likely the other(s) would encounter repayment difficulties. There is no specific provision referring to the ability of SAMA to exercise discretion in applying the definition, but the assessors were informed that it had been able to exercise such discretion in some instances.</p> <p>Limits on connected party exposures apply on a consolidated basis and include both on- and off-balance sheet exposures (without deduction of collateral):</p> <ul style="list-style-type: none"> • For non financial counterparts, individual exposures cannot exceed 25 percent of a bank's paid up capital and reserves. The 1994 circular also indicates that SAMA does not expect such exposures to exceed 15 percent and require additional scrutiny when it happens. On a case by case basis, SAMA is authorized to raise the limit to 50 percent. SAMA grants such exceptions. In April 2011, a large bank was holding a large exposure exceeding 35 percent of its capital and reserves, with the authorization of SAMA. • For banks and other financial institutions, limits are set respectively at 50 percent of paid up capital for adequately capitalized banks (defined as having a capital adequacy ratio above 8 percent and a Tier 1 ratio above 4 percent) and at 25 percent for other banks and financial institutions. • Limits do not apply to Saudi government and quasi-government institutions, GCC and OECD central banks and central governments. SAMA indicated that state-owned enterprises are not considered as quasi-government institutions. <p>Only off-balance sheet exposures are risk-weighted. Basic criteria are applied to derivatives (e.g., 10 percent of notional for foreign exchange contracts up to two years, 5 percent of notional per year for interest rate contracts).</p> <p>The 1994 circular requires banks to "establish a written policy for large credit exposures to customers, banks, countries and economic sectors to be approved by its Board of Directors". It also indicates that banks should carefully monitor all large credit exposures. More detailed requirements are set for exposures</p>

	<p>to banks and financial institutions (daily monitoring and reporting to senior management in case of non compliance with internal and regulatory limits).</p> <p>In its clarifying memo on powers and responsibilities of members of the Board of directors of Saudi commercial banks, SAMA indicates that it expects the Board (i) to adopt policies that prevent undue concentration of credit; (ii) to ensure their banks have reporting systems which enable the Board to watch the trend and behavior of the bank's loan portfolio; and (iii) to approve largest credits and review those approved by the Managing Director and other bank officials.</p> <p>All exposures exceeding 10 percent of a bank paid up capital and reserves must be reported to SAMA on a monthly basis. The sum of non bank exposures exceeding this 10 percent threshold cannot exceed 8 times a bank's paid up capital and reserves.</p> <p>As part of the annual ICAAP process, SAMA also requires banks to measure credit concentration risk (related to single names, industries, sectors or countries) and allocate capital accordingly. The ICAAP analysis is communicated to SAMA and discussed in details during Supervisory Review Visits.</p>
Assessment	MNC
Comments	<p>The possibility for SAMA to raise the limit on non financial counterparts to 50 percent of a bank's paid up capital and reserves, which is periodically used for projects considered to be of national importance, does not appear prudent and should be removed. SAMA should stop granting such exceptions without waiting for the amendment of such requirements. Similarly, the 25 percent limit on banks with a capital adequacy ratio below 8 percent and a Tier 1 ratio inferior to 4 percent appears outdated.</p> <p>SAMA could usefully implement a more systematic approach to reviewing risks large exposures may pose (accompanied by appropriate procedures) including:</p> <ul style="list-style-type: none"> • Banks' practices regarding the definition of connected parties (i.e. aggregation of all relevant related parties), in particular during on-site inspections. The latter is contemplated by SAMA policies, but sometimes not reflected in the defined scope of full-scope on-site missions, nor in the detailed inspection reports, • Specific assessment of risks large exposure may pose as part of the off-site preparation of banks' risk profiles. This is currently covered under the broader heading on risk management (with no mention or details on large exposures in some cases). <p>SAMA could also consider strengthening its capacity to assess the links within large private nonlisted groups (see CP 10), which would help improve further its ability to independently assess banks' proper implementation of the large exposure regime.</p> <p>In line with SAMA's efforts to promote modern market risk management, risk weighting criteria for derivatives should be revised to ensure that exposures are prudently valued.</p>
Principle 11.	<p>Exposures to related parties. In order to prevent abuses arising from exposures (both on balance sheet and off balance sheet) to related parties and to address conflict of interest, supervisors must have in place requirements that banks extend exposures to related companies and individuals on an arm's length basis; these exposures are effectively monitored; appropriate steps are taken to control or mitigate the risks; and write-offs of such exposures are made according to standard policies and processes.</p>
Description	<p>Relevant laws and regulations: (i) BCL (Art. 9); (ii) SAMA Circular, Limits on credit exposures to nonbank counterparties and banks and financial institutions, June 1994; and (iii) SAMA Circular, Further clarifications concerning lending to related parties covered in SAMA's circular on limits on credit exposures dated June 1994, June 2008.</p> <p>The 1994 Circular defines related parties as (i) members of the Board of Directors and external auditors; (ii) unincorporated establishments in which a Director or external auditor is a partner or manager, has a direct financial interest or is a guarantor; (iii) principal owners or shareholders (i.e. control over 10 percent of voting shares); and (iv) affiliated companies and partnerships (includes establishments related to the bank by a common parent or a controlling shareholder). Close family members are not covered, nor are senior management and key staff (for which specific provisions apply as described below). There is no specific provision referring to the ability of SAMA to exercise discretion in applying the definition, but the assessors were informed that it had been able to exercise such discretion.</p>

	<p>The 2008 circular indicates that:</p> <ul style="list-style-type: none"> • Lending or other exposures to related parties on preferential terms is prohibited, • Approval for such transactions, including write-offs, is to be at Board level (members of the Board with a conflict of interest are excluded from the approval process), <p>Banks' risk management frameworks need to include policies, processes and procedures to identify related lending exposures, their total amount, and monitor them on an ongoing basis through an independent credit review process. Moreover, banks need to identify all exceptions to policies, processes and limits and report them to senior management and, if necessary, to the Board for timely action. Senior management and the Board of directors are responsible for regularly monitor such transactions and provide their oversight.</p> <p>Limits on related party exposures apply on a consolidated basis and include gross on- and off-balance sheet exposures (see CP 10 for a discussion of derivatives' risk weighting). Collateral cannot be deducted from related party exposures, although they have to be fully secured.</p> <p>Specific provisions apply to bank staff (not covered under the definition of related parties). The 1994 circular stipulate in particular that unsecured loans and credit facilities they receive shall not exceed four month salary, except for housing loans which are secured by the property being financed.</p>
Assessment	MNC
Comments	<p>The definition of related parties should be broadened to include (i) close family members as well as (ii) senior management and key staff (and their direct and related interests, close family members and corresponding persons in affiliated companies).</p> <p>SAMA could usefully implement a more systematic approach to review risks related parties may pose (accompanied by appropriate procedures) including:</p> <ul style="list-style-type: none"> • Banks' practices regarding the definition of related parties (i.e. aggregation of all relevant related parties), in particular during on-site inspections. The latter is contemplated by SAMA policies, but sometimes not reflected in the defined scope of on-site missions, nor in the detailed inspection reports, • Specific assessment of risks related parties may pose as part of the off-site preparation of banks' risk profiles. This is currently covered under the broader heading on risk management (with no mention or details on exposures to related parties in some cases). <p>As described in CP 4, SAMA could usefully prepare a methodology to facilitate the collection and analysis of relevant information to identify banks' beneficial owners (and their different associates). At the time of the mission, the assessors were informed that beneficial owners were in practice well-known as there were few significant domestic or foreign shareholders in banks.</p>
Principle 12.	<p>Country and transfer risks. Supervisors must be satisfied that banks have adequate policies and processes for identifying, measuring, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining adequate provisions and reserves against such risks.</p>
Description	<p>Relevant laws and regulations: SAMA Circular concerning requirements for banks to address country and transfer risks, 2008.</p> <p>SAMA requires banks to institute the following controls in their risk management framework (2008 Circular):</p> <ul style="list-style-type: none"> • Policies, processes, and procedures that give due regard to the identification, measurement, monitoring and control and transfer risk; • Identification and monitoring of exposures on an individual country basis (in addition to the end-borrower /end counterparty basis); • Monitor and evaluation of developments in country and transfer risks and application of appropriate countermeasures; and • Appropriate provisioning against country and transfer risks where applicable. <p>The 2008 circular also indicates that SAMA will periodically review the methodology for setting provisions related to country and transfer risks.</p>

	SAMA requires quarterly reporting on banks' country risks using the BIS template.
Assessment	C
Comments	
Principle 13.	Market risk. Supervisors must be satisfied that banks have in place policies and processes that accurately identify, measure, monitor and control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.
Description	<p>Relevant laws and regulations: (i) Internal control guidelines for commercial banks operating in Saudi Arabia.</p> <p>The Internal control guidelines require that the bank management adopt policies and procedures of internal control that:</p> <ul style="list-style-type: none"> • Safeguard the holdings of the trading securities portfolio; • Define authorized trading activities and authority limits of trading in securities; • Prepare periodic reports which fairly present the assets and liabilities of trading securities portfolio, the movement and the results of security trading transactions; • Immediately notify the bank's senior management of the risk associated with trading in securities; • Alert the bank's senior management when deviations from policies and procedures adopted by the bank's management with respect to trading in securities have been noted. <p>It also indicates that the Board should review at least quarterly underwriting /trading policies and periodically ensure that applicable policies are adhered to.</p> <p>Only securities and foreign exchange on- and off-balance sheet activities are covered by the internal control guidelines (i.e., other derivative activities are not).</p> <p>During its on-site inspections and ICAAP discussions, SAMA determines that banks perform scenario analysis, stress testing and contingency planning, as appropriate and periodic validation or testing of the systems used to measure market risk.</p> <p>There is no requirement for banks to establish and maintain policies and processes for considering valuation adjustments/reserves for positions that otherwise cannot be prudently valued, including concentrated, less liquid ad stale positions. SAMA indicated that Saudi banks had limited such exposures.</p>
Assessment	LC
Comments	<p>Market activities remain limited in Saudi Arabia, but are growing, and banks can hold significant investment portfolios abroad (the latter being initially reviewed and approved by SAMA). As a result of structured investments (CDOs, hedge fund investments etc.), Saudi banks suffered material, but manageable, losses during the global crisis.</p> <p>SAMA could consider updating its framework for market activity to (i) clearly cover all derivative activities; (ii) incorporate new best practices (e.g., reserves for illiquid positions such as some CDOs or hedge fund investments); and (iii) make core requirements binding rather than simply guidelines.</p>
Principle 14.	Liquidity risk. Supervisors must be satisfied that banks have a liquidity management strategy that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control liquidity risk, and to manage liquidity on a day-to-day basis. Supervisors require banks to have contingency plans for handling liquidity problems.
Description	<p>Relevant laws and regulations: BCL Article 6, 7, circular on maximum loan /deposit ratio, July 2006, circular on liquidity management (December 2008), Basel III liquidity ratios (circular of 5944 o February 2011)</p> <p>BCL, Article 7 sets a minimum liquid assets ratio. This requires banks to hold 15 percent of their deposit liabilities, in the form of cash, gold, claims on banks and other financial institutions maturing in 30 days and Saudi Government and government guaranteed securities. Foreign currency assets may be included The ratio may be, and has been, increased to 20 percent. (the actual ratio is currently about 34 percent for the system as whole.) In addition, Article 7 requires banks to hold a "statutory deposit" of no less than 15 percent of deposits with SAMA. This ratio can be varied between 10 percent and 17.5 percent. Finally banks are subject to a guideline maximum ratio of 85 percent for loans as a proportion of deposits, defined broadly to include all third party liabilities. This ratio was raised from 60 percent in 2006 to 85 percent (see circular 392 of July 2008 which also applied the ratio on a consolidated basis). This ratio, unlike the</p>

	<p>other two ratios, is a ‘guideline’ in the sense that banks are not penalized for breaches, but are expected to explain why they failed to observe it and rectify the deficiency. Excessive drains on liquidity are also constrained by the requirement in Article 6 of the BCL, which requires that deposits do not exceed 15 times capital and reserves. 50 percent of any excess must be deposited with SAMA.</p> <p>In 1992, following publication of the Basel Committee’s first paper on liquidity management, SAMA set up a reporting requirement showing maturity gaps and net funding requirements for the banks. No specific limits on maturity gaps were required, but the data was used as a basis for supervisory discussions with banks. This reporting system included off-balance sheet items.</p> <p>The Basel paper on liquidity management was refined in 2008 and a set of principles derived from it. Banks were then required to undertake a self-assessment of compliance with the principles (see circular 771 of 5 December 2008). Banks had to submit a timetable for rectifying any deficiencies revealed by the assessment.</p> <p>Liquidity management strategies, which must be approved by a bank’s board, are discussed in annual supervisory reviews. Implementation of liquidity policies are confirmed during on-site examinations. Discussions of liquidity risk also take place within the context of the ICAAP process. Although no bank has elected to set aside additional capital under Pillar 2 for liquidity risk, this is hardly surprising given the high levels of liquidity Saudi banks have conventionally maintained.</p> <p>SAMA has announced that it will apply the Basel III regime on liquidity, and 3 banks participated in the Quantitative Impact Study carried out by the Basel Committee, revealing unusually high levels of liquidity. In circular 5944 of 15 February 2011, SAMA described how it intended to phase in the Liquidity Coverage Ratio (LCR) from 2012, initially on an observation basis but with mandatory effect from 2015. The Net Stable Funding Ratio will also be implemented by 2019. Detailed application will be discussed with the banks during the coming year and during the observation period.</p> <p>The data reporting of maturity mismatches, based on the Basel Committee paper of 2008, provides a basis for discussion of net funding requirements of banks.</p> <p>As regards foreign currency business, predominantly in U.S. dollars, Saudi banks have also been very liquid with little demand for dollar lending.</p> <p>Annual meetings with banks’ treasurers also provide an opportunity for discussion of liquidity policies and their implementation.</p> <p>Banks are expected to conduct scenario analysis of liquidity and undertake stress testing. The results are discussed in the ICAAP context. Banks are expected to have contingency planning arrangements even though the risk appears at present very low. There is currently very little foreign currency market borrowing because it is more expensive than local sources which more than cover loan demand in foreign currency. Any funding concentrations are reported and are discussed with respective bank treasurers.</p>
Assessment	C
Comments	<p>Liquidity is taken seriously despite the fact that banks have traditionally run highly liquid books. However, with loan demand growing again, the 85 percent loan/deposit ratio is beginning to act as a constraint in some cases.</p> <p>SAMA is in the process of implementing Basel 3 liquidity requirements and intends to start monitoring banks’ LCRs and Net Stable Funding Ratios in 2012.</p>
Principle 15.	<p>Operational risk. Supervisors must be satisfied that banks have in place risk management policies and processes to identify, assess, monitor and control/mitigate operational risk. These policies and processes should be commensurate with the size and complexity of the bank.</p>
Description	<p>Relevant laws and regulations: Basel committee on operational risk (see circular 1277 of December 2010), Basel II – Detailed Guidance Note, Draft No. 2 (June 2006), Rules on outsourcing (July 2008)</p> <p>As part of the Basel II process, banks are expected to have a coherent operational risk management structure, based on the Basel Committee’s 2003 paper on the management and supervision of operational risk, which banks have been expected to observe, and the revised version of which was issued as circular 1277 of 21/12/2010. The topic is also covered in the guidance document on the Basel II arrangements and the banks are required to observe the capital requirements in that document. Currently all the banks use either the basic indicator approach or the standardized approach. Management of operational risk is</p>

	<p>discussed in the ICAAP process and the annual supervisory reviews and the topic is also expected to be covered in a bank's internal audit programs. It is covered in more detail in periodic on-site inspections. Before Basel II, various aspects of operational risk had been separately covered. For example, SAMA issued rules on outsourcing in July 2008. Rules on physical security were issued in 1995 and in January 1994 SAMA issued guidance on disaster recovery planning together with a questionnaire on the subject which is used as a check list in annual supervisory reviews. Banks are required to have OR policies approved by the board and to establish an operational risk unit in the bank. Banks have been collecting operational loss data and guidance has been issued in December 2010 on the 'advanced management approach' but no bank has yet applied to use this. Staff from the Banking Technology Department (which handles payments system issues) participates in annual supervisory reviews so that expertise is available in order to review IT systems and IT security questions. This area is also covered by expert staff from the accounting firms that participate in on-site examinations. BT department staff also review electronic banking products of banks and test new banks' IT systems before they are permitted to open for business. Banks are expected to report material operation risk losses to SAMA and breaches of physical security to the Ministry of Interior. There is also a reporting template for electronic banking failures. Legal risk is covered in annual supervisory reviews. The outsourcing rules require a board approved policy and contracts for outsourcing arrangements have to be approved by SAMA. As far as subsidiaries are concerned there is no particular requirement for a group policy but the CMA has rules on firms they regulate.</p>
Assessment	C
Comments	
Principle 16.	Interest rate risk in the banking book. Supervisors must be satisfied that banks have effective systems in place to identify, measure, monitor and control interest rate risk in the banking book, including a well defined strategy that has been approved by the Board and implemented by senior management; these should be appropriate to the size and complexity of such risk.
Description	<p>SAMA first introduced this subject by circulating the Basel Committee paper of July 2004. As part of the ICAAP process, which requires board approval before submission to SAMA, banks are expected to set a capital charge for interest rate risk as a component of the pillar 2 requirements for Basel II. The adequacy of this charge is assessed during annual supervisory reviews.</p> <p>Regular meetings with banks treasurers also provide an opportunity for SAMA to ascertain the extent of interest rate risk, which is subject to regular reporting, and to discuss banks' appetite for interest rate risk and its management.</p> <p>Banks have relatively limited exposure as liabilities are mainly short-term but corporate lending is normally at floating rates repriced once a quarter. Although consumer lending is done at fixed rates its average maturity is only 2 and a half years. Measurement systems are also investigated during full-scope examinations. Stress testing is done regularly and is part of the input to the ICAAP process. Management of interest rate risk is expected to be within the responsibilities of CROs of banks.</p>
Assessment	C
Comments	SAMA should closely monitor the impact on banks' interest rate risk in the banking book of the expected growth of mortgage loans once the mortgage law is passed, as well as that of the financing of the ambitious long term infrastructure projects recently initiated by the government.
Principle 17.	Internal control and audit. Supervisors must be satisfied that banks have in place internal controls that are adequate for the size and complexity of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding the bank's assets; and appropriate independent internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.
Description	<p>Relevant laws and regulations: The CMA Corporate Governance Regulations of 2006, Guideline on compensation practices (May 2010), Framework for internal control systems circular of 1988), Manual on compliance (December 2008), Guideline on Audit Committees (July 2006), Notification of material events, circular of February 2011.</p> <p>As all banks, apart from NCB, are listed companies, they are all expected to comply with CMA Corporate Governance Regulations of 2006. SAMA has also issued to banks the most recent BCBS guidance on</p>

	<p>corporate governance in banks.</p> <p>In addition, during on-site supervisory reviews and examinations, SAMA stresses the role of boards in ensuring control over the activities of a bank and verifies their role in practice. Recently SAMA applied the Financial Stability Board’s compensation requirements to banks (circular of March 2010) (one of the first G-20 countries to do so) and these stress the role of the Board and its committees. SAMA has conducted a thematic review of this aspect and this led to some strengthening of corporate governance in the banks.</p> <p>SAMA has issued a circular in 1988 which closely follows the BCBS <i>Framework for internal control systems in banking organizations</i>. Compliance is, in part, assured by external auditors who identify weaknesses in management letters to which SAMA has access, although they do not express an opinion on the effectiveness of internal control. The area is covered extensively in on-site examinations. The area is also covered in annual supervisory reviews. In addition, SAMA has issued a compliance manual (<i>Compliance and compliance functions in banks</i>, May 2005) which requires compliance officers to ensure that controls are effective.</p> <p>The on-site review process is also important for ensuring that Boards and managements understand the underlying risks in the business. SAMA has general powers in BCL Article 22 which could be used to influence the composition of boards. On-site review visits are also used to ensure that the control functions of banks are appropriately resourced.</p> <p>The compliance requirements mentioned above ensure that all banks have adequately staffed compliance functions and on-site examinations check that they have operational independence.</p> <p>A bank is required to have an independent internal audit function reporting to an audit committee of the board (which may include outside expert members). Audit committees are required to have a majority and chairman who are independent directors. (<i>Guidelines for Banks for organizing Audit Committees</i>, November 1994). Audit plans and methodology are discussed during on-site examinations and reviews. Audit reports are reviewed by examiners who assess their quality in order to ascertain the extent to which they can be relied on.</p> <p>SAMA has issued detailed rules on outsourcing (see CP 15) which specify functions that may be outsourced and conditions that should apply in such cases.</p> <p>Following the 2004 FSAP, SAMA issued a regulation requiring banks and external auditors to notify it of any material issues which may negatively affect the fitness and propriety of a member of a board or senior management.</p>
Assessment	LC
Comments	<p>SAMA interviews annually Chairmen of banks and Chairmen of audit committees but does not meet with boards as a whole. Such meetings could also help SAMA to be sure that all directors understand their responsibilities fully.</p> <p>Updated requirements on internal control are needed to take stock of evolutions in the Saudi banking system and of practices internationally in recent years.</p>
Principle 18.	Abuse of financial services. Supervisors must be satisfied that banks have adequate policies and processes in place, including strict “know-your-customer” rules, that promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities.
Description	<p>The assessment of this principle is to a large extent based on the detailed assessment report of compliance with Financial Action Task Force (FATF) requirements prepared by a MENAFATF /FATF team and published in May 2010.</p> <p>The 2003 Anti-Money Laundering Statute (AMLS) specifies SAMA’s responsibilities and powers related to the supervision of existing requirements to fight criminal activities. Within the Banking Inspection Department, a Combating Financial Crime Division has been established. It includes three units: Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) unit, 19 staff; Anti-Fraud unit, 18 staff; and Communication Channel Unit, 6 staff. This unit has primary responsibility for both off- and on-site AML/CFT supervision.</p> <p>Full-scope and limited scope inspections are undertaken to ensure that banks comply in particular with</p>

	<p>existing requirements regarding policies and procedures, suspicious transaction reporting (STR), Know Your Customer (KYC) and Customer Due Diligence requirements and have adequate recruitment and training arrangements.</p> <p>The number of on-site examinations fell sharply in the past two years and is expected to increase again in 2011, in particular thanks to the beginning of a new cycle of full-scope on-site examinations. However, off-site supervision remained intense in the past two years to follow-up on corrective measures implemented to address weaknesses identified during previous inspections and hold one day supervisory visits on an annual basis to discuss and assess the design and implementation of banks' AML/CFT frameworks.</p> <p>The AMLS requires banks to inform SAMA of any STR they file. SAMA analyzes such reports and produce aggregate analyses.</p> <p>Bank staff who report in good faith are protected by law.</p> <p>SAMA cannot directly file STRs, but would ask bank to file an STR if need be. SAMA is allowed to exchange information with the Financial Intelligence Unit (FIU). It maintains a close good working relationship with the FIU (facilitated by some 10 ex-SAMA staff now working for the FIU).</p> <p>SAMA has been able to cooperate with foreign supervisors when needed (also see CP 1(6) on the BCL confidentiality provisions).</p>
Assessment	LC
Comments	<p>The MENA FATF /FATF Mutual Evaluation Report primarily highlighted weaknesses related to nonbank financial institutions. SAMA should follow up on recommendations made by this assessment for entities it supervises, especially regarding the need to have requirements to conduct ongoing due diligence set in "primary or secondary legislation" and to improve the implementation of requirements to identify beneficial owners (also see CP 8 on related issues).</p> <p>The on-site AML/CFT examination plan could be better organized to avoid crowding effects (i.e., many inspections one year, none the following one).</p>
Principle 19.	<p>Supervisory approach. An effective banking supervisory system requires that supervisors develop and maintain a thorough understanding of the operations of individual banks and banking groups, and also of the banking system as a whole, focusing on safety and soundness, and the stability of the banking system.</p>
Description	<p>Over the last five years, SAMA has developed a risk based approach to supervision. This has involved the development of risk profiles for each bank and a more elaborate assessment system, replacing the old CAMELS approach. As well as the relatively infrequent full scope on-site examinations, SAMA now conducts, on-site, a one-day annual supervisory review, after which the risk profile is updated. The profile may also be updated at any other time if significant changes merit it. There is also an annual meeting to discuss each bank's ICAAP submission. In addition SAMA has annual meetings with chairmen of boards and audit committees, and frequent ad hoc meetings with management at various levels. There are also periodic and regular meetings with CEOs, CFOs, CROs, etc. where issues common to all banks are discussed and where new regulatory and supervisory initiatives as well as other issues related to SAMA's broader mandate are discussed. These processes provide ample opportunity for SAMA to understand the business helped by the fact that there are only 23 banks and active branches of foreign banks. Banks confirm that virtually every policy decision made by a bank is in practice discussed with SAMA first. Failure to do so would involve considerable attention from the supervisors.</p> <p>In addition to intelligence on individual banks SAMA also assesses developments in the sector as a whole. This work is done by a joint team from the bank supervision and economic research departments. Information on the system is published in SAMA's annual report and summary statistics in monthly and quarterly releases. The annual report covers the whole financial sector and there is frequent contact with the CMA—regulator of the securities sector. Insurance is supervised by SAMA itself.</p> <p>The risk profile exercise, the annual supervisory review, and the ICAAP process ensure that SAMA can assess the soundness of each bank regularly as well as its strategy and prospects.</p> <p>Because the system is small there are frequent occasions to compare banks. The supervisory reporting system, ERMS, also allows formal peer group analysis. On-site examination is steered by these</p>

	<p>assessments.</p> <p>Full scope examinations are meant to be prioritized according to risk profiles and result from intensive discussion between the two departments. An increasing share of onsite examinations is devoted to limited scope and thematic reviews of areas of interest or concern.</p> <p>SAMA relies on the regular reporting system (see CP 21), and on-site examination to ensure compliance with prudential requirements and other legal requirements. Such breaches are extremely rare. SAMA has recently set up a requirement for banks to report any material adverse developments although the frequent informal contact also helps SAMA to be aware of such developments.</p> <p>SAMA's ERMS facilitates the analysis of statistical reporting and indicates areas that need follow-up, which is done initially by the Relationship Officer for the bank concerned. The ERMS system appeared very advanced flexible and easy to use providing a rich tool for off-site supervision. The ICAAP process is sufficiently forward looking to focus on prospective developments and to identify emerging risks.</p>
Assessment	LC
Comments	<p>SAMA's approach reflects a move towards modern risk-based supervision and benefits from more ample resources than many supervisory authorities in other countries can command.</p> <p>Risk profiles only contemplate three ratings and the assessors were informed that very few banks were rated other than medium risk, thereby limiting the usefulness of ratings to prioritize supervisory actions. A comprehensive risk profile analysis should be undertaken at least on an annual basis for banks and branches of foreign banks (a bank's risk profile was sometimes updated only once every two year at the time of the assessment).</p>
Principle 20.	Supervisory techniques. An effective banking supervisory system should consist of on-site and off-site supervision and regular contacts with bank management.
Description	<p>The Inspection (on-site) and Supervision (off-site) Departments are responsible for banking supervision. They report to the Director General of the Banking Control department (a vacant position at the time of the mission) and are organized as follows:</p> <ul style="list-style-type: none"> • The Banking Inspection Department (BID) counts 156 employees (of which 30 are studying abroad) including the examination division (50 people including about 15 studying abroad and 5 to 10 dedicated to money changers); the combating financial crimes division (43 staff), as well as the compliance (20) and banking services monitoring (30) divisions which are less involved in core supervisory tasks. • The Banking Supervision Department (BSD) counts 71 employees (of which 12 are studying abroad) including the local bank division (35); the foreign branch division (7); the licensing division (11 people with responsibilities ranging from the approval of new ATMs to new banks) and eventually the money changer division (11) whose responsibilities fall outside the scope of this assessment. <p>Supervision is carried on through full scope on-site examinations, annual one day on-site supervisory reviews, thematic examinations across all banks, and special ad hoc examinations of individual banks. Off-site analysis and preparation of risk profiles is carried out by the relationship officer who coordinates the whole process.</p> <p>The full scope examinations are labor intensive, and can involve a large part of the examination department for up to 3-4 months each. Two or three of the 12 banks are meant to be examined each year with the frequency determined by the relative risk profiles and the period since the last examination. Periodicity still varies in practice between 3 to 5 years, although the risk-based on-site inspection policy framework and procedures (2008 with a 2010 update) contemplates a periodicity ranging from 1 to 3 years based on risk. SAMA completed a cycle of full-scope examinations in 2008 and will start a new one in the second half of 2011 (4 banks inspected in 2007; 6 in 2008; 1 in 2009; and 0 in 2010).</p> <p>This accounts for about 40 percent of examiners' time. A specific process is designed for branches of foreign banks, with examination conducted by SAMA examiners without the support of an audit firm. Only one branch of a foreign bank was ever subject to a full scope on-site inspection, due to the limited activities of these branches. Targeted examinations focused on AML/CFT and operational risk occur on a</p>

	<p>regular basis.</p> <p>An increasing share of onsite examinations is devoted to limited scope and thematic reviews of areas of interest or concern (2 in 2007; 17 in 2008; 21 in 2009; and 34 in 2010). The 2010 program of limited scope and thematic reviews appeared more oriented towards compliance with SAMA requirements, than with assessing banks' risk profiles and ability to manage their risks (e.g., the risk management framework and its components is only reviewed during full-scope inspections).</p> <p>The supervisory reviews, usually lasting a full day, take place annually and most of the senior management of the banks is required to be present. All risks and activities are covered, sometimes only leaving limited time for important issues (e.g., 15–20 minutes for internal audit).</p> <p>SAMA indicates this is compensated by other frequent meetings, including the review of the ICAAP, at SAMA, which involve contact with a range of management.</p> <p>Because the system is small, SAMA did not feel the need to put in place a formal quality assurance and consistency check and this function can be handled by department managers who know each bank individually. Departments involved in supervision are not in practice subject to SAMA's internal audit.</p> <p>The work of the BID is subject to an annual plan which is discussed at length between the BSD and the BID with senior management of SAMA also involved. There is room in the examination plan to schedule special examinations of individual banks if that is found necessary.</p> <p>Full scope on-site work is usually done by a joint team of SAMA examiners and staff from an accounting firm. The firm is selected from those of the 'big 4' firms that are not external auditors of the bank or providers of other services to the bank. The fee is negotiated by SAMA and paid by the bank concerned. Other types of exam are done solely by SAMA staff.</p> <p>Supervisory reviews usually include both examiners and off-site supervisors including the relationship officer. They may also include staff from the investment and banking technology departments of SAMA. On-site work includes verification of corporate governance, risk management and internal control.</p> <p>There is a structured quarterly follow up process, which is led by on-site (with participation of off-site) and relies on quarterly reports which banks have to file to show progress made. Discussions with banks also appear to regularly take place to discuss progress (focusing on major issues) and require actions when necessary. Special examinations are also used to follow up on major weaknesses.</p> <p>The relationship officer is responsible for the analysis of regular reporting and coordinating other supervisory work including the annual supervisory review. He also prepares the risk profile and is responsible for keeping it up to date. He has input to the prioritization of onsite work. As a result of the regular contacts described above as well as frequent ad hoc meetings at all levels risk profiles can be continually updated and reviewed.</p> <p>With the help of the annual meeting with the Chairman the role of the board is assessed although no meetings with the full board take place.</p> <p>Considerable attention is paid to the internal audit function and its role is assessed to ascertain to what extent SAMA can rely on its output in determining how much substantive testing needs to be done by SAMA. All the processes noted results in a written communication to the banks to which it must respond with details of actions being taken. Subsequent progress reports are monitored by the relationship officers.</p> <p>Moreover, SAMA still exercises extensive powers to review ex ante and approve bank policies, as well some individual transactions (e.g., lending to non-residents) and investments.</p>
Assessment	LC
Comments	<p>The size of available resources explains that SAMA can conduct a thorough supervisory process of Saudi banks. There are over 200 supervisors; that number has doubled over the past five years and further increases are contemplated (partly to prepare the likely inclusion in SAMA's supervisory perimeter of finance companies once the related draft law is passed). Although some staff are in training or dedicated to non-core supervisory tasks (e.g., licensing of branches, ATMs etc.), this represents a very significant staffing for a system that counts only a limited number of banks.</p> <p>The annual supervisory review is an intensive one day process involving a top-down approach. Regular</p>

	<p>bilateral meetings with the banks' key staff (MD, CFO, CRO etc.) usefully complement this process, keep information up to date and cover some issues in more depth.</p> <p>The schedule for full-scope examinations should be better defined to avoid crowding effects (i.e., most banks covered in 2007 and 2008, only one in 2009 and 2010), they could usefully be more frequent in line with SAMA's risk-based policies.</p> <p>While the traditional on-site examinations are more extensive, they appear to concentrate heavily on control procedures and, perhaps because the process seems to be executed largely by the accounting firms involved, appear less concerned with traditional loan-by-loan reviews and the adequacy of specific provisioning, or detection of large exposure, relationships between borrowers and between the banks and its related parties. SAMA should consider devoting resources to examine, individually, large exposures and significant problem assets and their associated classification and provisioning. As noted above (CP17) as well as meetings with board chairmen SAMA could consider having meetings with whole boards to ensure that its assessment of boards' effectiveness is well founded and so to ensure that all directors understand the view that SAMA takes of the bank.</p> <p>Limited scope examinations should focus more on actual risks and banks' ability to manage them. Overall, Increased attention should be paid to branches of foreign banks</p>
Principle 21.	Supervisory reporting. Supervisors must have a means of collecting, reviewing and analyzing prudential reports and statistical returns from banks on both a solo and a consolidated basis, and a means of independent verification of these reports, through either on-site examinations or use of external experts.
Description	<p>Relevant laws and regulations: BCL Articles 15 and 17,</p> <p>BCL Article 15 and 17, respectively, empower SAMA to collect a consolidated monthly balance sheet and other information it deems necessary for the purposes of supervision. The requirements are elaborated in the Ministerial Decision on rules for enforcing provision of the BCL and permit SAMA to collect information on a consolidated basis. The reporting requirements cover all main risks and include large exposures, related lending etc., as well as profitability and capital adequacy.</p> <p>The reports are based on accounting principles for banks which are based on IFRS (see CP 22 below). Valuation procedures are those set out in IFRS.</p> <p>Data is collected monthly, quarterly, and annually. Some data are not collected from branches of foreign banks as the subject is not relevant, e.g., capital.</p> <p>SAMA also has full access to all a bank's records during on-site examination, including internal management accounts, which is authorized under Article 18.</p> <p>Although the BCL is silent on access to staff, in practice examiners also have full access to all staff and SAMA report no case where access was denied. Article 23 authorizes SAMA to impose penalties on any refusal or delay in meeting information requirements.</p> <p>The bank's senior management is held accountable for the accuracy and periodicity of information (see BCL Article 22). Information is validated by SAMA and during onsite examination.</p> <p>SAMA reports that the quality of information supplied is good.</p> <p>In addition to accounting firms' participation in on-site examinations (see CP 20), SAMA has occasionally employed experts, for example in validating applications for use of advanced approaches for Basel II. External auditors are required by the Ministerial Decision and also by a SAMA circular of 2010 to bring to SAMA's attention any shortcomings identified by them during their audit work. In addition SAMA has access to auditors' management letters.</p>
Assessment	LC
Comments	The reliability of ERMS returns should be systematically assessed during full-scope on-site visits. This is contemplated by existing procedures but not always reflected in the scoping of the mission (which is particularly important due to the large role played by auditing firms in this process) nor in the report.
Principle 22.	Accounting and disclosure. Supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with accounting policies and practices that are widely accepted internationally, and publishes, on a regular basis, information that fairly reflects its financial condition and profitability.

Description	<p>Relevant laws and regulations: (i) BCL (art. 14, 15, 24), (ii) Rules for enforcing the provisions of the BCL, 1986, (ii) Circular on accounting standards for banks, 1994, (iii) Circular # 26897 dated 24 November 2010 External audit engagement letter, (iv) SAMA, Rules for banks in Saudi Arabia for organizing and implementing Audit Committees, 1994.</p> <p>Article 14 of the BCL requires banks to have two external auditors chosen among persons registered with the Ministry of Commerce and Industry. There is no specific requirement giving SAMA power to reject and rescind the appointment of an external auditor it considers unfit. In practice, SAMA expects Saudi banks to appoint external auditors affiliated to the networks of the Big four accounting firms (and periodically rotate partners). SAMA can also request from auditors “any data, explanations or information” on a bank (art. 3 of the rules for enforcing the provisions of the BCL). SAMA also requires to be notified if an external auditor resigns or is dismissed (1994 rules on Audit Committees)</p> <p>The Chairman, Managing director and Directors of banks can be held responsible for contraventions with the provisions of the law (BCL Article 24).</p> <p>In the early 1990s, SAMA communicated to Saudi banks that it expects them to prepare their public financial statements using International Accounting Standards (now IFRS). The 1993 accounting circular indicates in particular that banks are required to apply IAS in full on financial statements published as of December 1994. A review of a sample of banks’ published financial statements as well as discussions with banks and external auditors confirm that Saudi banks use IFRS (rather than the less detailed Saudi accounting standards mandated for listed companies). This provides the basis for valuation rules that are consistent, realistic and prudent and detailed disclosure.</p> <p>SAMA expects Big four external auditors to implement ISA when conducting their work and leverage of their global expertise. Saudi auditing standards issued by SOCPA strictly restrict advisory services auditors can provide (i.e. tax related only).</p> <p>CMA, disclosure requirements apply to all banks. The obligation to publish financial statements for all banks (included non-listed ones) is defined in an old SAMA circular. Banks also comply in practice with IFRS disclosure requirements.</p> <p>SAMA ensures that banks regularly publish financial statements in line with IFRS disclosure requirements (i.e. detailed quantitative and qualitative information covering inter alia governance, risk management, risk exposures and transactions with related parties), as well as its own Pillar 3 requirements. In practice, banks are required to submit to SAMA their financial statements and obtain its letter of no objection before releasing them. When necessary, SAMA uses this window of a few days to communicate to each bank its expectations in terms of counter-cyclical provisioning and capital retention (e.g., dividend distribution). Requirements vary from bank to bank in light of their risk profiles. SAMA only issues its letter of no objection once it is satisfied its expectations are met, which proved to be an effective approach.</p> <p>SAMA regularly publishes aggregate information on the banking system and a more detailed presentation in its Annual Report. Such information includes aggregate data on balance sheet indicators and statistical parameters that reflect the principal operations of banks’ operations.</p>
Assessment	LC
Comments	<p>SAMA’s supervisory approach has allowed the early introduction of IFRS and ISA for Saudi banks, thereby strengthening the reliability of their financial statements and SAMA’s supervisory process.</p> <p>SAMA’s proactive approach also lead Saudi banks to build countercyclical provisions (and capital buffers), which proved very useful in recent years in a more challenging economic environment. However, the timing of the communication of SAMA’s expectations sometimes proved challenging for banks and their auditors. SAMA should contemplate communicating its expectations at an earlier stage.</p> <p>Although most banks are listed, the assessors were informed that none disclosed their exposures and risks related to Al Gossaibi and Saad after these groups defaulted in 2009. The assessors were further informed that disclosing information on individual customers would not be allowed by the provision of the BCL. It is unclear how market discipline (Pillar 3 implemented by SAMA) can be effective if banks cannot disclose the impact of material event (such as the default of a large exposure) on their profitability and financial strength or how the capital market authority can allow large listed companies not to disclose such</p>

	<p>information.</p> <p>The strict confidentiality requirements applied in these matters should be revisited to ensure that proper disclosure can be implemented and all market sensitive information disclosed when necessary. For cases where the release of such information could affect the safety and soundness of an institution, coordination between SAMA and CMA should be carefully organized and covered in their proposed MOU so that the market impact of any disclosure can also be managed in the interests of depositors and financial stability preserved.</p>
Principle 23.	Corrective and remedial powers of supervisors. Supervisors must have at their disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability, where appropriate, to revoke the banking license or to recommend its revocation.
Description	<p>Relevant laws and regulations: (i) BCL, (ii) Rules for enforcing the provisions of the BCL, 1986</p> <p>As part of the off and on-site supervisory process, SAMA has frequent opportunities to raise concerns with banks' senior management and boards. For instance:</p> <ul style="list-style-type: none"> • A structured process is in place for on-site inspections, with detailed recommendations issued at the end of the mission followed by quarterly progress reports on their implementation and follows up actions when necessary. • A detailed monitoring of capital adequacy is undertaken off-site, including an in-depth dialogue of the ICAAP process at the end of which SAMA can (and has) required that Pillar 2 capital adequacy targets be raised. • Article 22 of the BCL contemplates a formal graduated process when a bank does not comply with provisions of the BCL or “adopts a policy that might seriously affect its solvency and liquidity”. It has never been used, as other supervisory interventions proved sufficient to ensure the implementation of appropriate corrective actions where needed: • SAMA may, with the approval of the Minister: (i) appoint one or more advisers; (ii) order the suspension or removal of any director or officer; (iii) limit or suspend the granting of credits or the acceptance of deposits; or (iv) require the bank to take such steps as it may consider necessary. The rules for enforcing the provisions of the BCL further mention that (i) SAMA may appoint an observer in the Board of directors; and (ii) may take any other measures that it deems necessary, with the approval of the Minister, • If the violations persist, SAMA may, with the approval of the Minister, call upon a bank to submit its reasons for the contravention accompanied by its proposals to rectify the position within a stated period. If such proposals are not sufficient or not implemented, the Minister may, subject to the approval of the Council of Ministers, revoke the license of the bank. <p>Article 23 also empowers SAMA to fine banks in cases of non compliance with provisions of the BCL and its implementing regulations. Depending on cases, sanctions are taken either by the Governor or Deputy Governor for technical affairs to which supervision reports. No fines were ever imposed on individuals. The assessors were informed that significant fines were imposed on banks.</p> <p>A circular also indicates that as part of the no objection process, SAMA may restrict the payment of dividends. In multiple instances, SAMA requested banks to reduce their payout ratios.</p> <p>Sanctions and fines can both be imposed on legal and natural persons. They are not made public.</p> <p>There have been no recent instances of problem banks in Saudi Arabia. In the distant past, SAMA participated in the orderly resolution of problem banks (e.g., in 1958 when the government took over a failed private bank and in 1994 when a distressed institution was taken over by a larger and stronger peer).</p> <p>Should a bank become bankrupt, general corporate bankruptcy provisions would apply and be administered by a party with no links to SAMA. Applicable legal provisions do not contemplate a role for SAMA in this process (i.e. it would neither be involved when the decision to declare a bank insolvent is taken and a receiver appointed, nor during the actual liquidation of the bank).</p> <p>There is no prompt corrective action framework to guard against the supervisor unduly delaying appropriate corrective actions.</p> <p>Despite a lack of formal arrangements for non bank financial institutions, SAMA mentioned it would</p>

	ensure they are aware of its actions and, where appropriate, coordinates its actions with them.
Assessment	LC
Comments	<p>The BCL gives very broad powers to SAMA which can take supervisory action where a bank adopts a policy which might seriously affects its solvency or liquidity. SAMA considers that any material and lasting breach of its circulars and guidelines would constitute such a situation. Only the formal power to impose fines has been used in a few cases.</p> <p>In the distant past, SAMA has been able to deal with problem banks in an orderly manner without using the specific measures contemplated by the BCL. While the lack of formal enforcement action might suggest a relaxed attitude to compliance or even forbearance, assessors encountered no evidence of this yet.</p> <p>SAMA indicated that all Saudi banks were meeting all prudential requirements and were solid; reducing the likelihood it would have to deal with problem banks in the short term. Still, the current framework would be strengthened further by (i) introducing, in line with other G20 countries, a specific resolution regime for banks (including a specific bankruptcy regime taking into account the specificities of banks and giving appropriate responsibilities to SAMA) and (ii) lifting the need to obtain the approval of the Minister (or any other authority) to take formal supervisory action.</p>
Principle 24.	Consolidated supervision. An essential element of banking supervision is that supervisors supervise the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential norms to all aspects of the business conducted by the group worldwide.
Description	<p>Relevant laws and regulations: (i) BCL; (ii) Rules for enforcing the provisions of the BCL, 1986; (iii) SAMA, Circular on consolidated supervision, June 2008.</p> <p>Saudi banks increased the number of their domestic and foreign subsidiaries in recent years. Banking group structures remain relatively simple with a limited number of subsidiaries and foreign branches which represent only a small, but sometimes growing, share of banking groups' consolidated assets and revenues. SAMA reviewed and approved the establishment of any new subsidiary or foreign branch. It is familiar with the overall structure of banking groups and has an understanding of all material parts of these groups.</p> <p>Under the broad powers defined by the BCL, SAMA can review the overall activities of banking groups and impose consolidated requirements. In practice, key regulatory requirements (capital requirements, large exposures, related parties etc.) apply on a consolidated basis, with detailed and regular reporting requirements through ERMS. Off- and on-site supervisory processes cover risks non banking activities may pose to a bank.</p> <p>SAMA maintains regular contacts with domestic (CMA and SAMA Insurance department) and foreign supervisors to keep abreast of material risks that may surface in Saudi banks' subsidiaries and foreign branches. This includes (i) regular discussions with banks' senior management to ensure they maintain proper oversight of foreign operations and (ii) regular visits to foreign subsidiaries of Saudi banks and their host supervisors (on average every two years) to assess their financial condition and adequacy of risk management ad controls. Through its contacts with host supervisors and periodic visits abroad, SAMA ensures that the local management of foreign subsidiaries, branches and joint ventures has the necessary expertise and information to oversee such activities, and can rely on an appropriate internal control framework. There was no case where a Saudi bank could not access all material information from their foreign branches and subsidiaries.</p> <p>There is no specific provision empowering SAMA to require the closing of foreign offices or impose limitations on their activities (i) if host supervision is inadequate or (ii) if SAMA cannot access relevant supervisory information. Although no such case ever occurred, SAMA considers that its broad powers would allow it to react appropriately (e.g., ability to give direction to a bank when it "adopts a policy that might seriously affect its solvency or liquidity").</p>
Assessment	LC
Comments	SAMA practices consolidated supervision as part of its broad mandate ("to regulate commercial banks") and uses extensive powers defined in its Charter and the BCL. Consolidated supervision is becoming increasingly important as the number and size of domestic and foreign subsidiaries is growing. SAMA

	<p>would benefit from a more specific habilitation and powers in the area of consolidated supervision, as recommended by the previous FSAP and contemplated in a 2008 draft amendment to the Ministerial decision regarding rules for enforcing the provisions of the BCL.</p> <p>On-site inspection is appropriately used as a key component of the consolidated supervision process. More systematic attention should be paid during full-scope on-site visits to the effectiveness of the oversight framework established by the head office both for domestic and foreign subsidiaries and branches (including links between the different internal control functions —internal audit, risk management, compliance etc., — effective exchange of information between them and follow-up on identified shortcomings by the from head office).</p>
Principle 25.	Home-host relationships. Cross-border consolidated supervision requires cooperation and information exchange between home supervisors and the various other supervisors involved, primarily host banking supervisors. Banking supervisors must require the local operations of foreign banks to be conducted to the same standards as those required of domestic institutions.
Description	<p>SAMA believes it has good informal but effective relations with home and host supervisors in respect of operations of foreign banks in Saudi Arabia and operations of Saudi banks abroad. So far SAMA has not felt the need to formalize these relationships with MOU or other written agreements. The amount of information requested and supplied has been adequate to meet SAMA’s needs. Foreign supervisors regularly visit Riyadh for the purpose of examining subsidiaries and branches of banks for which they are home supervisors and SAMA officials visit foreign home and host supervisors. No permission is required for the examination of Saudi operations by foreign supervisors but home supervisors are required to notify SAMA in advance and SAMA officials normally meet visiting supervisors at the time of the visit. SAMA is not aware of any problems preventing access to all the information that home supervisors require. Before licensing a branch or affiliate of a foreign bank, SAMA would always ascertain the home supervisor’s views and obtain an assurance that it had no objection. SAMA also assesses the quality of home supervision before entertaining a license application. Home supervisors have full access to the books and records of Saudi affiliates and branches in order to verify KYC requirements. There are no shell banks in Saudi Arabia. It is rare to take supervisory action in respect of branch of a foreign bank, but SAMA stated that it would inform the home supervisor as quickly as possible.</p>
Assessment	C
Comments	<p>SAMA should consider again the value of formal written understandings with other supervisors. Although informal arrangements have their advantages, negotiation of an MOU can reveal barriers to the provision of information which it is useful to be able to resolve rather than discovering them in an emergency when time is short. The aggressive foreign expansion plans of some Saudi banks make such planning a pressing need.</p> <p>Exemptions from the confidentiality provisions in the BCL should be explicitly allowed to facilitate the exchange of information for supervisory purposes</p>