



# Evolving banking regulation and supervision

Banking  
regulation and  
supervision

## A case study of the Saudi Arabian Monetary Agency (SAMA)

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### Abstract

**Purpose** – The purpose of this paper is to analyze the effectiveness of the Saudi Arabian Monetary Agency's (SAMA's) regulatory policies.

**Design/methodology/approach** – Both descriptive and comparative analyses are used, especially in highlighting SAMA's monetary policies and approach during the 2008 world financial crises.

**Findings** – The analyzes revealed that SAMA has more than adequately met international regulatory supervision standards, but will face challenges in regulating the domestic Islamic banking sector, meeting the self-imposed 2010 Gulf Cooperation Council (GCC) gulf monetary union under a fixed parity rate regime, developing cross border regulatory and supervisory skills, and suggests possible solutions.

**Practical implications** – The paper noted the role of SAMA in managing monetary policy under a fixed parity regime, its banking supervision policies, and the evolving nature of banking regulation in the face of globalization challenges, World Trade Organization (WTO) accession in 2006 and in coping with the 2008 global financial crises which could be a template for other GCC central banks. The paper highlighted the major elements and effectiveness of Saudi banking law and restrictions on Saudi banks in terms of capital adequacy, reserve requirements and financial services, and address issues such as the impact of new regulatory reforms by SAMA, and their effectiveness on monitoring and supervising Saudi banks.

**Originality/value** – The paper concludes that the effectiveness of SAMA's regulatory policies has withstood both domestic and international financial crises and that SAMA can play a powerful influence in the proposed GCC monetary union.

**Keywords** Banking, Regulation, Saudi Arabia, Monetary policy, Globalization

**Paper type** Research paper

### Introduction

In this case study we examine the structure of regulation, regulatory reform, and banking supervision in one of the most important countries of the Gulf Cooperation Council (GCC) – Saudi Arabia, whose economy dominates all the other five GCC countries (Ramady, 2005; SAMA, 2008; Azzam, 1997), and examine the role of the Saudi Arabian Monetary Agency (SAMA) in managing monetary policy under a fixed parity regime, its banking supervision policies, and the evolving nature of banking regulation in the face of globalization challenges and World Trade Organization (WTO) Saudi

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accession in 2006. We also examine the major elements of Saudi banking law and restrictions on Saudi banks in terms of capital adequacy, reserve requirements and financial services, and answer questions that address issues such as the likely impact of regulatory reforms by SAMA, as well as the effectiveness of SAMA's monitoring and supervision regime on Saudi banks to gauge whether SAMA is well placed to meet future global regulatory challenges, and the manner by which SAMA has tried to cope with most recent financial turbulence that has affected world markets.

Banks and other financial institutions operating in any country of the world have to operate under some form of regulation and supervision enforced by a Central Bank, a Monetary Authority, or an independent regulator such as the UK's Financial Services Authority (FSA). Given the importance of the financial sector to the economic wealth of nations and public confidence, one of the major objectives of bank regulations is to reduce the risk of failure, contagion and systemic risk in the financial system (Corrigan, 1985/1986; Rose, 1999). This became self evident during the most recent financial upheavals and the various responses of world financial regulators to contain the crises. Bank regulations are designed to prevent financial institutions from becoming too risky in their services. This is based on the need for such regulation and that banking, by its very nature, could be prone to market failure by assuming too much risk. If this were to materialize, the costs imposed on society as a whole by such a failure could exceed the direct and indirect costs of regulating the banking system (Spong, 1994; Peltzman, 1976; Hoening, 1997).

There is some debate on whether more regulation is welcomed or not by those being regulated. According to some (Stigler, 1971), firms in a regulated industry actually seek out regulation because it brings benefits in the form of monopolistic rents due to the fact that regulation often blocks entry into the regulated industry. Others argue that such regulation protects a firm and could induce institutions to take on more risk (Peltzman, 1976; Boyd *et al.*, 1993). Some err on the side of more regulation; arguing that this increases customer confidence in banks (Kane *et al.*, 1983). The 2008 world financial crises brought these different dilemmas to the forefront as different regulators either assumed a direct intervention role through bank share purchase, or injected liquidity to ensure the system functioned again, after inter-bank lending virtually seized up.

The principal reasons for bank supervision and regulation are many, and stem from the general pursuit of sound micro-economic policies and goals (Fischer, 1993). These range from protecting the safety of customer savings, promotion of public confidence in the financial system, ensuring the smooth flow of the payment system for goods and services, to ensuring adequate credit to the borrowing sectors. At the same time, regulation must be balanced and limited so that banks can develop new services to meet public demand and promote financial product innovation, without inhibiting such innovation (Rose, 1999).

In this paper, we examine SAMA and its institutional operating framework, and proceed to discuss the Saudi banking regulation and supervision framework. The future challenges to the Saudi banking sector in light of post-WTO accession and globalization of financial services are examined, as well as of the 2008 global financial crises. The paper concludes with recommendations for public policy and highlights the major issues that SAMA will face in the future, especially in the area of Islamic banking supervision, cross border bank supervision, and the issue of the unified GCC common currency and fixed dollar/Saudi Riyal (SR) peg.

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**SAMA's role: the institutional framework**

SAMA was established by Royal Decree in 1952 and has seen its role expand and evolve since its inception with foreign technical assistance (SAMA, 2004; Jasser, 2002; Ramady, 2005). SAMA is supervised by a Board of Directors that is headed by a Governor and Vice-Governor, both of whom are appointed by Royal Decree by the King for terms of four years. These terms can be extended by Royal Decree for similar periods. SAMA's Board consists of three other members nominated from the private sector who are also appointed by Royal Decree to serve for periods of five years.

SAMA's 1952 founding Charter stipulated that it would conform to Islamic Law. It could not be a profit-making institution and could neither pay nor receive interest. There were additional prohibitions, including one against extending credit to the government, but this was dropped in 1955 when the government needed funds and SAMA financed about one-half of the governmental debt that accrued in the late 1950s (Abdeen and Shook, 1984). The global financial crises of 2008 has forced SAMA to take a more proactive role through extending guarantees on all bank deposits in Saudi banks in line with other conventional central banks around the world.

The introduction of the Banking Control Law in 1966 was a watershed in SAMA's history, as the new regulation clarified and strengthened SAMA's role in regulating the Saudi banking system (SAMA, 2004, Jasser, 2002). The Banking Council Law vested SAMA with broad supervisory powers, and allowed the Monetary Agency to issue regulations, rules and guidelines regarding international supervisory developments that called for provision of capital adequacy, liquidity, reserve requirements, and loan concentration ratios. The Banking Control Law supported the broad range of financial services including banking, investments, and securities through their branches.

SAMA sees its main roles as follows:

- issuing the national currency the SR;
- acting as banker to the government;
- supervising commercial banks operating in Saudi Arabia;
- advising the government on the public debt;
- managing the Kingdom's foreign exchange reserves;
- conducting monetary policy for promoting price and exchange rate stability; and
- promoting economic growth and ensuring the soundness of the Saudi financial system.

The management of SAMA mostly draws upon Western central bank and International Monetary Fund (IMF) philosophies, and close technical and training cooperation is carried out with leading Western Central banks and the Basel-based Bank for International Settlements (BIS). This has resulted in SAMA adopting a basically Western central banking approach in terms of bank supervision and risk management (Dukheil, 1995). As such SAMA will, by and large, implement global regulatory supervisory policies that may be adopted following the financial crises of 2008.

**Saudi banking regulation and supervision**

Independence of central banks to perform their mission without coming under political or other pressure from governments is critical to the success of central bank policies

and retaining public confidence (Woodward, 2000; Alesina *et al.*, 1993). Some have defined two different types of independence of central banks – “instrument independence,” or the ability of the central bank to set monetary policy instruments and “goal independence,” or the ability of the central bank to set the goals of monetary policy (Fischer, 1993). The SAMA seems to possess both types of independence, but as will be examined later, it is restricted in “goal independence,” given the fixed rate parity of the Saudi Arabian currency – the SR to the US dollar (Jasser, 2002).

Research seems to support the conjuncture that macro-economic performance will be improved by making a central bank more independent (Friedman, 1982). When central banks are ranked from least independent to most independent, inflation performance is found to be the best for countries with the most independent of central banks. Others (Posen, 1995) have cast doubt however, on whether the causality runs from central bank independence to improved inflation performance.

### **SAMA’s objectives**

The key objectives of the Saudi Arabian monetary policy are to stabilize inflation and the general level of prices, to maintain a fixed exchange rate of the SR against the US dollar, and to allow free movement of currency and capital (Azzam, 1997; Jasser and Banafa, 2003). To this may be added policies to ensure the financial soundness of the Saudi banks and their viability in the face of global financial crises. There are no capital controls in Saudi Arabia, as the Kingdom adopts a free market economic system and feels that capital controls are seldom effective as evidenced from experience from other parts of the world (Edwards, 2000). According to SAMA there are limitations to current monetary policies in Saudi Arabia due to the openness of the economy, with the riyal effectively pegged to the US dollar since the suspension of the special drawing right riyal link in May 1981 (Jasser and Banafa, 2003).

In terms of major regulatory requirements as applicable to Saudi banks, Table I sets out SAMA’s key regulatory framework.

Table I demonstrates that SAMA has employed a wide range of regulatory requirements in line with international banking practice to effect monetary policy (Friedman, 1999). SAMA has been particularly active in ensuring that local banks are more than adequately capitalized. Saudi banks apply the standardized approach – for both credit and operational risks – of the revised Basel II capital accord from January 1, 2008. Banks are expected to gradually move to internal ratings-based approaches for measuring regulatory capital changes for loan portfolios between 2009 and 2001, after pooling credit risk data under the patronage of the Saudi Credit Bureau (SAMA, 2008).

In line with other Central Banks in the Gulf region, SAMA is solely responsible for monetary policy formulation and implementation (Hussein *et al.*, 2007). It is free to select its operating procedures and to determine the choice of instruments as well as when to apply them. SAMA applies no direct controls, particularly with respect to control of interest rates and foreign exchange. The first is due to SAMA’s charter, which prohibits the payment and receiving of interest; furthermore, there is no discount rate policy. This is unlike the banking regulation and supervision practices of some other GCC countries (Hussein *et al.*, 2007). As such, interest rates play a subsidiary role, as they are predominantly affected by US dollar interest rates.

While SAMA’s Charter precludes it from acting as a “lender of last resort” in the traditional manner, the monetary agency has played a supportive role in the local

Statutory and general reserves	In accordance with the Saudi Arabian Banking Control Law, a minimum of 25 percent of the annual net income is required to be transferred to a statutory reserve until this reserve equals the paid up capital of the bank. This reserve is not available for distribution
Capital adequacy	Saudi Arabia has implemented the principles set forth in the Basel capital accord, under the provision that cross-border exposures to all GCC countries be weighted at 0 percent. Under the Basel Accord, only cross-border exposure to Organization for Economic Cooperation and Development member countries has weighting of less than 100 percent. Mortgage loans, however, are risk weighted at 100 versus 50 percent. In addition, under the Banking Control Law, customer deposits may not exceed 15 times a bank's capital and reserves. The average capital adequacy ratio stood at 18.2 percent at December 31, 2007, and 18.9 percent in October 2008
Equity participations	Banks may not hold stakes in other companies of more than 10 percent of in the company's paid in capital, and the nominal value of this stake must be no greater than 20 percent of the bank's equity
Verification, examination and inspection	SAMA performs this role, and it can be carried out at any time, onsite and offsite. Evaluation based on the capital, assets, management, equity, and liquidity model
Mergers and acquisition	Permission has to be granted by SAMA
Related-party exposures	Exposure to a single group is subject to a legal lending limit of 25 percent of equity, which SAMA can increase to 50 percent in exceptional circumstances. Lending to related parties is restricted to 5 percent of capital on an individual basis, and to 50 percent of capital on an aggregate basis. In addition, such exposures must be fully collateralized
Foreign-exchange risk	The level of foreign currency in the banking sector is rather limited. SAMA takes a relaxed view of the riyal's exposure to the US dollar (due to the fixed-exchange rate between the two currencies), but adopts a tougher approach toward banks that take on significant exposure to other currencies. Banks state their foreign-exchange positions in their financial statements
Consumer lending	In January 2006, tenure of consumer loans was reduced from ten to five years, while installments were capped at one-third of the monthly disposable income
Liquidity	Saudi banks are subject to reserve requirements of 13 percent of demand deposits and 4 percent on time and saving deposits. Banks must also maintain liquid reserves of no less than 20 percent of their deposit liabilities in the form of cash (Saudi government bonds or assets, which can be converted into cash within 30 days), and 85 percent loan-to-deposit ratio. Banks can also raise additional funds through Repo facilities with SAMA against Saudi development Government Bonds (up to 75 percent of the nominal value of bonds held by the bank)
Asset classification provisioning (non performing loans, NPLs)	The classification of NPLs is in line with international standards, as the banking regulation in the Kingdom of Saudi Arabia defines NPLs as loans past -due for 90 days. SAMA issued a circular in January 2004 on rules governing loan classification, provisioning, and credit review. Banks should have five grades of loan classifications, two for performing (standard and special attention) and three for nonperforming (standard, doubtful, and loss). After collateral

(continued)

**Table I.**  
Major regulatory  
requirements applicable  
to Saudi banks

Anti-money laundering  
measures

adjustments, the minimum specific provision requirement is 25 percent for substandard loans (90 days past due), 50 percent for doubtful loans (180 days past due), and 100 percent for loss loans (360 days past due) Legislation was passed in 2003, and the Kingdom is a member of the FATF via the GCC, and even a founding member of the Middle East & North Africa financial action task force. Banks must obtain maximum information on account holders and borrower, as well as their formal identification, notably through the know-your-customer regulation that has been strengthened in 2003. SAMA guidelines require banks to establish a transaction monitoring threshold of Saudi Arabian riyal 100,000. Action against suspicious transaction include freezing accounts. The Kingdom has set up the Financial Intelligence Unit and the Saudi Anti-financial Crime Unit, within the Ministry of Interior to liaise with financial institutions and refer to SAMA any case needing further investigation

Table I.

Source: SAMA, *Annual Report* (2008)

banking system. No bank in Saudi Arabia has ever failed, and episodes of banking uncertainties are scarce in the Kingdom's history, although this sector is cyclically affected by the erratic oil prices and revenue fortunes of Saudi Arabia. While SAMA has not stated explicitly that it will support every bank, it has intervened by using the "purchase and assumption" method in supporting troubled financial institutions as illustrated in Table II. The failure of one bank in a system that has 12 commercial banks would have material consequences for the entire banking system and the economy as a whole (Suhaimi, 2002; Dukheil, 1995).

Some of SAMA's actions could raise issues of moral hazard, given the unofficial government support, but SAMA's main preoccupation seems to have been to ensure that the overall Saudi banking system continues to function and to avoid the spread of systemic risk. To minimize moral hazard, SAMA has pursued a vigorous accounting transparency and disclosure policy by Saudi banks (SAMA, 2008). All commercial banks' accounts are prepared in accordance with International Financial Reporting Standards and SAMA regulations. The regulator introduced on a regular basis new accounting requirements, such as IAS39 (pertaining to the recognition and measurement of financial instruments) in 2001; or more recently International Accounting Standards Institute (bank's capital management and level of disclosure), and other International Financial Reporting Interpretations Committee requirements.

Financial disclosure has improved considerably in recent years. All banks, however, do not fully disclose certain pieces of information that would be useful for analytical purposes such as a breakdown of the investment portfolio by sector or rating category, given that the portfolio represents a significant proportion of Saudi banks' balance sheets. However, with the application of the second pillar of the Basel II framework, additional analytical information is expected to become available. Overall, transparency and disclosures at Saudi banks compare well with international standards and are high by emerging market standards (Federal Reserve, 1994). Auditors of the major banks are the local affiliates of internationally recognized firms, and all Saudi banks are required to have two auditors to confirm their financial statements.

The Saudi Arabia Monetary Agency relies on four policy instruments in conducting monetary policy: cash reserve ratio (CRR)/minimum reserve policy, repos and reverse



Period	Event and SAMA Action
1960-1961	Al Watany Bank and Riyadh Bank suffer liquidity issues. SAMA liquidates the insolvent Al Watany Bank and organizes its merger with Riyadh Bank. SAMA holds 38 percent stake in the new entity on behalf of Ministry of Finance
1980s	Two senior managers at the now defunct Saudi Cairo Bank concealed unauthorized billion trading, while accumulating losses exceeding bank's capital. SAMA required bank to issue new shares and double capital by 1986, the increase taken up by Public Investment Fund of Ministry of Finance. Saudi Cairo later merged with United Saudi Commercial Bank, which later merged with Saudi American Bank
1990-1991	During 1990-1991 Gulf crises and war, SAMA provided Saudi banks with necessary liquidity by extending overnight overdraft facilities and injected deposits and government securities which could be used at the discount window
1999	Recapitalizing and relaunching of National Commercial Bank (NCB). The NCB is Saudi Arabia's largest commercial bank. The bank's capital was virtually wiped out by bad loans during the 1980s and failed to produce financial statements for 1990 and 1991. In 1999, the Public Investment Fund acquired 50 percent of the bank's shares from its previous private shareholders. This was increased to 80 percent by 2006
2008	Injects \$2.5 billion into the banking system, guarantees all Saudi commercial bank deposits, introduced unlimited swap arrangements to exchange riyals for dollars

**Table II.**  
SAMA and Saudi bank  
crises management

**Sources:** Dukheil (1995); Suhaimi (2002); Jasser (2002); Saudi Press Agency (2008)

repos, foreign exchange swaps and, finally, placement of public funds and are summarized in Table III.

Analyzing the operational usage and effectiveness of the various policy instruments at the disposal of SAMA, we note the more active use of CRRs since 1980. The last time this was changed was in 1980, when SAMA adjusted the CRR from 12 to 7 percent on current account liabilities of banks and 2 percent for savings and time deposits. During 2007 and 2008, the policy reversed, and SAMA increased the CRR on current account to 9, 10, 12, and then 13 percent from November 2007 to May 2008. It also increased the CRR on saving accounts from 2 to 4 percent in May 2008 (*Arab News*, 2008). The main reason for raising the reserve ratios earlier was that during 2007 and 2008, inflationary trends in the GCC and Saudi Arabia increased sharply in line with buoyant government expenditures and record oil prices. SAMA was signaling to the banking sector to ease on credit expansion so as to curb inflation, which was beginning to cause official concern (Abdul Ghafour, 2008).

In November 2008, SAMA policy changed and the reserve ratio on current accounts was reduced to 10 and then to 7 percent in the face of the global financial crises in order to stimulate additional domestic liquidity. Unlike other central banks around the world who have been reducing or eliminating their reserve requirements (Friedman, 1999), SAMA seems set to continue using it as a powerful signaling tool and an effective monetary policy given that some SR 328 billion were held in current accounts by the Saudi banks in February 2008, or 47.3 percent of total deposits (SAMA, 2008). Unlike action by major world governments to assume a more direct ownership in their banking systems during the financial crises of 2008, to create public confidence, SAMA did not

Policy instrument tool	Rationale and operational usage	Effectiveness
CRR	To ensure banks have adequate liquidity to cover customer deposits 7 percent on current accounts and 4 percent on savings/time deposits	Used for implementing structural changes in bank liquidity (credit creation control) and for fine-tuning short-term liquidity Produces strong signal effects. Infrequently used since 1980, until 2008 Not imposed on inter-bank transactions
Repos	SAMA alters liquidity position of banks by dealing directly in the market to make temporary additions to bank reserves through short-dated repurchase agreements (overnight). Used during the 2008 financial crises to provide liquidity support for Saudi banks	Allows for short-term injection of reserves and automatic withdrawal upon repo maturity Efficiency depends on SAMA's holding of securities and size and depth of market
Reverse repos	Need for banks to place excess liquidity with SAMA through overnight matched sale-purchased operations	SAMA can absorb rather than provide bank reserves A definitive purchase of financial assets reversible at short notice not affecting prices in bond market; serves to regulate the money market
Foreign exchange swaps	Intention to influence capital outflows, avoiding disruptions to monetary policy from foreign exchange markets Used for liquidity management and currency speculation	More flexible than repos/reverse repos in terms of their maturity and volume per deal Affect liquidity but do not generally exercise influence on foreign exchange rate. Used during 2008 crises
Placement of public funds	At SAMA's discretion to place governmental institutions' funds with selected banks	A "rough tuning" instrument providing banks with long-term liquidity support Can signal crises management and problems in banks

**Table III.**  
SAMA's monetary policy instruments: comparative analysis

**Sources:** SAMA; *Annual Report* (2008); Ramady (2005)

take this route to support its banking system, feeling that their capitalization level was more than adequate to support Saudi banks compared with their western counterparts.

### Reliance on "open market" operations

As indicated in Table III, SAMA has several other monetary policy instruments at its disposal, including foreign exchange swaps, placement of public funds and open market operations. Placement of public funds with banks is entirely at SAMA's discretion and complements its efforts to fine-tune day-to-day liquidity instruments. The placement of public funds is a way of "rough tuning" the money supply; basically the central bank is seen to provide long-term liquidity support to a bank. In Saudi Arabia, SAMA does this by placing funds of semi-autonomous government institutions. SAMA has used this in



the past to provide support to those banks facing liquidity problems or going through crisis management. However, it sends a negative signal to the market about the state of health of the recipient bank and SAMA did not use this policy option during the 2008 financial crises.

Similarly, SAMA used foreign exchange swaps very sparingly, but mostly during periods of external uncertainties and currency speculation, such as the 1991 Gulf War, speculative pressures in 2003, and more recently during the speculative pressures on the SR during 2007 (Reuter, 2007, 2008) and the, 2008 financial crises when it set up unlimited swap lines for Saudi banks. SAMA uses foreign exchange swaps to provide emergency liquidity to the banking system, and rates up to one year are actively traded. Swaps affect liquidity but do not, under Saudi Arabia’s fixed exchange rate system, directly influence the exchange rate (Jasser and Banafe, 2003).

In common with most other developed central banks, SAMA has come to rely more on repos and reverse-repos as the most flexible operating instruments of monetary policy, through the buying and selling of government bonds and securities in so-called “open-market operations.” The Saudi bond market is still in its early stages, mainly restricted to SAMA, the Saudi banks and a few other institutions. The Saudi capital market Law envisages broadening the range of instruments and players over time. In the short-term, open market operations are an effective and more precise tool in changing the money supply of the banking system through the buying and selling of government short and long-term securities. During the 2008 financial crises SAMA actively used the repo rate and aggressively cut its repo rate in line with similar actions by the Federal Reserve Bank of the USA.

In 1986 the Saudi Arabian government introduced its first borrowing instrument – the Bankers Special Deposit Account or BSDA, as a means of financing growing budget deficits and as an alternative to drawing down on foreign assets to finance the budget deficits (Dukheil, 1995). Table IV sets out the main securities that are currently offered by SAMA and it illustrate how far SAMA has evolved since those early days.

Security issue	Currency denomination	Tenor	Pricing	Offering	Observation
Treasury bills	SR	1, 4, 13, 26, and 52 weeks	SR Interbank buying price rate	Weekly basis	Replaced the 180 days bankers special deposit accounts
FRNs	SR	5 and 7 years maturity	Saudi Interbank offer rate plus margin	Monthly basis	Introduced in 1996 to provide rate risk hedging
GDBs	SR	2, 3, 5, 7, and 10 years maturity	Priced to reflect relative value in alternative investments (US bonds) plus 25 – 75 basis points premium	Quarterly basis	Issued on a fortnightly basis until 1996

**Table IV.**  
SAMA: current securities offerings

Source: SAMA; *Annual Report* (2008)

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Table IV reveals an extensive “menu” of financial securities that are now on offer, ranging from very short-term liquid instruments such as one-week treasury bills, to long-dated 10-year bonds. The introduction of floating rate notes (FRNs) in 1996 added a new dimension and provided a further rate risk-adjusted option for purchases of Saudi government securities. Pricing is competitive compared to other market instruments, with premiums added to longer-dated securities, especially for Government Development Bonds (GDBs), which in turn are priced at a premium to comparable US bonds. “Reverse Repos” allow Saudi banks to deposit surplus funds with SAMA for a short period of time.

### **The centrality of SAMA’s exchange rate policy**

According to some analysts, economic theory suggests that when a country fixes its exchange and interest rate and is subject to high capital mobility, it loses its ability to conduct an independent monetary policy. In terms of economic policy, this means that in Saudi Arabia, fiscal, not monetary, policy is the primary instrument for economic growth management. Fiscal policy – or more precisely government expenditures – can be used to increase or decrease gross domestic product, while monetary policy is focused on fixing the exchange rate and interest rates (NCB, 2001; Abalkhail, 2002; Jasser and Banafe, 2003). Monetary policy is used to “fine tune” the effects of fiscal policy. With the SR effectively pegged to the US dollar since 1981, there have been limitations to Saudi monetary policy on interest rate adjustments. In effect, the SR interest rates closely track dollar interest rates.

In essence, Saudi interest rates – and by implication, Saudi monetary policy – is closely tied to that of an external Central Bank, specifically of the USA. What might be prudent and necessary monetary policy in the USA (expanding or dampening the money supply) might not necessarily be the most appropriate interest rate level desirable for Saudi Arabia at the same period of time.

In Saudi Arabia, the exchange rate is central to monetary policy. SAMA’s intervention under the fixed exchange rate regime is influenced by two factors: the level of foreign exchange outflow from the country and the level of dollar/riyal interest rate differentials. As such, SAMA’s stated goals center on internal price stability and balance of payments considerations (SAMA, 2008).

SAMA continues to defend its fixed exchange rate policy, with the monetary agency believing that the fixed dollar/riyal peg has worked well due to the fact that all of Saudi exports and most of its imports are denominated in dollars; that the riyal is fully backed by foreign exchange reserves; that such reserves are the result of oil revenues and investment income, and finally that the stability of the dollar/riyal exchange rate sharply reduces risks for foreign investors (Karam, 2007). There are powerful arguments for both fixed and floating exchange rates and Table V examines these arguments.

As far as Saudi Arabia is concerned, there is certainly some basis for reduction in investor risk due to a fixed rate policy. Saudi Arabia did not experience any of the upheavals seen in other countries during the East Asia and Mexican currency crises of the mid- and late-1990s. However, rising inflationary trends and a weakening of the US dollar has made some analysts argue for pegging the SR to a wider diversification of a basket of currencies. Some have argued for a possible revaluation of the SR to ease domestic inflationary pressure in the short-term (Jadwa Investment, 2008).

Advantages	Disadvantages
<p><i>Fixed exchange-rate regimes</i></p> <p>Maintains investors' confidence in the currency, thus encouraging domestic savings and investment and discouraging capital outflows</p> <p>Reduces inflationary pressures associated with devaluation</p>	<p>Does not allow the implementation of independent monetary policy</p> <p>Exchange rates cannot be used to adjust for external shocks or imbalances</p> <p>A fixed peg is also a fixed target for speculators</p>
<p><i>Floating exchange-rate regimes</i></p> <p>Allows pursuit of an independent monetary policy; when an economy suffers a downturn, monetary expansion can soften the impact</p> <p>Allows a country to adjust to external shocks through exchange rates; that is, lower export prices and higher import prices would help the country regain external equilibrium</p>	<p>Reduces investors' faith in the currency, thus discouraging capital inflows to avoid exchange risk</p> <p>Floating rates can overshoot and become highly unstable, leading to speculation</p>

**Source:** Adapted from Azzam (2002, p. 98)

**Table V.**  
Advantages and disadvantages of fixed and floating exchange-rate regimes

### Future developments and challenges

The upgrading of Saudi Arabia's sovereign credit rating by both Standard & Poor's (S&P) and by Moody's in the summer of 2003 was a welcome development for the Kingdom, and reflected the positive medium and long-term outlook for the Kingdom based on macroeconomic stability, substantial external liquidity, low inflation, stable exchange rate and a sound banking system. SAMA takes a lot of credit for this development, which saw S&P assign a credit rating of "A + " for long-term local currency and "A" for foreign currency, with both local and foreign short-term currency assigned "A-1".

While this development was welcome news, SAMA is faced by several domestic and international challenges in the years ahead that could test the monetary agency's ability to adapt to new circumstances. Table VI summarizes SAMA's major challenges in the short, medium and long terms.

SAMA has come a long way since 1952 and, in essence, is now a fully-fledged central bank in all but name. It has tried to overcome the limitations imposed on it through its founding Charter and has successfully introduced a range of innovative capital market instruments to add to the liquidity options of the Saudi commercial banks.

By its own admission, SAMA recognizes that in the years ahead it faces a range of domestic, regional and international challenges. Key objectives set out by SAMA include expediting the issue of regulations and legislations aimed at promoting and expanding the range of financial services in conformity with the "trends towards liberalization of international financial markets and WTO requirements" (SAMA, 2008). This, according to the Monetary Agency, requires the streamlining of the operations of the capital and insurance markets and other financial services. The 2008 financial crises has tested SAMA and, compared with many other financial centers around the world, there has been no sign of either a run on the Saudi banking system, bank failures or systemic breakdown in interbank lending.

Short-term	Medium-term	Long-term
Control of money laundering and terrorism funding	Establishing guidelines for Islamic banking supervision and regulation	Effective participation through Islamic Banking Financial Services Board
E-commerce application and internet banking	Ensuring Saudi banks comply with new BIS capital adequacy ratios	Effective participation in Gulf Cooperation Council Monetary Union and proposed single currency for GCC
Ensure Saudi banks are adequately prepared for Saudi WTO entry	Supervision and integration of newly licensed foreign banks into Saudi banking system	Develop corporate bond market
Overseeing effective "Saudization" of bank personnel	Effective participation in international financial supervisory standards	Supervision and regulation of cross-border Saudi bank mergers and acquisitions
Establishment of data base and supervision of the insurance sector	Supervision and regulation of non-bank financial institutions into the markets	Re-examine SR/US dollar fixed exchange parity policy
Completion of mergers of local money exchangers into one financial institution	Develop secondary market instruments for capital market	
Overseeing partial privatization of government-held bank shares in capital market	Upgrade SAMA's Banking Training Institute to provide broader financial services expertise	
Effective participation in new Saudi capital market structure		

**Table VI.**  
Challenges faced by  
SAMA

The list of challenges set out in Table VI seems daunting but SAMA has already started to confront some of the issues. A notable success has been the vigorous implementation of procedures to prevent money laundering and the funding of terrorism. SAMA received a clean bill of health on these matters from the financial action task force (FATF) in April, 2004. Islamic banking services and operations are becoming more important for SAMA, given the expansion of such services by most Saudi banks and the GCC countries. SAMA became a member of the Islamic Banking Financial Services Board in 2002, which will help in establishing new guidelines and rules to oversee this important market segment. Future development might necessitate a separate Banking Control Law, targeting Islamic financial institutions and subjecting them to proper rules and supervision. This has been successfully achieved in nearby Bahrain, where Islamic banking supervision co-exists with "conventional" and investment banking activities. The 2008 financial crises has also highlighted the relative stability of Islamic financing in overcoming problems such as derivative financing, synthetic products and sub prime loans. This has not gone unnoticed by SAMA and it is probable that the monetary agency will be more receptive to allowing Saudi banks to operate under Islamic financing modes or convert their operations to Islamic financing. This was the case with Saudi Arabia's largest bank, the National Commercial Bank's decision to convert all its retail branches to Islamic finance branches.

Other long-term issues that might need to be addressed include revisiting SAMA's 1966 Banking Control Law to allow the Monetary Agency to make more effective use of the full range of monetary policy instruments. In particular, there must be a wider use

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of the open-market operations, with outright sales and purchases of government securities by the central bank itself as a monetary tool, as opposed to the current policy of action initiated by Saudi commercial banks. This will add depth and breadth to the capital market.

The plan of the Gulf Co-operation Council for full monetary union, including the adoption of a single Gulf currency by 2010, is another issue that will have to be addressed by SAMA and by the other Central Banks of the GCC countries. Whether to opt for a unified GCC currency pegged to one currency – the US dollar – or adopt a more flexible multi-currency peg will also be an important issue that SAMA will have to face. This could affect its current fixed parity rate policy.

The sharp fall in the value of the US dollar during 2007/2008 has created some doubt on whether the unified Gulf currency will materialize by 2010. At a meeting in Doha, Qatar in April 2008, the Governors of the GCC Central Banks agreed to keep meeting to complete the “legislation and matters relating to monetary union” (Jadwa Investments, 2008). However, there seems to be many barriers to the introduction of a formal GCC single currency and many doubt that it will materialize by the stated date, as Kuwait opted for a different exchange rate arrangement (peg against several currencies within a band), while Oman said it will not be ready to join by 2010 (Jadwa Investment, 2008; Dubsy, 2006; *Arab News*, 2007; Reuters, 2007). While the rise of the American currency against other currencies, and the Euro in particular, during the early phases of the 2008 financial crises brought some respite to the Gulf countries, the longer term outlook for a weakening dollar will once again renew the debate on the appropriateness of a currency peg solely against the US dollar.

### **WTO and international banking regulation**

The accession of Saudi Arabia to the WTO in December 2006, has added a new dimension to SAMA’s regulatory objectives. In the long-term, SAMA might face cross-border banking and other financial services mergers and acquisitions, with Saudi banks forming international strategic alliances and with foreign banks acquiring interests in the Kingdom (Suhaimi, 2002). This will test SAMA’s cross-border regulatory and supervisory skills. SAMA will also need to supervise foreign-owned financial institutions in the Kingdom whose objectives might be divergent from broader national considerations (SAMA, 2004, Knight, 1998). This was the case in some instances in the 1970s, before the Saudization of foreign banks; and was one of the major factors for the Saudization drive to align national interests with those of the “Saudized” banks.

Following Saudi entry into WTO, wholly foreign-owned banking licenses have been issued. SAMA feels confident that it has gained sufficient experience from the Saudization era to be able to manage the new circumstances, helped by its active participation and membership in leading international multilateral bodies such as such as the IMF, the World Bank, and the BIS.

### **Conclusions**

Financial markets and how they are regulated have a significant effect on the well being of economies and the personal welfare of nations as so vividly highlighted during the 2008 global financial meltdown. The financial markets have evolved rapidly, introducing new financial instruments with potential risk management implications, if such innovation is left unregulated and which has forced the leading

countries of the world to introduce more stringent and adaptable regulatory tools following the lessons of the most recent crises. Saudi Arabia, being a member of the G-20 countries, will be able to observe first hand on such regulatory developments and apply the same conditions at home.

The Saudi Arabian economy is one of the more important developing economies of the world, with the Kingdom holding around a quarter of the world's proven oil reserves (Cordesman, 2003). A well-regulated and efficient Saudi financial sector is thus important, not only for the Kingdom, but for the wider world economy. To allow banks to compete and keep pace with such changes, monetary regulatory authorities need to develop appropriate expertise and implement a plan for regulatory reforms that is both flexible and able to adapt to future challenges.

SAMA has been a proactive and supportive regulatory authority, often erring on the side of caution and conservative prudential oversight of the Saudi banking system. It has been at the forefront in ensuring that the Saudi banking system is liquid and highly capitalized – well over the Basel set minimum capital adequacy requirements. It has overseen the “Saudization” of branches of foreign banks in the 1980s, and at the same time licensed foreign banks back into the Kingdom post-WTO accession.

Looking ahead, SAMA faces some continuing challenges which highlight further areas of possible research. One major area is developing regulatory and supervisory expertise for the growing number of Islamic financial institutions, or specialist Islamic financial units operating through conventional banks. Islamic banking accounting standards have to be brought in line with International Accounting Standards (IAS) standards, or create separate Islamic IAS standards. Another area of SAMA regulation could be increased expertise in electronic banking and its security, without compromising on consumer privacy.

A third issue is for increased cooperation and harmonization between the different GCC monetary agencies if the objective of a unified GCC currency by 2010 is to be realized. SAMA will have to coordinate with these GCC monetary agencies on economic convergence and internal harmonization of policies relating to inflation, which become a major issue for all the GCC in 2007 and 2008. Such a harmonization could lead to an inter-GCC process of financial integration through strategic alliances, joint ventures or mergers, leading to greater efficiencies and further globalization of the Saudi financial sector.

Some Saudi banks have already ventured abroad, and Al Rajhi Bank took a significant step in this direction by acquiring a retail branch network in Malaysia that fitted its Islamic finance credentials (Al Rajhi, 2007). SAMA will have to adapt to such globalization processes, by developing in-house expertise in regulating Saudi banks operating in many locations, just like Western central banks developed expertise to monitor the activities of overseas branches of their local banks. Cooperation among regulators in different countries, and standardization of regulatory requirements, provides potential solutions to the problems of regulating international banking.

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#### **Further reading**

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