Kingdom of Saudi Arabia Banking Perspectives 2020

KPMG in Saudi Arabia

March 2020

Foreword

Our evaluation of the key financial indicators for the past year suggests a positive outlook for the banking environment in Saudi Arabia, with promising profit growth fueled by a proactive government and a range of initiatives driven by the regulators.

We are pleased to introduce you to the first edition of our annual Kingdom of Saudi Arabia Banking Perspectives report 2020. We have examined pertinent issues and trends affecting global banking today, with a particular focus on Saudi Arabia.

Banks today face profound industry challenges driven by evolving customer expectations, digital challengers and increasing regulatory compliance. However, big challenges often mean big opportunities and therefore, the disruptors of today are likely to create a future paradigm that is far beyond the usual ambitions. A customer-centric innovation approach, guided by big data and regulatory eminence is reshaping the way banks have traditionally operated.

The government is committed to building a stronger financial sector, which is underpinned by the Financial Sector Development Program of Vision 2030, defining specific targets for the industry and providing incentives and infrastructure support to achieve these. The program is aptly supported by Saudi Arabian Monetary Agency (SAMA) which is defining and shaping regulations catering to the evolving model of banking.

We foresee the banks will continue their preference to finance large public infrastructure projects but higher volumes and yields are expected from growth in SME and mortgage finance. Moreover, non-technological aspects such as workforce diversity, women empowerment and ever-relevant cost optimization continue to have a significant bearing on management's operating style and stakeholder expectations.

Banks across the Kingdom would soon be striving for a future that is more interconnected, more collaborative and frictionless – one where trust, growth and delivering value are paramount. In our Kingdom of Saudi Arabia Banking Perspectives 2020, our thought leaders has delved into the more granular aspects of the factors driving the global, regional and local banking landscape. We look forward to discussing these themes with you as part of our endeavors to seek facts and provide insights.

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Executive Summary

On a country level, Saudi Arabia has witnessed a variety of positive developments, fueled by firmer government spending and economic growth in multiple sectors, including the hard-pressed construction sector which has posted growth in recent periods. With the key non-oil drivers such as finance, trade and government services posting gains, the medium-term economic outlook continues to remain positive.

Although it is one of the biggest financial sectors by assets in the MENA region, the Saudi banking industry has weathered the storm of recent economic downturn relatively well; an advantageous market, credit environment and a stringent governance mechanism – with each bank reported to be serving approximately 2.5 million people on average. Overall, total assets across the listed banks grew by 11.98% during FY 2019 with a healthy 4.46% growth in net profits before zakat and income tax. This was coupled with a 10.51% growth in the total deposit base across these banks. As such, despite subdued growth in recent years across credit underwriting and deposit acquisition, Saudi banks continue to be well-positioned to take advantage of the improving economic outlook and an evolving technological landscape.

A decade after the global financial crisis, banks face fresh challenges from new-age disruptive forces driven by technological changes, regulatory developments, evolving growth strategies and evolving market demand.

Despite recent challenges, Saudi Arabia has witnessed a robust growth in the adoption of financial technology, partly due to the banking sector's cognizance of its potential to be a major disruptor.

The agreement with crypto-currency Ripple and the announcement to work with the UAE on a new digital currency, and the establishment of the Sandbox, providing several local and international firms a real-life environment to test new digital solutions, are all testament to SAMA's positive attitude towards fintech.

With an approximate 90% smartphone ownership rate and a tech-savvy population that prefers a mobile interface for its banking interactions, digital solutions present a highly competitive yet cost effective avenue for streamlining services, boosting banking inclusion, enhancing customer experience and increasing process efficiencies.

The rapid advancement in digital technologies also fuels an increasing threat on the cybersecurity front. With an increasing realization that there is no 100% secure environment, banks are looking to continuously develop their cybersecurity infrastructure with adequate tools, techniques and processes to be able to detect, protect, respond and recover from cybersecurity attacks.

The static nature of M&A in Saudi Arabia banking sector has already begun to undergo a shift, with mergers and new market entrants poised to shake up the market structure and competition. If the merger between SABB and Alawwal Bank in mid-2019 was any indicator of a new trend, we expect to see the creation of mega financial institutions with high underwriting capacity and profitability.

In terms of new market entrants, several institutions in the GCC and other global entities have applied for licenses to operate in the Kingdom.

The higher pricing power of 'merged giants' and 'aggressive growth strategies' of new entrants would post stiff challenges for existing market players.

In the regulatory landscape, SAMA, the Kingdom's monetary policy regulator, continues to play a vital role in supporting the overall financial sector. In addition, with an objective to further strengthen the sector, the government launched the Financial Sector Development Program (FSDP) as part of Vision 2030. FSDP aims to enable financial institutions to support private sector growth, without contradicting the strategic objectives of maintaining stability in the financial sector. According to SAMA, money supply (M3) reported an increase of 7.1 percent y-o-y, which is attributed to factors such as increase in time and saving deposits, currency outside banks and because of government's efforts to move out of deflation. Moreover, in line with the Vision 2030 objectives, the government remains committed toward implementing initiatives to bolster the economy and attract both foreign and domestic investment.

From a fiscal policy perspective, the zakat and tax related developments, such as the introduction of VAT and prior year zakat and tax settlements, had a significant impact on the banking industry, not only from a commercial, reporting and compliance perspective but also in terms of pricing and business models. With financial services income being VAT exempt, a skewed input-output ratio has ramifications for banks' medium to long term cost optimization and profit strategies.

From a risk and compliance perspective, it is widely acclaimed that the stability of the Saudi banking sector is primarily on account of SAMA's prudence. This is epitomized by its continued focus and initiatives to critical areas such as anti-money laundering and counter-terrorism financing (AML/CTF), cybersecurity, responsible lending and financial inclusion.

For banks, the ensuing regulatory compliance and the financial impact of potential noncompliance have ramifications in the form of increasing cost of compliance which some experts estimate could rise to 10% of revenue. This has implications for how banks approach data governance with a need to move towards sophisticated automation, leveraging on technology made available by regtechs.

The area of financial reporting has also had its fair share of developments for the banking sector in recent years. The most notable change was the implementation of International Financial Reporting Standard 9 (IFRS 9) that resulted in a fundamental change in the computation and recognition of credit losses for 2018, demanding to be a continued area of management's judgement at year-end. The other developments include implementation of IFRS 15, IFRS 16 and the presentation of zakat and tax in the statement of profit or loss as against changes in equity. The latter, though a presentation matter, had implications for reported bottom line of comparative figures in 2019 and hence earning related KPI going forward.

Another key development on the horizon is the imminent transition from Interbank Offer Rates (IBOR) to Alternative Reference Rates (ARR) in the western markets. This long overdue change, instigated by a series of scandals, has sealed the fate for Libor after decades of dependency by global financial markets. As a result, banks around the globe are expected to be affected across various aspects in a significant way, ranging from legacy contract management to financial reporting issues and from valuation bases to changes in future business and pricing models, processes, systems and strategies. SAMA started a data gathering exercise for an initial assessment of the sector's readiness and expectation of potential impacts of this change.

While lending to the corporate sector has traditionally been the preferred growth tool for most Saudi banks, the Kingdom's increasing banking penetration, housing demand and improved credit reporting system are facilitating strong credit growth across the retail and SME segments. It is up to the corporates now to align their strategies and work with the disruptive forces to cater to evolving market demand and potential, while maintaining robust governance.

Financial Results 2019

Industry Highlights

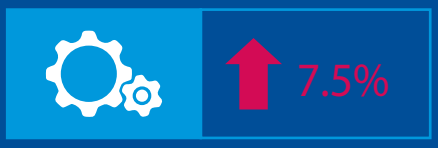
Net profit before zakat and tax

Impressive growth in bottom line despite prevailing challenges

Total assets

Total assets edged up to US$ 652 billion fueled by strong growth in loan book

ECL allowance for loans



Total ECL allowance has increased due to organic growth in loan book and certain M&A activity

Capital adequacy ratio

Capital adequacy ratios reduced marginally, yet still continue to be well above minimum regulatory requirements

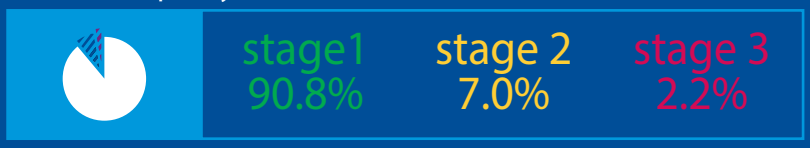
Coverage ratio

With improving credit quality, coverage ratio witnessed a decline from 168% to 160%

ROE ROA

High growth in total assets and net equity relative to bottom lines resulted in slight decline in ROA and ROE

Loan book quality



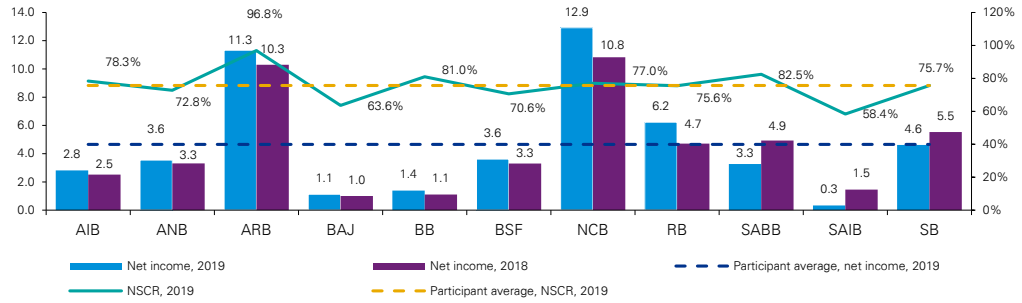
2019 loans with significant increase in credit risk and those which were credit impaired represented 7% and 2% of the total loan book respectively

Total customer deposit

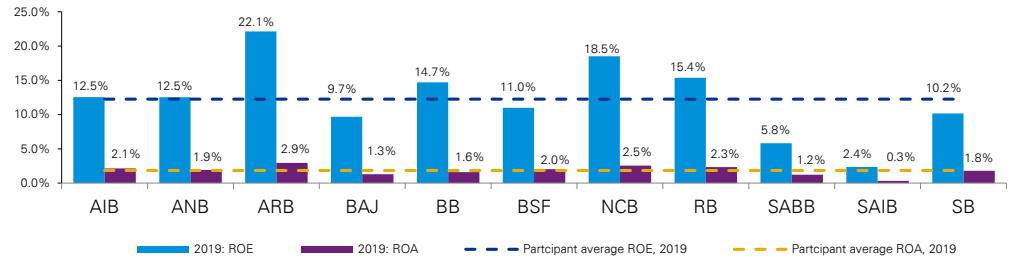
Improving economic environment and recent developments contributed towards a healthy growth in deposit base

Performance Highlights

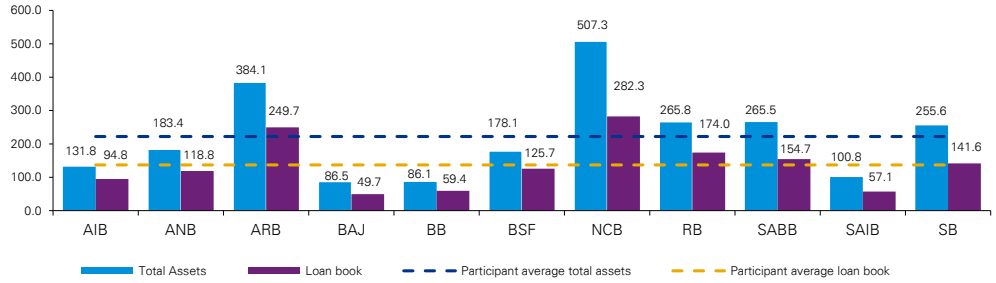
Net income (in SAR billion) and net special commission income ratio (NSCR*, percentage)
2019 v/s 2018



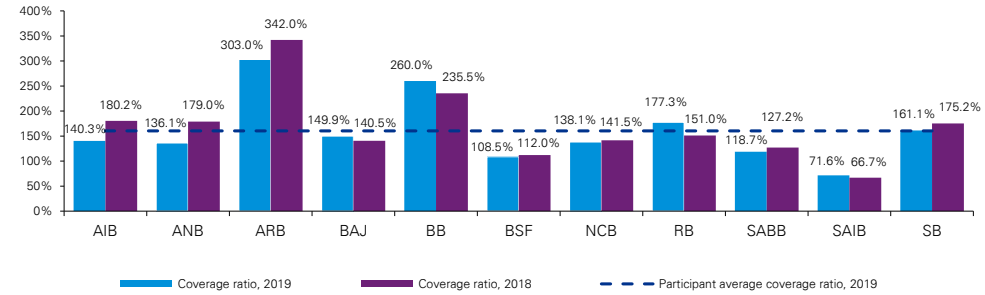
ROE/ROA (percentage)
2019



Total assets and loan book (in SAR billion)
2019



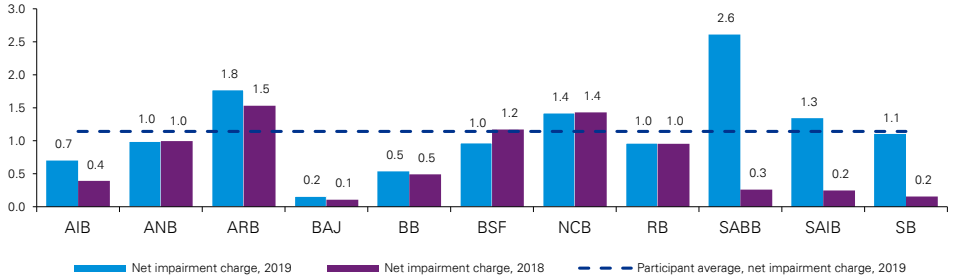
Total coverage ratio (percentage)
2019 v/s 2018



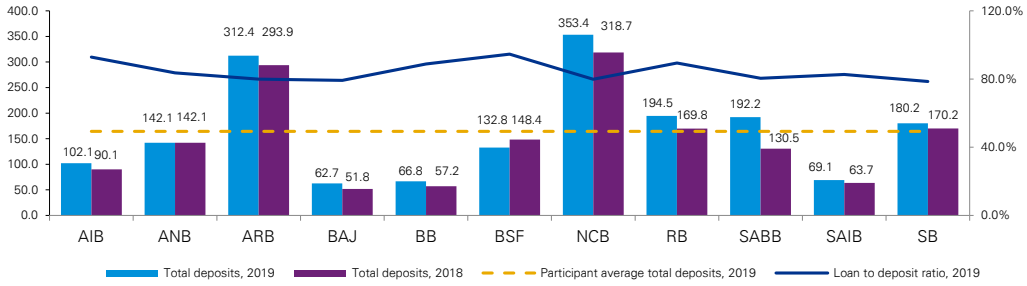
Legend:

Alinma Bank	AIB	Bank Al Bilad	BB	Saudi British Bank	SABB
Arab National Bank	ANB	Banque Saudi Fransi	BSF	Saudi Investment Bank	SAIB
Al Rajhi Bank	ARB	National Commercial Bank	NCB	Samba Bank	SB
Bank Al Jazira	BAJ	Riyadh Bank	RB		

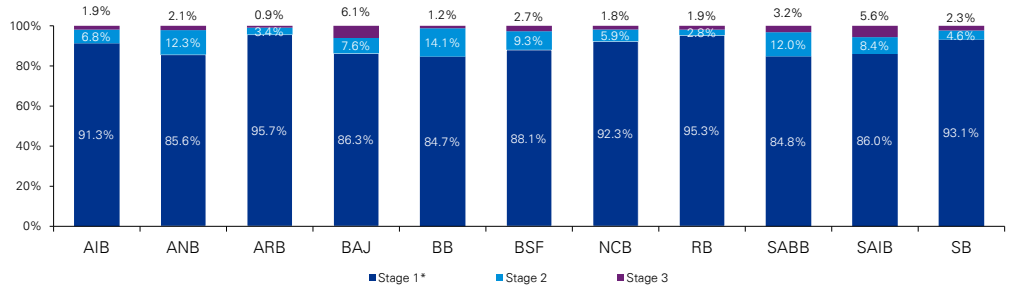
Net impairment charge (in SAR billion)
2019 v/s 2018



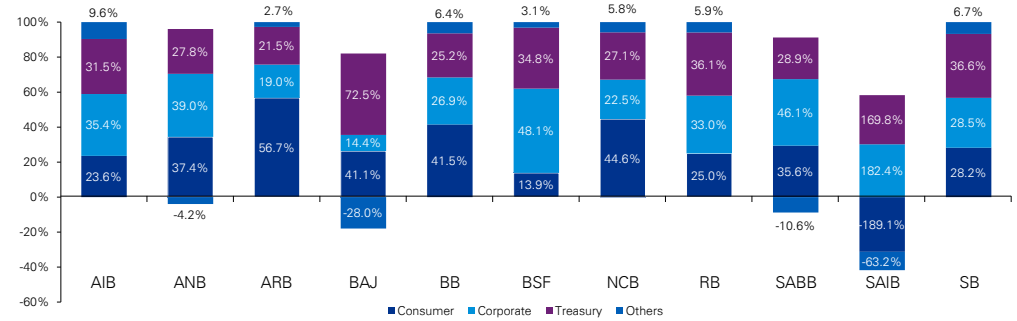
Total deposits (in SAR billion) and loan to deposit ratio (percentage)
2019 v/s 2018



Loan, stage-wise composition (percentage)
2019



Income/(loss) by segment (percentage)
2019



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ROE is the ratio of net income to total equity. ROA is the ratio of net income to total assets. Net special commission income ratio is the ratio of YTD net special commission income to YTD total special commission income. Coverage ratio is the ratio of total ECL for loans and advances to total NPL. Loan to deposit ratio is the ratio of total loans and advances to total deposits. Stage 1 exposure also includes purchased credit impaired loans.

** SABB financial numbers for 2019 are based on its published financial statements which include its post merger consolidated results.

Banking Environment

Dynamic Banking Environment: Shifting Sands

Despite a challenging global and regional environment, Saudi banks have performed reasonably well in 2019 and continued to invest in technology and people to assist in the growth of the banking sector.

Saudi banks have faced a challenging economic environment over recent years. The decline in oil prices, which began in late 2014, led to concerns about reduced government spending and muted private sector demand. The process of economic reform, while welcomed as a necessary measure for long-term growth and stability, has led to more market uncertainty.

For the past few years, banks are reporting lower lending opportunities as the companies adopted a wait-and-see stance towards expansion plans. The knock-on effects of the oil price decline and economic uncertainty were the main factors for the slow recovery in credit extension. While the banks remained profitable, the loan book growth was limited, and the banks were more focused on retaining and restructuring existing credits rather than expanding the credit base to more risky avenues.

Certain regulatory changes have further affected the muted lending environment. SAMA introduced tighter corporate lending rules designed to limit a bank's exposure to a single customer to 15% of its Tier-1 capital against the previous limit of 25%. Further, the implementation of IFRS 9 in 2018 changed the way of calculating potential impairment of loans from a historical one to a forward-looking one. The resulting increase in impairment allowance, impacted banks' solvency positions and shareholders' equity and impacted their overall credit strategy.

Sector resilience

Overall, Saudi banks were able to remain profitable throughout the low growth period, demonstrating the sector's resilience despite economic challenges.

Though lending to the corporate sector has traditionally been the preferred route to margin for the Kingdom's financial institutions, expansion of the bankable population, advances in risk assessment practices and the advent of new technologies have allowed banks to make greater inroads into the retail and commercial segment. Banks have shown enough flexibility allowing them to shift their focus and tap the retail market to drive growth. The government's focus on housing projects has also helped their cause.

The sector is also opening up to new entrants with a number of foreign banks looking to open their branches in Saudi Arabia. In addition to new market entrants, the banking sector is also looking to transform with the mergers of some of its biggest institutions.

Signs of recovery in Q3 2019

Saudi banks have reported a better-than-expected performance for third quarter of 2019 as lending picked up on the back of mortgage financing in the retail sector driven by a variety of government initiatives to increase home ownership. In Q3 2019, the eleven Tadawul-listed banks made a cumulative profit that was 13 percent higher than in the same period in 2018. This performance indicates that Saudi banks have successfully managed to offset any decline in net interest margins ensuing from falling interest rates globally by solid growth and internal efficiencies

A positive development for the sector as a whole was the fact that lending picked up due to rising government-supported economic activity and growth in the private sector. The rise in long-term

loans by 14.4 percent comparing to the previous year, was the biggest standout of the quarter indicating that economy is recovering. This positive economic development should gradually translocate to other parts of the economy. The recovery is led by the government as lending to public sector and quasi-government institutions rose by 25 percent per annum.

Outlook for 2020

The inclusion of Saudi Arabia in the MSCI Emerging market (EM) index and the Aramco IPO, are likely to have a long-lasting positive effect on the Saudi market's overall depth and liquidity profile.

The listing of Saudi Aramco, in addition to other funding sources, should provide meaningful capital to support the government's investment plans.

The anticipated increase in overall credit growth in 2020 supported by an increase in both project lending and the mortgage market should counter any adverse effects to overall profits coming from margin compression and zakat taxes. Capitalization levels are above regulators' stringent requirements, leaving potential for increased lending. Saudi retail mortgages are likely to remain a key driver of credit after expanding 31 percent year-on-year during the third quarter of 2019, compared with total-loans growth of 4 percent.

Conclusion

Overall, 2019 has shown signs of growth for the financial sector, especially in the second half and largely driven by mortgage lending. It is critical for the sector that the country continues to demonstrate its willingness to reform and to diversify away from its petroleum economy, as investors will be keen to see a continuation of the progress already made.

The challenges for Saudi banks in 2020 include growing loan books outside of SME lending and mortgages, containing any increase in cost of funds if oil prices remain weak, driving cost efficiency through digitization, and countering competition from digital payment platforms. Saudi banks are well-positioned to take advantage of opportunities arising from the recovery in the oil prices and the anticipated acceleration of economic growth.

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Mergers and Acquisitions: Driving the Change

Across the GCC, large banks are consolidating to gain pricing power and market share. To achieve credible success with these mergers and acquisitions, they need to be cognizant of determining prospects and growth.

In today's era of significant economic change, companies continue to look for partners that can leverage their abilities for cross-selling, accessing new markets and customers and other synergies to enhance financial performance and gain competitive advantage, boosting the combined market share. Over the past decade, we witnessed a tremendous amount of activity in the field of mergers and acquisitions where companies joined forces and achieved increased value for shareholders. There was, however, also a number of transactions that could not achieve the desired objectives, resulting in value destruction due to inappropriate planning or process breakages.

While Saudi corporations have engaged in successful M&As over the years, reaping significant benefits, most notably Almarai and Western Bakeries, and NADEC and Al Safi Danone, the local banking sector has been largely devoid of any major M&A activity up until recently, where a flurry of M&A activity among banks in the GCC emerged.

What's driving M&A?

In recent years, the region's M&A landscape witnessed the creation of the largest bank in the UAE with the merger of National Bank of Abu Dhabi and First Gulf Bank.This was followed by the three-way merger involving Abu Dhabi Commercial Bank, Union National Bank and Al Hilal Bank during 2019 resulting in ACDB Group.There is also activity across other GCC countries, notably the progressing merger of Kuwait Finance House with Bahrain's Ahli United Bank.

In Saudi Arabia, the Saudi British Bank (SABB) and Alawwal Bank successfully completed the merger in June 2019, creating the Kingdom's third largest bank by assets. At the same time,the National Commercial Bank (NCB) and Riyad Bank entered into negotiations that were called off in December 2019. While this merger would have created the Kingdom's largest bank and the Gulf's third largest lender; the positive side is that the two banks will continue their contribution to the economy in their own ways and provide healthy competitive environment.

While experts believe that this increase in M&As is 'credit positive' for the region, it is vital to identify the instigators thereof in both regional and local banking sector. As such, the following factors are pertinent to note:

- Across GCC and especially in Saudi Arabia, growth of the banking sector is largely dependent on GDP growth and government spending. Low oil prices in recent years have adversely impacted government spending, slowed down economic growth and intensified competition for deposits and borrowers.
- Too many banks often serve small populations in the region. Many banking systems in the GCC are also dominated by a few large banks with many smaller banks competing for the rest of the market. These situations fuel the need for merged, more stable and competitive entities.
- Most GCC banking systems are heavily reliant on government deposits and competition is high, resulting in pressure on margins. Consolidation will result in the banks having greater pricing power.
- Mergers are expected to improve profitability in the long run due to common synergies.

Despite integration challenges in the early stages, merged banks will gain market share and benefit from greater pricing power and cost synergies through improvement in efficiencies and rationalization of operations.

The merger of SABB and Alawwal Bank resulted in the following outcome at the time of completion of the merger:

- Second largest lender in Saudi Arabia as per corporate book size with 15% market share
- Home finance market share of 16% and credit card balance market share of 19%
- FX income market share of 12%
- Significant growth in distribution network with 143 branches and over 1,500 ATMs
- Enlarged balance sheet capacity and capital base to support transformational infrastructure and privatization projects
- Pooled-in staff talent and experience from both the merging entities

However, with all their potential benefits, many M&As have been seen to fail in achieving their intended objectives or worse, led to the demise of both parties. As such, banks need to be wary of the critical factors that underpin a successful M&A. In this respect, robust merger planning, including a detailed readiness assessment, is fundamental. In addition, management of stakeholder expectations is equally paramount.

Apprehensions of what the future holds, especially in terms of potential staff redundancies, need to be tackled well, not just for overall employee morale but also for the sustenance of brand image.

Finally, it is crucial to proactively identify the financial reporting impacts of all M&As.

Defining success steps

As the sole measure of quantitative performance of success, both before and after an M&A, key matters such as asset valuations (especially goodwill), impairment of assets and off-book asset/liability recognition, alignment of accounting policies, pre-existing relationships and restructuring costs must be considered. While considering these, the significance of professional advisors that can support management across the full M&A journey cannot be emphasized enough. It has been proven time and again that with the right professional support, various groups have successfully tackled merger challenges such as management alignment, due diligence and valuation sensitivities as well as process, system and culture integration through setting up integration committees and developing integration blueprints.

In conclusion, it can be said that in lieu of the various benefits discussed earlier, despite economic recovery across most Gulf regions and positive growth forecasts for 2020, experts anticipate consolidation of banking entities via M&As to continue.

However, the timing and success of finalization are largely dependent on regulatory direction, stakeholder reception, experienced advisors and most importantly, proper planning, execution and management alignment.

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SME Lending: Banking on the Untapped Potential

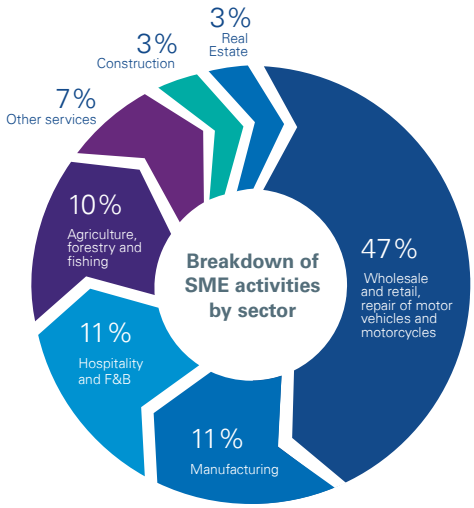
While the government in light of Vision 2030 is taking various initiative such as introducing multiple programs to promote investment and support eminence building in the SME sector, the directive for the banks is to drive this vision further by adopting a customized approach towards SME lending and further diversify its income sources.

Over the last few decades, small and medium enterprises (SMEs) have not been a key priority area for Saudi Arabia from a policy, financing and development perspective. However, with their growth and successful contribution to the advanced nations, SMEs have caught the attention of policymakers in the Kingdom.

The overall employment contribution of SMEs, Saudis and expats together, is 43%, and 5% to the total exports. SMEs currently contribute 21% to the GDP and one of Vision 2030's objectives is to increase this to 35% by 2030.

Factors limiting growth in the past

There are multiple reasons for SME's low contribution to the GDP. The continued reliance on the oil economy is one factor, along with the lack of an effective policy environment for SMEs in the past, access to financing sources, inadequate managerial skills, access to skilled and trained human capital, marketing challenges, poor access to international markets, limited access to technology and bureaucratic hurdles.



Source: Monsha'at

Forward looking government strategy

Recognizing the strategic importance of the SME sector, the Saudi government has launched multiple programs to solve its recurring issues and leverage its growth potential. It has recently established the SME General Authority (Monsha'at), which aims to enhance the role of SMEs. It has also roped in multiple institutions which provide different levels of support for development of the sector. The Saudi Industrial Development Fund (SIDF) is focusing on growth of the industrial sector SMEs and has developed a business resource center, modernization center and financing facilities for SMEs. The Ministry of Finance has launched SME loan guarantee program 'Kafala', to facilitate bank lending to SMEs.

The Financial Sector Development Program (FSDP) has outlined many initiatives, such as raising the share of SME loans as a percentage of total bank loans by 2020, raising the level of private equity and venture capital financing to SME funding, introducing fintech companies to facilitate SME financing and expansion and helping SMEs to get listed in the Nomu parallel market.

SMEs in Saudi Arabia are financed through commercial banks and government financial institutes such as the Social Development Bank and SIDF. Banks adopt a cautious lending approach for this sector. Banks are apprehensive

to lend to SMEs due to low revenues per client, high risk of business failure, governance issues, insufficient collateral, and absence of audited financial statements. SMEs also face challenges in securing bank financing due to their lack of knowledge of banking products, high profit rates and checklist-based approach adopted by banks. In addition to the above, the legal and regulatory framework for SME lending also needs to be strengthened.

Banks showing ingenuity towards SMEs

Banks need to adopt a customized and differentiated approach toward SME lending. They should look at identifying high growth SME industry segments and strive to attain market leadership in these. This would enable them to increase their competitiveness by specializing in select products. Banks can reduce their overall risks and increase profitability at a customer and book level by adopting the following:

- Developing differentiated offerings for micro, small and medium segments
- Adopting appropriate insight-based customer segmentation strategy
- Selection of cost-effective distribution channels
- Maintaining a wider and distributed customer reach
- Comprehensive approach for pricing and product development
- Adopt quantitative and qualitative credit risk scoring and rating tools to radically improve the consistency of credit decisions
- Enhancing customer service
- Deploying non-traditional sources of information such as checking account transaction history, ATM usage, relationship tenor, and third-party information such as utility bills and rent payment for qualitative assessments
- Adopting risk-based pricing at sub-segment or customer level to maximize portfolio profitability

Conclusion

Diversifying income sources through SMEs is an important element to enhance the private sector contribution to GDP and provide jobs to the growing young population. Banks can play a pivotal role in meeting the financing gap faced by this sector.

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Restructuring: Imperative or an Opportunity?

Regardless of which school of economics you belong to, the consensus in the 21st century is that the economic prospects of a country lie primarily in its ability to offer entrepreneurs and business owners an enabling environment to take risks and create jobs.

In one respect, entrepreneurship is an almost heroic activity and deserves much recognition by society. Similarly, but to a lesser extent, the capital deployment by business owners, or investors, is a necessary and imperative activity for the growth and survival of an economy. Saudi Arabia and other countries in the region have developed new legal frameworks to protect the private sector, recognizing the need to create wealth by encouraging local businesses and attracting foreign capital. Local companies, entrepreneurs, and international investors should feel safe taking financial risks. Banks play a fundamental role in the development of the private sector and the economy. Like investors, lenders assess the risk of lending and demand a fee in return. But unlike the return on capital injected by entrepreneurs, investors and shareholders who have all their capital to lose and must wait in line before receiving a dime of profit, lending returns (interest) are naturally lower as they bear significantly lesser risk. Interest payments are senior in the capital structure, they are due on specific dates irrespective of business performance and are very often along with loan principal secured by assets.

When business is doing well, investors are eager to invest, and banks rush to lend. Good economic times induce complacent behaviors while stakeholders – banks and shareholders – undervalue the risks and drop their guards. Banks tend to extend under-collateralized loans and misprice assets or risks, hungry for fees and eager to further grow their portfolio and market share. Bankers get paid high commissions for originating loans, but never for collecting the loans back. As soon as the cycle turns the peak, demand for goods drops, margins tighten, firms become under pressure, and repayment of borrowed money becomes at risk. Only then does a company start realizing it is in distress, but also, only when a loan payment is missed or delayed, does the bank formally recognize its client is facing serious issues.

The reality is that businesses rarely go from prosperity to failure in one step. Companies' boards and the management must work together with banks to recognize early signals of commercial and financial distress. The sooner the company recognizes patterns of inefficiencies and disruptions, acknowledging its current or potential underperformance and takes aggressive measures accordingly, the more likely it is to survive the downturn, and grow stronger afterwards.

Management and shareholders must have the courage to look the tiger in eye and embrace the need for a turnaround early, including a drastic change in business or operating model. They must consider preemptive disruptive market force and use certain short-term and longer-term restructuring and turnaround tools to transform the business from an under-performing company into a potentially top performer. While recognition is the business' responsibility, banks and advisors have a role to play through their close relationships with decision-makers.

As such, following the recognition phase, companies must carry out three main restructuring tasks:

1- Diagnosis

The prerequisite to any such step carries a change or adjustment of stakeholders' attitude, a resolve to act in good faith for the sake of the company, and a strong focus on one goal; that of saving the company and overcoming the current and upcoming challenges. Egos must be put aside. Management and board of directors must act in full transparency by articulating and confronting the problems. A culture of honesty, empathy should reign in, replacing one of reprimand and blame. The diagnosis is built primarily on the identification of (i) internal factors such as working capital mismanagement, underperforming sales, etc. and (ii) external factors such as change in regulations, recession, litigation, new market forces, etc. An advisor's most important role in this step is to get the truth about the underlying issues and deal holistically with the complexity of restructuring a business, by asking deep and sometimes embarrassing questions, by determining whether an observed difficulty or problem is cause or effect, by deploying diagnosis tools such as cross-sectional analysis, financial ratios assessment, dashboard cash-flow models, tailored interviews with team leaders, by reviewing internal policies and procedures, by appraising the decision-making processes, and by mapping the business and operating models processes to the existing business capability (capacity, infrastructure, team sizes, governance). The sooner the recognition and diagnosis, even if it is believed to be preventive, the quicker the causes of financial distress are identified.

2- Design and implementation of short-term and longer-term solutions

The optimal solutions to the diagnosed problems would typically include a combination of top-down and bottom-up approaches. A top-down approach could include a design of large-scale

quarterly objectives such as a cost-saving and efficiency program (e.g. cost cutting by 45%), a shift in strategy (e.g. focus on younger customer segment), an adjustment or transformation of the business model (e.g. digitization of sales, asset light model), a simplification of the operating model (e.g. outsourcing of procurement). Considering recent changes of the regulatory and taxation landscapes (e.g. Saudi markets opening to global investors, privatization reforms, VAT implementation, increased labor and energy cost, etc.) such objectives must ensure the company is able to develop economy of scale and compete with global players. A bottom-up approach typically includes highly impactful initiatives such as the layoff of non-performing highly paid staff, or the reverse engineering of sales numbers of a loss-making product, resulting in a Required Sales Target which, if not achievable, would trigger the prompt exclusion of such product. What is also required is a balancing act between meeting short-term saving and investing in long-term performance. Cutting staff across a highly performing sales team is suicidal for the business especially if sales targets were not met in the past due to shortage of products. The immediate closure of an under-utilized cash bleeding plant, the sale-lease-back of warehouses, and the focus on working capital enhancement are all short-term wins and great sources of much needed cash in the initial turnaround phase, while the capital investment in the expansion of a profitable product line should be implemented as soon as the funding source is identified.

As solutions are designed and implemented, the stakeholders must not lose sight of their customer value proposition and should maintain an outward view towards their client base and competitors. External disruptions are far more lethal and inflict permanent damage.

3- Identification of funding sources

It takes money to sustain operations and time for transformation to take effect. A major challenge is finding resources to keep a business going while it is being transformed and restructured. Raising capital for a company in distress can be difficult, time consuming and expensive. The advisor and the stakeholders would need to race against the clock to find more creative solutions that can come in the form of fixed assets divestiture, aggressive receivable collections, inventory liquidation, or more generally cash cycle optimization. The advisor must identify the excess assets and implement an efficient use of the remaining ones. To the extent such assets were funded by debt, their liquidation is a great relief. As the company progresses in taking corrective measures and achieving planned milestones, the advisor would help showcase the future re-birth of the business to equity investors for new capital injection and/or to banks for existing debt rescheduling or restructuring, renewal of working capital facilities, and potentially new lines of financing.

Conclusion

A successful restructuring is a win for everyone, and an unorganized collapse and liquidation on the other hand is certainly an outcome the banks wish to avoid at any price. The current and recently enacted bankruptcy law in Saudi Arabia leveled the playing field by offering businesses some protective options and room to work out agreeable restructuring solutions with banks. An unprecedented collaboration amongst all stakeholders through the formation of restructuring team or committee, comprising of representatives from the company's management, its shareholders, the banks and the restructuring and turnaround advisors who come with commercial, financial and technical know-how, is of vital importance, starting from the early recognition of distress signals, to the implementation of solutions and finally the rehabilitation or rebirth of the business.

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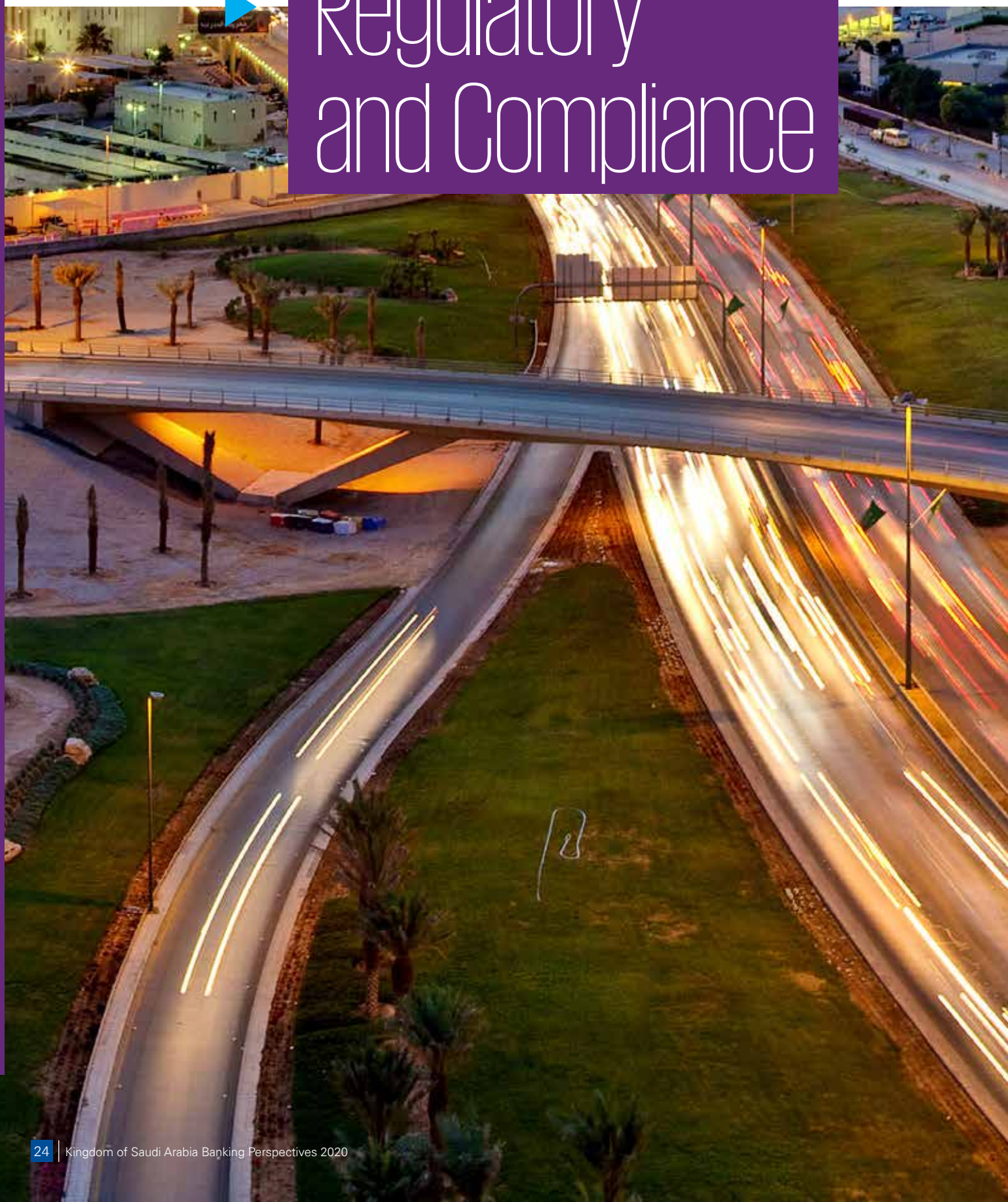
Regulatory and Compliance



VAT: More compliance, more costs?

VAT regulation in Saudi Arabia allow banks for a VAT deduction if an expense is put to a mixed use, ie. an expense is made for both taxable and exempt supplies. Such exempt activities in the industry impact cost and profitability. Effectively managing VAT and implementing the right steps will help banks in Saudi Arabia in complying and handling costs successfully.

Setting the context

Value added tax (VAT) has been part of the global taxation system for more than half a century, originating in France and spreading to well over 150 countries around the world. Often described as 'a simple tax', VAT has had a profound impact on business in areas as diverse as supply chain and human resources because it is transactional in nature.

VAT was implemented in the Kingdom on 1 January 2018 and thus far, only the UAE and Bahrain have joined Saudi Arabia in implementing VAT. Qatar, Kuwait and Oman are scheduled to introduce the tax by 2021. The standard rate of VAT is five percent with certain specified goods and services qualifying to be taxed at zero percent or to be VAT exempt.

Over the past two years, our understanding of VAT and its impact on certain industries has developed rapidly. It is clear that industries such as banking have been more impacted by the introduction of the tax than others.

The banking industry is complex and broad, traditionally encompassing retail, corporate and investment banking services. The industry is now disrupted by fintech and convergence with non-traditional competitors such as telecom operators and global technology players such as Apple and Samsung entering the market. In this region, Shari'a law prohibits the earning of interest and therefore specific structures are required to provide debt financing which must be compliant with this law. All these factors influence the application of VAT in the industry.

How it works?

In broad terms, banks make a mixture of taxable (fees, commissions, discounts) and exempt (margin-based, interest bearing, sales of securities) supplies. Taxable supplies entitle the business to deduct VAT incurred on business expenses in full whereas exempt supplies prohibit such deduction in full. Immediately, a cost arises where the business makes exempt supplies because VAT deduction is blocked. The VAT regulations in Saudi Arabia allow a VAT deduction if an expense is put to a mixed use (that is, the expense is used to make both taxable and exempt supplies) but only to the extent that it can be demonstrated that there was some taxable use.

Typical examples of mixed-use expenses would be overheads, centralized costs such as office accommodation, accounting, trading systems, information systems, legal. Saudi VAT regulations stipulate how taxpayers can calculate the amount of VAT that can be deducted where the expense is put to a mixed-use.

Currently, the approach adopted in Saudi Arabia is that the taxpayer determines the deduction percentage annually and makes an adjustment retrospectively to VAT returns already submitted — either paying additional VAT to the authorities or receiving a refund. The taxpayer must also apply this percentage going forward for one year.

The calculation is based on a pro rata formula as follows:

Value of taxable supplies

The resulting percentage should be applied to the value of mixed-use VAT.

The exempt activities in the industry have a direct impact on costs and, consequently, pricing and profitability. It can be very difficult for banks to link expenses directly to either taxable or exempt supplies and therefore a significant proportion of expenses can be described as mixed-use. Typically, banks deduct a low percentage (15–25 percent) of mixed-use VAT and must invest a lot of time and effort to manage this cost.

Banks must also determine how much VAT can be deducted on the purchase of capital assets according to the taxable use of the asset over time. The adjustment periods are six years in respect of moveable tangible or intangible capital assets and 10 years in respect of immovable capital assets which are permanently attached to land or real estate. This requirement adds another layer of complexity to the compliance obligations of the taxpayer. Accessing the data necessary to enable compliance can be a challenge given the multiple systems and huge volumes of data which are common to this industry.

Undoubtedly, the introduction of VAT has had a significant impact on the banking industry from a reporting and compliance perspective but also in terms of pricing and business model. For example, an outsource model (call center, IT support) will now create additional VAT costs if expense relates to exempt activities.

We believe that the approach to effectively manage VAT in the industry will evolve as it becomes pressing to comply and manage costs. In this sense, Saudi Arabia is following in the footsteps of taxpayers operating in more established and developed VAT regimes.

Further impact

In a continuation of this chapter reviewing the impact of VAT on banks in Saudi Arabia, we shall be releasing a series of articles focusing in more detail on how the banks manage VAT in terms of the cost of funds, product pricing, systems costs, and overall profitability. We shall also review the more subjective areas of the tax such as direct attribution, the proportional calculation and the application of the capital assets adjustment provisions in the Implementing Regulations.

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FATF: Focus on effective AML/CTF Regulations

Full membership of the Financial Action Task Force (FATF) is both a recognition of the progress the Kingdom has made, and also raised the bar in terms of expectations for the future. Consequently, SAMA is both strengthening standards, urging banks to take their own measures in anti-money laundering and counter-terrorism financing (AML/CTF) and enhancing monitoring and oversight at system-wide and individual banking institution level. In parallel, SAMA is also focusing on regulatory reforms to proactively set the direction in response to rapid changes in business models resulting from advancements in use of technology in banking sector, which are creating new threats but also new solutions to prevent, detect and monitor fraudulent behavior.

In June 2019, Saudi Arabia was accepted as the 39th – and first Arab member of the Financial Action Task Force (FATF), an inter-governmental body established in 1989, responsible for setting standards and promoting effective implementation of legal, regulatory and operational measures for combating money laundering, terrorist financing and other related threats to the integrity of the international financial system. The full membership was granted after the Kingdom had observer status for almost four years. Saudi Arabia joining FATF is a significant milestone and demonstrates the Kingdom's sustained and institutional engagement on combating terrorist financing.

As a full member of FATF, there is expected to be further impetus to enhance and increased effectiveness of AML/CTF rules, processes and associated measures.

Specifically, the FATF mutual evaluation report noted that SAMA is committed to requiring all financial institutions within the Kingdom's jurisdiction to implementing recommendations for combating money laundering and the financing of terrorism issued by FATF. SAMA is, therefore, likely to provide further focus around standards, monitoring and risk oversight around AML/CTF issues.

Based on our extensive work across the sector, we expect that this is likely to encompass:

- Enhanced supervision and monitoring, in so far as it related to existing AML and related regulations and standards.
- A more hands-on focus on key areas of risk, including likely enhancement enforcement actions.
- New standards and developments, for example in the context of SAMA's focus on e-banking and digital banking related market provision.

We explore below what this will mean for leadership teams in financial institutions

Further focus on key risks and key risk indicators, including more effective use of technology

AML/CTF threats and the risk landscape are continuously evolving, largely due to changing business models and digital developments like automated payments and transactions, the use of Artificial Intelligence (AI), Robot Process Automation (RPA) and related new capabilities that have entered into the domain of financial services. This increases the challenge in 'connecting the dots' between different entities in a bank's systems and between different transactions to effectively identify risks, such as:

- Identifying links and correlations between different fraud (or suspected fraud) instances over different timeframes, to identify new AML schemes, identify and analyze trends in AML cases.
- Identifying suspicious connections between bank employees and/or branches and customers, such as irregular clusters of transactions performed by specific tellers, family or other relations between bank employees and customers.
- Tracing money paths and identifying suspect links between customers, potential undisclosed relationships between customers used to bypass AML, know-your-customer (KYC) or anti-bribery and corruption (ABC) restrictions, and fictitious customers.
- The identification of suspicious mobile or online transactions, transactions suspected of being designed to bypass transaction cap restrictions, special approvals.

A key priority is the integration of intelligent automation and innovative technology into the existing technology infrastructure. Financial institution leaders could explore and leverage new technology capabilities to automate their

compliance activities alongside similar transformations being undertaken by their business counterparts. For instance, robotic process automation (RPA) can assist in retrieving data for money-laundering investigations and scanning public databases for changes to laws, rules and regulations. Machine learning can be used to identify risks using public information and historical outcomes of previous investigations. Meanwhile, cognitive technology can be used, capable of mimicking aspects of human judgment to, for example, interpret transaction activity.

It is imperative for banks to enhance their risk identification efforts, and as part of that there are possibilities to support better harvesting of data across systems and take a multichannel approach to fraud, compliance and operational risk management.

Accounting for emerging insights from the Terrorist Financing Targeting Center (TFTC)

The Terrorist Financing Targeting Center (TFTC) is a multilateral initiative between the United States, Saudi Arabia and the other GCC countries. The TFTC's goals are to:

- Identify, track, and share information regarding terrorist financial networks.
- Coordinate joint disruptive actions.
- Offer support to countries in the region that need assistance building capacity to counter terrorist finance threats.

TFTC identifies and develop lists with targeted sanctioned entities. It will be important for banking sector entities in the Kingdom to effectively account for the output of TFTC initiatives and take necessary steps to enhance and revise their AMT/CTF monitoring arrangements.

Focus on strengthening application of existing AML/CFT arrangements

In the short term, institutions in the banking sector may want to prioritize the following:

1- Remediating the areas for development identified through the recent assessment of the AML program. Financial institutions should prioritize a review of the compliance risk assessment framework aimed to ensure it covers all business areas and enables them to identify and adequately prepare for money-laundering risks. These are continuously evolving with the entry of new financial products and players in the competitive market, as well as with Fintech developments such as digital finance and cryptocurrency. Secondly, they should implement a monitoring program to validate that the annual compliance plan, transaction monitoring and KYC processes address regulatory requirements and are aligned with the firm's risk profile

2- There should be a greater focus on effectiveness by ensuring that key risks are clearly understood, and mitigation measures are designed and implemented to ensure compliance with the regulatory provisions on AML and sanctions.

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Shari'a Compliance - A practitioner's perspective

With an increase in complexity and volume of Islamic financial products, Islamic Financial Institutions (IFIs) are in need for a well-defined internal and external assurance process to manage risk of Shari'a non-compliance, and seek maximum Shari'a obedience.

The world has observed several financial crises in recent years. Each crisis highlighted the inadequacies of the existing financial systems and calls for scrutiny of the conduct of the key players. In an attempt to provide an alternative, Islamic Financial Institutions (IFIs) across the world, have made efforts to develop comparable financial products while retaining the deep commercial wisdom of Shari'a principles as well as the high ethical standards it holds.

However, with increasing complexity and volume of Islamic financial products, there is growing concern among market participants, regulators and industry commentators that the IFIs need not only be genuinely Shari'a compliant but also to be viewed as such.

Risk of Shari'a non-compliance

Shari'a risks for an IFI emanate from an actual or perceived non-compliance with an acceptable interpretation of the Shari'a. These risks are manifest in various ways and are broad in their emergence, occurrence and impact.

Shari'a compliance risks affect IFIs in all stages of their lifecycle, starting from conceptualization of Islamic instruments, followed by structuring the products, legal documentation, selling and market conduct, execution and implementation, recovery and mechanisms of dispute resolution, restructuring and renegotiations and lastly, accounting and disclosure.

In order to address these risks, IFIs endeavor to develop a framework for Shari'a risk management. In some cases, Shari'a risk management is embedded with the IFI's overall risk management framework, however, in most cases IFIs tend to deal with Shari'a risk separately. This separation is mainly driven by human resource constraints and sensitivities around interpretational aspects of Shari'a guidelines.

There have been several research papers authored in recent years by academics and Shari'a practitioners, defining various approaches to managing Shari'a compliance risks. Most of these highlight the need for an internal as well as external assurance process.

Internal assurance over Shari'a compliance

The currently most widely adopted approach is to establish independent bodies of knowledgeable agents. These bodies are usually internal to IFIs and part of its governance structures. They include Shari'a Supervisory Boards (SSBs) and Shari'a Review units. SSBs consist of Shari'a scholars responsible to provide guidance and support to IFIs in all aspects of their Shari'a risk management.

Shari'a review units are usually manned by individuals with knowledge of Shari'a as well as contemporary audit and compliance methodologies. These review units report to SSB on a pre-determined frequency and support SSB in providing their annual Shari'a certification to IFIs.

By observation and talking to industry specialists, it becomes very clear that there is scarcity of qualified, trained and experienced resources to conduct Shari'a compliance work. Internal Shari'a review units are evolving continuously and going through the 'learn as you go' phase.

This, coupled with limited authoritative literature on Shari'a compliance review methodologies, including documentation, sampling and quality assurance standards, creates significant challenges for such units and SSBs. Absence of a universally/regionally accepted qualification for a reviewer is another impediment in the progress.

External assurance over Shari'a compliance

While use of SSBs and Shari'a review units provides stakeholders with much needed comfort, need for independent and external reviews cannot be ignored.

Auditing profession, in general, is very well regulated and the robustness of its methodologies, along with high documentation, sampling and quality assurance standards, prepares them to play a significant role.

However, external auditors need to develop a general knowledge of Shari'a and specific knowledge of fatwa issued by SSBs to be able to perform this task.

They would also need a regulatory push to take an active role in this space. The Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) makes it mandatory for external auditors to look at Shari'a compliance aspects of the business and include comments in the report on the financial statements. However, this is limited to a few jurisdictions only.

Shari'a ratings and Shari'a indices

External rating agencies can play a positive role in providing assurance over Shari'a compliance. Similarly, Islamic stock market indices like FTSE Global Islamic Index and Dow Jones Islamic Index, contribute toward better Shari'a governance for publicly traded IFIs.

Conclusion

Compliance with Shari'a principles remains the cornerstone of each and every transaction undertaken by IFIs. Customers, shareholders, investors, board members and regulators are keen to seek the highest level of Shari'a compliance. There are improvement opportunities and a right mix of internal and external assurance process should be put in place to achieve this.

While external auditors' main focus is toward true and fair view of the financial statements, their knowledge of the business of IFIs and auditing experience and independence prepare them to play a significant role in providing assurance over Shari'a compliance. For them to play a role in this space, a regulatory push is needed.

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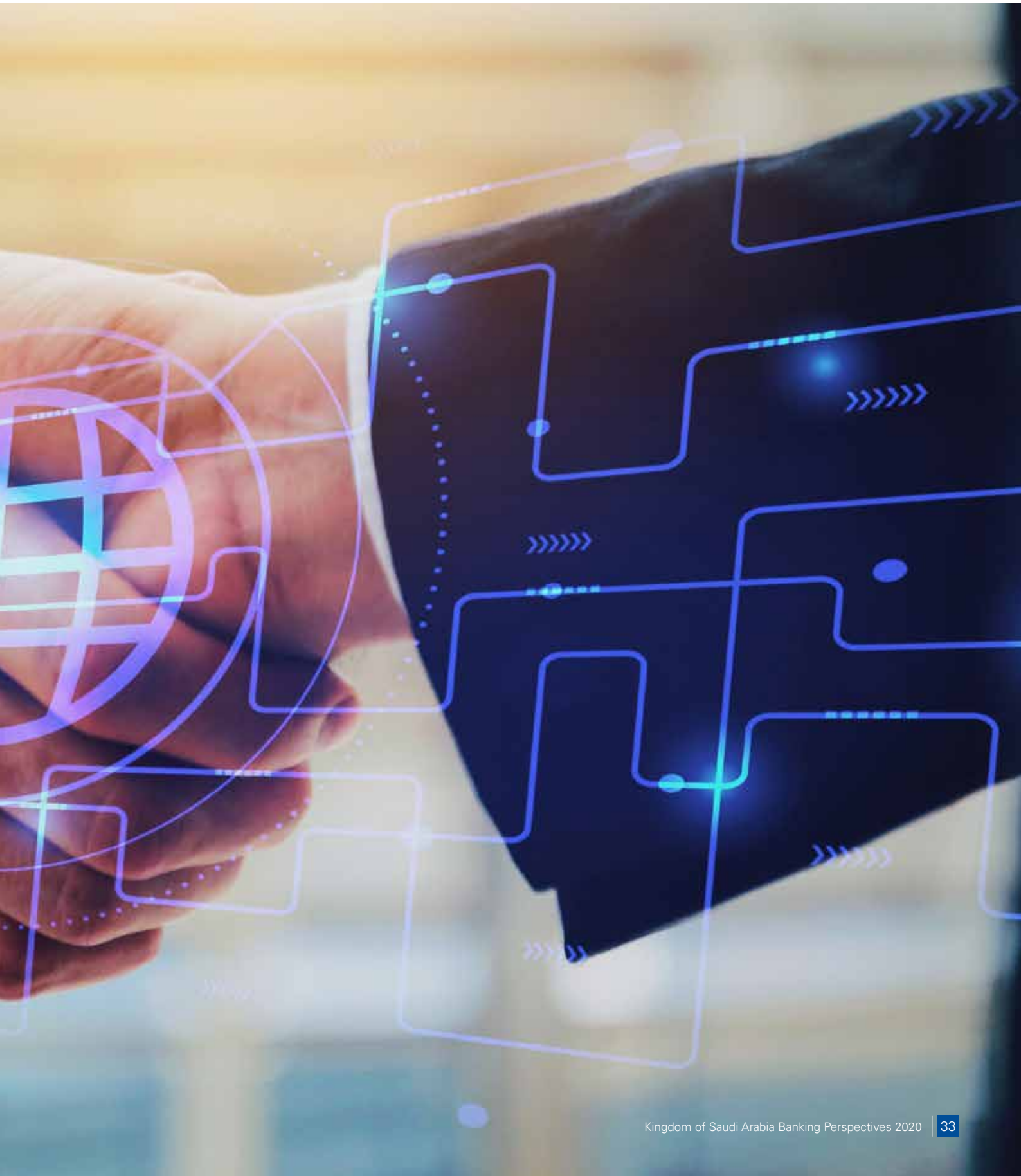
Information Technology



Fintech: Can Banks stay away from Fintechs?

The emergence of fintechs and the disruption caused by them thereon cannot be overlooked by the Saudi financial service industry. For banks to remain relevant, they need to break the silos and chalk out a clear collaboration plan to enhance overall customer experience and increase process efficiencies at the same time.

The financial services industry is undergoing a paradigm shift. Emerging technologies are providing new ways to enhance the customer experience, responding to regulatory change, underpinning new payments or digital delivery models, making service delivery faster and more cost effective, or improving the efficiency of back-office functions. A myriad of fintech solutions available, or in development, are helping to rapidly reinvent the entire value chain of financial services.

The evolving ecosystem

The swift evolution of fintech has forced traditional banks to face a new reality wherein products, services and business models that have worked in the past are no longer relevant or considered as a viable option in the digital world. Legacy IT infrastructure has to be replaced or augmented by newer, more efficient technologies. To survive and thrive in today's digital generation, banks need to recognize the need to reinvent the way they manage their business. Their competitors are evolving too, and it is not just fintechs knocking on the customers' door through various channels, but technology companies, telecoms, postal services, retailers, global and niche companies which are all looking for ways to provide what customers are demanding from their financial services providers which may no longer be a bank.

Remaining competitive in this constantly changing environment is an enormous ask for banks. This is driving banks to undertake major transformation journeys to transition from complex legacy technology environments to more agile operations and creating more efficient compliance processes that fully satisfy evolving global and local regulations, while ensuring a seamless customer centric client engagement. Financial institutions see fintech as a major part of the digital future.

Fintech – friends or foes?

While financial institutions recognize fintech is a substantial disruptor, banks are orienting themselves to define how they should approach and adopt fintechs in their businesses. Leading financial institutions globally are pursuing many ways of either partnering with fintechs to resolve specific issues or acquiring them with a view to prudent investment for the future. However, closer to home in Saudi Arabia, many banks are in the early to middle stages of evaluating how fintechs can help them with their issues related to front-end omnichannel-based customer servicing for increasing process efficiencies and regulatory compliance. One thing clearly emerging is that local Saudi banks are now open to the idea of evaluating how fintech solutions can help them rather than seeing them as a threat and investing in-house technologies as in the past. Banks are now rapidly looking at embedding the adoption of fintechs in their overall business and digital strategies.

SAMA launched 'Fintech Saudi' with the objective to make the Kingdom a pioneer in the fintech sector, in line with Vision 2030. Key regulations on digital signatures and customer versification will further facilitate in the buildup of the digital banking ecosystem.

There is no shortage of opportunities, but selecting the most appropriate one is imperative to success in implementing these new technologies for banks.

To be able to succeed in today's fast evolving digital world, banks need to define a clear fintech strategy that aligns to organizational objectives, considers current assets and capabilities, and includes an execution plan for addressing gaps and managing a transformation that may never have a defined end point as fintech will continue to evolve. There is not one clear-cut strategy or roadmap which can be deployed off the shelf when it comes to defining the individual fintech plans for banks.

Banks would need to ensure that fintech opportunities are well defined and fully aligned to their overarching business strategy. Leading banks have established specific fintech strategies that consider their business objectives, customer expectations, market position, organizational structure and culture, the geographies in which they operate, and the fintech opportunities and solutions available to them, together with buy in and support from the executive leadership.

Conclusion

For banks struggling to decide which solution is best suited to help them solve their business issues, help is close at hand with KPMG's Matchi platform, a leading global fintech innovation and matchmaking platform that connects financial institutions with leading-edge financial services technology solutions and companies worldwide. Matchi's database includes over 3,500 fintech solutions. Using the Matchi platform, financial institutions are able to search for a specific company or solution, or they can use the platform's proprietary 'Innovation Challenge' capability to present specific problem statements to the global fintech market and receive recommendations on solutions from fintech innovators.

It is clear that banks can no longer be engulfed in their own silos, oblivious to the rapid changing developments happening around them in the fintech world. Banks would need to adopt and adapt fintech strategies developed specifically for them to enhance their overall customer experience, increase process efficiencies and comply with everchanging regulations. Banks would be better off exploring ways and means to collaborate with fintechs rather than seeing them as a threat and trying to fight them off. The sooner the banks can see fintechs as their ally rather than competition, the sooner they will be able to confidently embark on the banking of the future journey together.

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Cybersecurity: Building Trust

Saudi Arabia aims to achieve an e-payments target of 70% by 2030, underpinned by SAMA's strategy for payment systems and the Financial Sector Development Program (FSDP).

Large amounts of sensitive information is processed, transferred and stored by multiple parties on different platforms and devices, some are more secure than others and some are not secure at all. For malicious actors this is a huge opportunity for large financial gains.

Cybercrime has become one of the most organized crimes across the globe. The cybercrime reported losses are dramatically increasing and In 2021, cybercrime damages might reach US$6 trillion what would be equivalent to the GDP of the world's third largest economy according to the World Economic Forum Global Risk Report 2020.

The fast-paced and dynamic cybersecurity threat landscape across the globe and the Middle East region creates a challenge for the financial sector in Saudi Arabia to prepare and respond to the ongoing waves of cybersecurity attacks.

Now is the time for banks to create a resilient cybersecurity infrastructure that can empower them to identify, protect, detect, respond and recover from cyber threats. This is essential to draw investments by creating a secure financial services ecosystem and to enhance customer's trust and confidence in the Saudi financial sector.

To begin with…

Being aware of these challenges and threats, the financial sector started this journey many years ago when SAMA recognized the importance of protecting the financial sector information assets through regular cybersecurity assessments covering the people, process and technology aspects of the financial sector member organizations with special focus on the banks. Since then, SAMA has been continuously raising the bar and developing suitable techniques for achieving the objectives of cybersecurity and protecting the sector's information assets. In May 2017, SAMA released its Cybersecurity Framework for the member organizations of the financial sector regulated by SAMA to effectively identify and address risks related to cybersecurity. SAMA is also aware of the increasing demand on cyber talents and the challenges faced by the financial sector entities in finding the right cadres in this filed. SAMA responded to this challenge by launching a specialized cybersecurity program which has been running for three years now (Secure 17, 18 and 19).This twenty-weeks program provides the trainees with scientific training and practical application, visits and various activities in the field of cybersecurity by international specialized bodies in this field.

In June 2019, SAMA issued the Financial Entities Ethical Red-teaming (FEER) Framework which is intended as a guide for the financial sector entities within Saudi Arabia in preparing and executing controlled attacks (i.e. threat intelligence based red teaming tests) against their production environment without exposing sensitive information with the help of certified and experienced Red Teaming Providers.

As per a recent publication from the Financial Stability Institute (one of the bodies hosted by the Bank of International Settlements BSI), SAMA FEER is one of only six similar frameworks issued around the world. This is only another indicator that SAMA

and the Saudi financial sector are very aware of the challenges and are acting upon them to increase the readiness of the sector.

Together, SAMA and the banks are working as one team through a strong governance structure toward achieving the ultimate objective of maintaining a trusted, resilient and secure banking sector in Saudi Arabia.

Maturity level

The current cybersecurity maturity of most of the banks within the Kingdom are between maturity level 2+ and 3, implying that they have been structurally implementing their cybersecurity controls. Some banks are potentially even reaching level 4, where they also need to demonstrate that the cybersecurity controls are periodically evaluated regarding the effectiveness of the implemented controls.

Need of the hour

The digital era and the increasing adoption of emerging technologies including, but not limited to, cloud, artificial intelligence, internet of things, blockchain, and robotics increase the attack surface and enable more sophisticated cybersecurity attack techniques that require an agile and adaptive cybersecurity defense mechanism. Banks and financial entities are expected to adopt the most recent technologies and provide the best and smoothest experience for their customers who are not easy to satisfy and retain. It is therefore a joint responsibility of the CISOs and businesses to work together to ensure that security is embedded in the design of new products, systems and solutions. Also, to make sure that business decision makers are made aware of the risks incorporated with the adoption of specific technologies that are immature or vulnerable.

Conclusion

There is no 100% secure environment. Cybersecurity is a state of mind in addition to having the adequate tools, techniques and processes to be able to detect, protect, respond and recover from cybersecurity attacks. Building a secure and trusted environment by design, which is periodically tested and improved, will benefit the overall business trust and enhance the economy by gaining the confidence of customers and investors.

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Culture and Governance

Culture, Conduct and Public Trust

As the country adjusts its focus with Vision 2030, all industries, including financial services, are expected to inculcate a sense of positive culture and conduct via stronger management frameworks that can reduce the risk of misconduct and protect the value of the brand.

Much has been done in recent years by the senior management of banks and banking regulators to enhance risk management frameworks and governance practices. Notwithstanding these measures, problems continue to occur which impact public trust in the sector and the reputations of previously esteemed institutions. Fines for compliance and conduct breaches have become almost the norm. Moreover, fair treatment of customers by the industry can no longer be taken for granted, necessitating a considerable regulatory response in some jurisdictions. An emerging theme is that the culture of banking institutions is at the heart of how employees are inclined to act, and more needs to be done to enhance corporate cultures to better serve the interests of shareholders, customers and depositors.

Trust can take many years to earn, but can be lost in an instant.

We now have a list of case studies over the last decade which underscore this theme.

- The global financial crisis of 2007–08 was brought on, in large part, through unsafe and unsustainable mortgage underwriting practices, and an assumption that through financial engineering and redistribution of risk, the institutions engaging in this initial activity would avoid the inevitable losses. A secondary issue was the lack of transparency regarding the risks when these contracts were packaged into structured financial instruments for onward sale. Many market participants in this activity have paid a hefty price through regulatory fines and other measures to offer redress to investors.

- The various rate-rigging episodes, most notably affecting LIBOR, have impacted institutions in London, New York and elsewhere, and have led to landmark developments to fundamentally rethink and change mechanisms for the setting of risk- free rates, the impact of which will continue to reverberate for many years.

- Most recently, money-laundering scandals have rocked several Nordic banking institutions. These cases are by no means the first involving the uncovering of significant financial crime compliance deficiencies, and follow on from the record of a US$9 billion fine along with a criminal conviction, imposed upon BNP Paribas several years ago for anti-money laundering and sanctions compliance deficiencies.

- The recent Banking Royal Commission in Australia shone a light on a litany of unsavory practices, from overcharging of customers to provision of biased and unsound financial advice, and poor customer complaints handling and resolution protocols.

Tone from the top

A theme running through each of these case studies is that at some level, employees in the institutions involved knew that their conduct was not befitting and was inappropriate. In some cases, the senior management and the board had knowledge of the matters and chose to turn a blind eye, arguably because the profits from operations were strong. In other cases, boards and senior management may not have been willfully negligent, but should have exercised better oversight and monitoring of activities.

In almost all cases, the consequences have been extreme, with CEOs, other senior management and chairmen often removed from their roles, in addition to the monetary fines and other sanctions. But, in addition to this accountability impact, institutions have often paid for the shortcomings for many years after the events through large remediation projects and significant distraction of management time.

"I may have the right to do this, but is it the right thing to do?"

It can be argued that something must have been wrong with the culture of the industry and its players to lead to the kind of behavior which has given rise to the quantum of misconduct across many jurisdictions.

- Was it caused, at least in part, by aggressive targets and unbalanced financial incentives for employees?
- Were boards cognizant of the risks?
- Why were monitoring and reporting mechanisms ineffective?

Regulators, including in the USA, the Netherlands, Hong Kong and Singapore, have started to turn their attention to these topics, in addition to international bodies such as the Financial Stability Board. The G30 has gone as far as calling for sustained and comprehensive reform of banking conduct and culture.

The Saudi Arabian context

This is a time of significant change in the banking industry in Saudi Arabia. The Vision 2030 agenda requires many industries, including the financial services sector, to play a supporting role. Areas of focus include sovereign debt raising, project financing, home financing and private savings. We are witnessing bank consolidation, in part improve positioning to meet these challenges. There are also the threat and opportunity of digital disruption, both for existing institutions and new entrants as new license approvals are granted for both local and foreign banks. Increasing competition can be one of the factors which drives poor conduct, as institutions and their employees feel the pressure to deliver results.

The backdrop of these industry challenges makes it a good time to consider the impact of culture and conduct in Saudi Arabia's banking industry. At the micro level, individual institutions can be better positioned to avoid costly and distracting incidents which damage the brand and reputation. At the macro level, the safety and soundness of the sector will be bolstered by it. And this is important to ensure that trust and confidence in the industry are maintained during this period of growing competition and change.

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KPMG in Saudi Arabia

KPMG in Saudi Arabia was established through its member firm KPMG Al Fozan & Partners and has operated in the Kingdom since 1992.

This early commitment to the Saudi Arabian market, together with our unwavering focus on quality, has been the foundation of our accumulated industry experience, and is reflected in our appointment by the Saudi government and some of the Kingdom's most prestigious companies.

KPMG operates through a national leadership with dedicated regional teams, which enables our network of professional talent, our technologies and our products and solutions to quickly come together to meet clients' needs. KPMG has made a significant investment in Saudi Arabia over the last five years with a number of professional staff being seconded to the local firm from across the globalnetwork.

The firm has grown to be one of the largest professional service providers in the Kingdom. During the last few years, it has achieved record growth, reaching our current workforce of 1,279 people across the Kingdom, based in three offices in Riyadh, Jeddah and Al Khobar.

119

Partners & Directors

1,279

Total employees

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