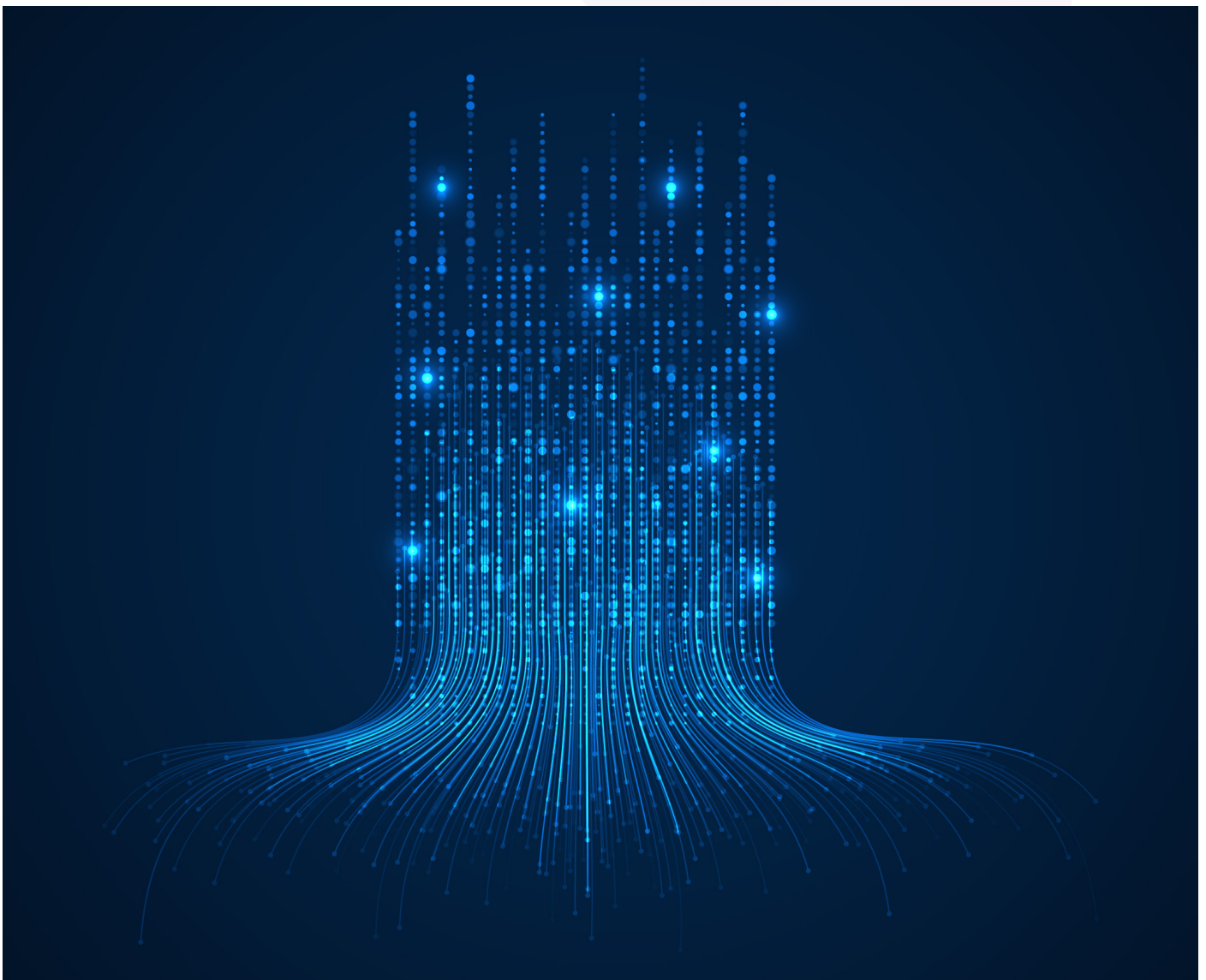


# Netting Evolution in Kingdom of Saudi Arabia

Building Resilient Financial Systems



# FOREWORD

The Saudi Central Bank (SAMA) recently introduced a comprehensive Netting Regulation, anchored in the Saudi Bankruptcy Law, to enhance legal certainty for financial contracts during insolvency. The regulation covers close-out netting agreements, financial collateral arrangements, and qualified financial contracts, including Shari'ah-compliant instruments. Importantly, these regulations are effective immediately, marking a significant shift in the legal and regulatory landscape for financial institutions operating in the Kingdom.

This paper discussed the potential impact areas arising from the netting of contracts, actions which banks will need to take, potential challenges which are expected to arise and how banks could consider addressing such challenges.

## Key Implications

- **EAD under CCR:** Enables banks to recognize netting agreements, substantially reducing exposure-at-default (EAD), leading to significant capital savings and more competitive pricing in derivative and repo transactions.
- **Credit Valuation Adjustment (CVA):** Legally enforceable netting reduces potential future exposures, decreasing CVA capital charges, and improving profitability for banks by allowing more accurate trade valuations and better hedging strategies.
- **Net Stable Funding Ratio (NSFR):** Allows banks to net derivative receivables and payables, freeing up liquidity, improving NSFR ratios, and enhancing banks' ability to support market-making and trading activities without liquidity constraints.
- **Leverage Ratio:** Reduction in gross derivative exposures due to enforceable netting significantly improves banks' leverage ratios, enabling more strategic asset growth and improved capital efficiency.

## Implementation Challenges and Considerations:

While the benefits are clear, successful implementation of these regulations requires careful consideration of the following challenges:

### Legal and Operational Complexity

Banks face the challenge of revising existing ISDA agreements, aligning netting practices with Shari'ah compliance, and assessing enforceability opinions across multiple jurisdictions.

### System and Data Readiness

Significant upgrades to existing risk, trading, and reporting infrastructure are required to effectively capture netting sets and maintain accurate data.

### Market Confidence

Immediate action is required to develop and publish ISDA netting opinions specific to Saudi Arabia, crucial for fostering market trust and fully realizing regulatory benefits.

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### Uniquis's Implementation Approach:

Uniquis recommends a structured three-phase approach:

- **Assessment:** Conducting detailed diagnostics of current capabilities and gaps.
- **Enhance and Build:** Standardizing data fields, modernizing legacy processes, automating netting logic, and integrating comprehensive risk frameworks.
- **Optimize and Knowledge Transfer:** Driving change management, training, and process optimization to fully embed and maximize the benefits of the regulation.

We now delve deeper into each of the specific aspects.



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# BACKGROUND AND LEGAL FOUNDATION

## Context and Objective

The Netting Regulation was introduced under **Article 214 of the Saudi Bankruptcy Law (2018)**, empowering SAMA to designate certain financial contracts as exempt from bankruptcy limitations such as **stays on set-off or collateral enforcement**. This legal certainty is crucial for mitigating systemic risk, enhancing creditor confidence, and facilitating seamless risk management in the event of counterparty default or insolvency.

## What It Covers

### Close-out Netting Agreements

Enables the termination and valuation of contracts and consolidation of obligations into a **single net balance**, immediately payable upon default.

### Financial collateral arrangements

Legal frameworks for securing exposures via **title transfer or security interest**, enforceable even after bankruptcy proceedings commence.

### Qualified Financial Contracts

Includes interest rate and currency swaps, credit derivatives, repos, securities lending, Shari'ah-compliant contracts such as murabaha and wa'ad, and others listed in **Annex (I)** of the Regulation.

## Scope of Application

The **Close-out Netting and Related Financial Collateral Arrangements Regulation**, issued by SAMA, applies to:

- Any **Netting Agreement** or **Financial Collateral Arrangement** related to a **QFC**.
- Involving **at least one financial institution supervised by SAMA**.
- Including **multibranch arrangements**, thereby covering obligations incurred by foreign financial institutions operating through branches in Saudi Arabia.

This ensures that protections under the regulation apply even when:

- Transactions are cross-border in nature,
- The **foreign counterparty's branch** in Saudi Arabia becomes subject to bankruptcy or insolvency proceedings.

This broad applicability brings Saudi Arabia in line with international standards and establishes a level playing field for both local and international participants operating within its financial system.



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# IMPLICATIONS OF NETTING REGULATIONS

## CCR

### Context under Basel III (SA-CCR):

The Standardized Approach for Counterparty Credit Risk (SA-CCR) allows banks to calculate exposure on net basis subject to legally enforceable netting/ISDA agreements.

### Changes & Benefits Post-Regulation:

#### BEFORE

EAD was calculated on a gross basis for counterparties lacking enforceable agreement.

#### AFTER

Banks can now:

- Recognize netting sets for derivative and SFT exposures.
- Use replacement cost (RC) and potential future exposure (PFE) based on netted portfolios.
- Apply collateral haircuts and offsets more effectively under SA-CCR.

### Impact Across Functions:

#### Capital Computation

##### CHANGES

Lower EAD → Reduced RWA under CCR

##### BENEFITS

Higher capital efficiency

#### Risk Data Systems

##### CHANGES

Need to capture netting sets, enforceable agreements

##### BENEFITS

Accurate net EAD computation

#### Agreements & Legal

##### CHANGES

Maintain up-to-date, enforceable ISDA/CSA documentation

##### BENEFITS

Avoids capital penalty for unenforceable netting

#### Front Office

##### CHANGES

Can price in better RAROC due to lower CCR cost

##### BENEFITS

Competitive pricing on trades

#### Risk Reporting

##### CHANGES

Revise exposure metrics and stress tests

##### BENEFITS

More precise reporting to ALCO/regulators

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**Overall Benefit:**



**Optimized derivatives and repo portfolios**



**Capital savings due to netting**



**Better utilization of limits and counterparty exposures**

## CVA

**Context under Basel III - KSA Region:**

Most banks in KSA have adopted the Basic Approach (BA-CVA) for CVA risk. CVA captures the loss in MTM from counterparty credit deterioration before default. Enforceable netting reduces expected exposures and thus CVA risk.

**Post-Regulation Impact:**

- Lower EAD → Lower CVA capital charge.
- Reduced maturity-adjusted exposure (EAD × M) in formula due to netting.
- Improved hedging strategies, as exposures are now clearly modelled.

**Impact Across Functions:**

	Risk Models	
<b>CHANGES</b>	BA-CVA model now incorporates netting impact	<b>BENEFITS</b>
		Lower capital provisioning
	Systems	
<b>CHANGES</b>	Update CVA calculators with netted exposures	<b>BENEFITS</b>
		More precise MtM estimates
	Valuation	
<b>CHANGES</b>	Expected exposure curve shifts downward	<b>BENEFITS</b>
		Accurate trade valuation
	Pricing & Treasury	
<b>CHANGES</b>	Less CVA cost → better pricing	<b>BENEFITS</b>
		Greater profitability on OTC
	Stress Testing	
<b>CHANGES</b>	CVA under stressed spreads becomes more stable	<b>BENEFITS</b>
		Improved stress scenario alignment

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**Overall Benefit:**



**Lower CVA Charge**



**Reduced drag on derivative portfolios**



**Enhanced derivative pricing strategy**

**NSFR**

Currently, payables and receivables on account of derivative transactions are reported under NSFR on gross basis under available stable funding (ASF) and required stable funding (RSF) respectively.

**Post-Regulation Impact:**

**BEFORE**

ASF and RSF calculated on gross basis leading to increasing funding needs.

**AFTER**

Netting enforceability allows:

- **Netting of derivative liabilities**, lowering RSF.
- **ASF utilization is freed up**, supporting new activities.

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**Impact Across Functions:**

Liquidity Reporting

**CHANGES**

Update RSF metrics to reflect netted liabilities

**BENEFITS**

Lower RSF, higher NSFR

Treasury & ALM

**CHANGES**

More efficient funding allocation

**BENEFITS**

Supports market-making, trading books

Systems & Data

**CHANGES**

Revise derivative exposure tracking

**BENEFITS**

Enhanced liquidity profiling

Policy & Governance

**CHANGES**

Reflect enforceable netting in NSFR policy

**BENEFITS**

Compliance with Basel III rules

**Overall Benefit:**



**Strengthened long-term liquidity profile**



**Reduced cost of stable funding**



**More room for capital markets activity without liquidity constraints**

# Leverage Ratio

The Basel III Leverage Ratio is a non-risk-based measure to restrict the build-up of leverage in the banking sector. It is defined as the ratio of Tier 1 capital to total exposure (which includes on-balance sheet exposures, derivative exposures, securities financing transaction exposures, and off-balance sheet items).

## Post-Regulation Impact:

### BEFORE

Derivative exposures calculated on a gross basis, leading to higher total exposure.

### AFTER

Enforceable netting allows for:

- **Netting of derivative exposures**, reducing total exposure measure.
- **Lower leverage ratio denominator**, improving the leverage ratio.

## Impact Across Functions:

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Capital Adequacy	
<b>CHANGES</b>	<b>BENEFITS</b>
Reduced total exposure measure	Improved leverage ratio

Risk Management	
<b>CHANGES</b>	<b>BENEFITS</b>
Better alignment with actual risk	More accurate leverage assessment

Regulatory Reporting	
<b>CHANGES</b>	<b>BENEFITS</b>
Reflect netted exposures in leverage ratio reports	Compliance with Basel III standards

Strategic Planning	
<b>CHANGES</b>	<b>BENEFITS</b>
Enhanced capacity for asset growth	Supports business expansion without breaching leverage constraints

## Overall Benefit:



**Improved leverage ratio**



**Enhanced capacity for balance sheet growth**



**Better alignment of leverage with actual risk exposure**

## Strategic Outlook and Market Impact

The Close-out Netting Regulation is more than a legal milestone—it is a foundational step in the evolution of Saudi Arabia's capital markets. Its broader impact includes:

- Alignment in the Regulatory Reporting, financial reporting and the way settlement happen with the counterparties on a net basis.
- Netting allows banks to engage more competitively in cross-border derivative transactions, particularly with global banks. This results in better pricing / valuation while entering in the contract.

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# ACTIONABLE FOR BANKS IMPLEMENTING SAMA'S NETTING REGULATION

While the genesis of the regulations is clear and has been in contention since long, along with the implications. However, implementation of these would require efforts in multiple directions as listed below:

## Agreement Review and Compliance

While ISDA agreements would typically be in place with the counterparties engaging in derivative transactions, it's imperative to undertake legal vetting to ensure that these agreements cover netting language and enforceability clauses.

Additionally, ISDA agreements might undergo a change to incorporate the enforceability clauses for bankruptcy scenarios in line with ISDA standards.

## Rapid Diagnostic of the CCR computation, NSFR and Leverage Ratio

These regulations will directly impact CCR, NSFR and the Leverage Ratio. Therefore, banks need to assess the current state vs the requirements stipulated in the netting regulation, in terms of - **data model enhancement, methodology change, and system level changes.**

Banks should also undertake an impact assessment of implementation of netting regulations on capital, liquidity, and leverage to evaluate how the potential benefits translate into bottom line improvements and more effective operations.

## Technology and Process Upgrades

**Implement netting-specific modules** in trading platforms to calculate single net sums post-default automatically. Enhance reporting platforms (OFSA, SAS, or other capital engines) by addressing required data model enhancements and methodology adjustments.

## Sensitization and Training Sessions

Considering its wide impact across functions – Treasury, Risk, Finance and IT, engage with the senior management for sensitization along with training sessions for the personnel involved in these processes.



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# IMPLEMENTATION CONSIDERATIONS AND CHALLENGES

While the Close-out Netting Regulation issued by SAMA provides legal and regulatory clarity, its effective implementation entails substantial transformation across legal, operational, and systemic dimensions. Below is a comprehensive analysis of the challenges and practical considerations for market participants.

## Legal and Structural Considerations

01

### Shari'ah Compliance Challenges:

Applying close-out netting to Islamic finance instruments such as Murabaha, Wa'ad, and Ijara remains novel. Harmonization between Shari'ah principles and commercial enforceability is essential, particularly for default scenarios.

02

### ISDA Agreement and Legal vetting

Capital recognition for netting under SA-CCR is subject to enforceable bilateral netting agreements/ISDA. In line with SAMA's Basel III Credit Risk guidelines and BCBS standards - The agreement must establish a **single legal obligation** across all included transactions (Cross-Product Netting).

**Enforceability must be confirmed** in all relevant jurisdictions where the bank has transactions, including:

- The counterparty's home jurisdiction.
- The jurisdiction governing the contract.
- The jurisdiction where the transactions are executed.

To support this, banks must obtain **reasoned and jurisdiction-specific legal opinions** including enforceability clauses:

- Conclude, with a high degree of certainty, that netting is enforceable in the event of default, bankruptcy, or liquidation.
- Are recognized as authoritative by the local legal community.
- Explicitly address the enforceability of each master agreement and the validity of the entire netting arrangement.

## Data and Systems Readiness Challenges

### Netting Set and Legal Mapping

- Banks must ensure availability of structured data on netting agreements, jurisdiction-specific terms, and counterparty documentation.
- Unique Netting IDs must be linked across front-office, risk, and reporting systems.

### System Enhancements

- Treasury, CCR, and regulatory systems need updates to reflect netting enforceability and real-time exposure aggregation.

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### Data Integrity Risks

- Incomplete or mismatched data across systems can result in non-recognition of netting, leading to higher capital requirements.

## Market Transition and Confidence Building

### Absence of Market Opinions

- ISDA netting opinions for Saudi Arabia are not yet publicly available. This hinders – capital release, interbank pricing confidence.

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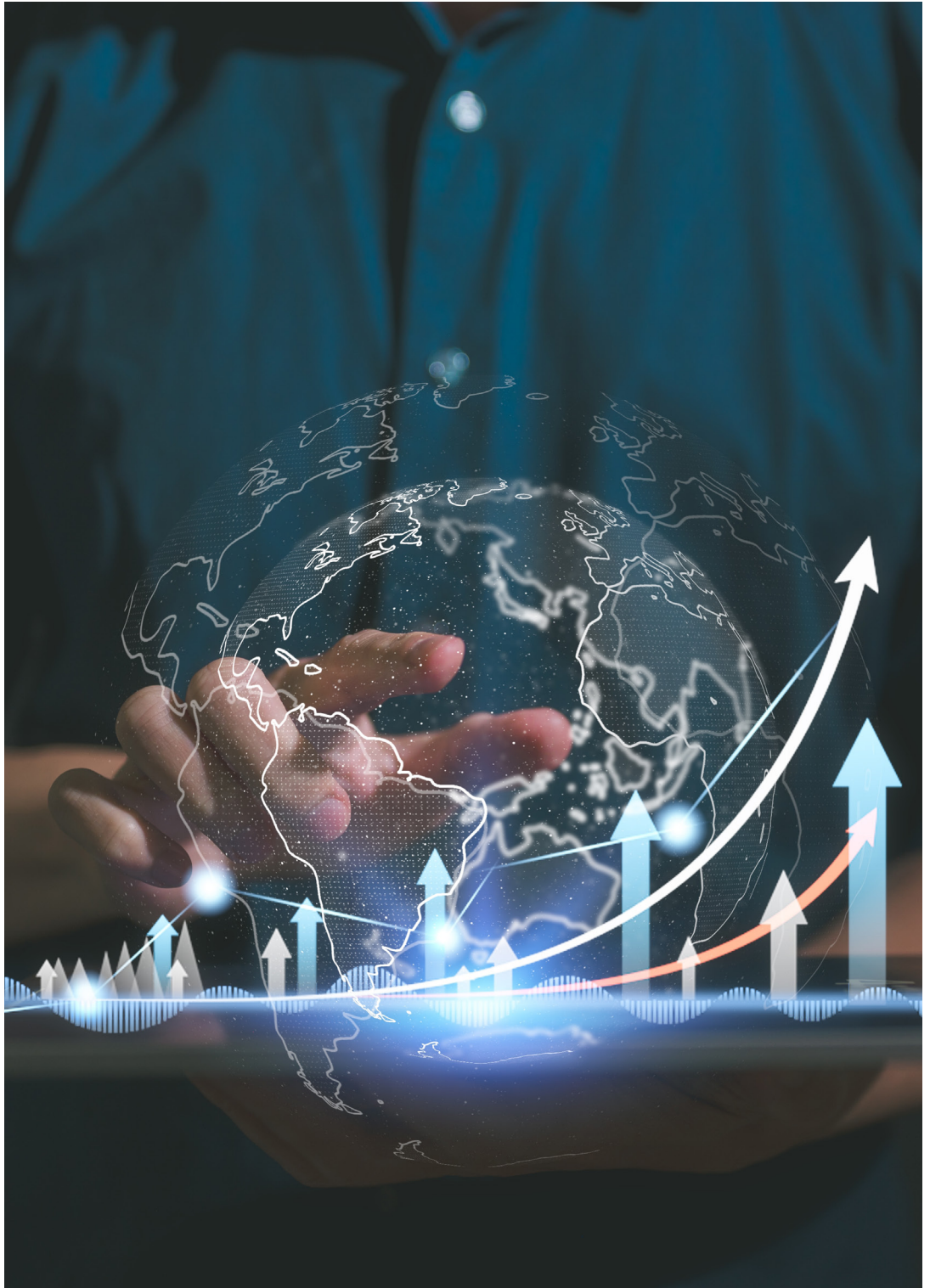
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We have seen the impact of these regulations, the actions banks need to take, and the associated challenges (data fields, legacy processes, unique customer identification, sourcing of netting IDs, and process overhauls).

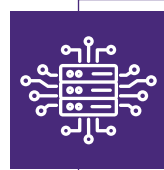
We envisage the implementation approach unfolding across three dynamic phases – starting with a Rapid Diagnostic in Phase 1, transitioning into Enhance & Build in Phase 2, and culminating in Phase 3 with Knowledge Transfer & Documentation.

## Assessment

Undertake an independent review of the bank's current state around CCR/CVA, NSFR and Leverage Ratio against the requirements of netting regulations.

This involves **thorough assessment of the bank's systems, processes, and compliance status regarding SAMA's netting regulations. This includes evaluating data fields, legacy processes, customer identification systems, netting ID management, and the need for process overhauls.**

## Enhance and Build



### Data Field Standardization

Identify required data fields for netting exposure across counterparty with same products, cross products, currency and tenors, and modernize these data fields by developing robust data model



### Unique customer identification

This is crucial to the overall implementation and hence implement robust customer identification frameworks to ensure accurate mapping of counterparties across transactions



### Overhaul legacy processes

Upgrade or integrate legacy systems to support automated netting calculations and enforceability tracking.



### Process redesign and Automation

Streamline data sourcing, workflow automation, and develop the whole logic to implement regulatory requirements to compute the exposure on a net basis which will flow for CCR, NSFR and Leverage Ratio computation.

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### Integration with overall risk management framework

Design the comprehensive framework covering limit management, collateral management along with implementation of stress scenarios to assess impact during counterparty defaults.

## Optimize and Knowledge Transfer

To optimize the whole process and assess the real impact, it's imperative to deploy change management program covering essential changes in processes and systems.

Additionally, conduct sensitization session and training sessions to reinforce the importance of these regulations and impact on bottom line.

These three phased structured approaches, ensures that banks address technical, operational, legal, and strategic challenges while maximizing the benefits of SAMA's new regulations and positioning themselves ahead of the curve.

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