

## An analysis of Saudi Banks’ Disclosures in Compliance with BASEL III Norms: A Case study of Saudi Bank Fransi

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**Abstract:** *basel iii places stricter norms for the banks in terms of capital adequacy and risk management in order to overcome any type of financial crisis. The reforms include changes at the macro level and at the individual bank level. The complete implementation of the full set of reforms has been scheduled to 2019. However, the banks need to comply with and make arrangements to comply with the new standards. The banking system in saudi arabia, monitored by saudi arabian monetary agency, has been actively trying to enforce the reforms as per the agreed timelines. So far, the agency has introduced the leverage, liquidity and capital adequacy ratios. A sample of banks will be studied in detail for their compliance with the new norms. The results will be of significance to the banks as well as the regulator to assess the current state of compliance. Further the banks in other countries of the region will also benefit from the findings of the study.*

**Keywords:** *banking; regulation and supervision, basel iii, saudi arabian monetary system*

### I. Introduction

The Basel Committee on Banking Supervision (BCBS) published new regulations for the banks in light of the financial crisis that touched the entire world. It is strongly felt that although the core principles and Basel III framework have been adopted by the member countries, the actual implementation will be divergent. Though the deadline for the full compliance is 2019, there is a need to keep things in order in advance. The direct impact of the new regulation is mainly on the capital held by the banks. The new regulations require new types of 'capital buffers'. In general, the Basel III norms comprise of three main elements namely, "higher capital ratios, better capital quality and stricter liquidity requirements". It is remarkable to note that the banks in Saudi Arabia and many other Middle Eastern countries always maintained a high capital adequacy ratio and were less exposed to risk. This enabled them to achieve the compliance required by Basel III. This study focuses on the unit level compliance because Basel provides its recommendations to the central banks but the actual implementation has to be executed by the banks. The study will study three different banks for a complete assessment of the compliance. However, at this stage the results of one bank is presented in this study. The assessment has been done entirely on the disclosures available on the different online resources. At the advanced stage of this study, multiple sources of information will be checked to ensure that there is no discrepancy in the disclosures.

### II. Historical Overview

Basel Committee got its name for the reason that the first meeting of governors of central banks to discuss the banking regulation was held at Basel, Switzerland in 1974 (Batainah 2014) Currently, the Committee has twenty seven members. The main aim of the Committee was to promote a uniform set of rules for the calculation of capital adequacy in order to ensure a stable banking system at the global level. A historical evolution of the Basel has been presented in the Fig 1.



**Figure 1** History of Basel (Vousinas2015)

The main impetus in the first set of norms, called Basel I, was on capital adequacy, competition and consideration of risk. Additionally, the Committee also addressed the supervision by the central banks. In the initial stage, the provision of capital was called "the rule of 8 percent". The Basel II was an improvement upon the norms laid down in Basel I. In the new norms, three pillars were established to manage the risk emerging from the operations of the bank. These pillars were called the Capital Requirements, Supervisory Review Process, and Market Discipline. The first pillar comprised of the capital requirements based on the credit, operational and market risks. The second pillar resulted in the formation of Internal Capital Adequacy Assessment (ICAAP) to provide the regulatory framework as well as considering new types of risks. The third pillar deals with raising the minimum capital requirements and the supervisory review process. This requires information exchange among banks and also with other stakeholders. This requires the banks to disclose details of their "financial exposures, risk assessment process and capital adequacy ratios." Finally, after the major financial crisis, the Basel Committee proposed new set of regulations in all the three pillars and added another standard. This was called the Basel III.

### III. Basel III

Basel III was approved by the Basel Committee in the G-20 summit held in Seoul in 2010. The main focus of the new norms were enhancing the resilience of the banks and facing the shocks (KPMG 2011). In order to achieve these two major objectives, the Committee sought to modify mainly the capital adequacy requirements. There are now new requirements for increased paid-up capital. Further the quality of banking has also been addressed in the new norms. Overall, Basel III proposes reforms in three main areas - Capital; Liquidity; General Stability. At the background of these proposed reforms is that the banks become more capable of withstanding the periods of deep recession or other financial or economic shocks. Hazarika and Dubey (2014) provided a detailed analysis of the state of implementation and impact of Basel III on emerging markets, Europe and the US. Aosaki (2013) also explain the challenges for Japan, USA, and the European Union in the implementation of Basel III.

#### 3.1 Reforms

The Basel III framework includes the three pillars and an additional standard on liquidity management. The main areas of reforms proposed by Basel III are summarized in Figure 2 .

**Basel Committee on Banking Supervision reforms - Basel III**

Strengthens microprudential regulation and supervision, and adds a macroprudential overlay that includes capital buffers.

	Capital				Liquidity	
	Pillar 1		Pillar 2	Pillar 3		
	Capital	Risk coverage	Containing leverage	Risk management and supervision	Market discipline	
All Banks	<p><b>Quality and level of capital</b> Greater focus on common equity. The minimum will be raised to 4.5% of risk-weighted assets, after deductions.</p> <p><b>Capital loss absorption at the point of non-viability</b> Contractual terms of capital instruments will include a clause that allows – at the discretion of the relevant authority – write-off or conversion to common shares if the bank is judged to be non-viable. This principle increases the contribution of the private sector to resolving future banking crises and thereby reduces moral hazard.</p> <p><b>Capital conservation buffer</b> Comprising common equity of 2.5% of risk-weighted assets, bringing the total common equity standard to 7%. Constraint on a bank's discretionary distributions will be imposed when banks fall into the buffer range.</p> <p><b>Countercyclical buffer</b> Imposed within a range of 0-2.5% comprising common equity, when authorities judge credit growth is resulting in an unacceptable build up of systematic risk.</p>	<p><b>Securitisations</b> Strengthens the capital treatment for certain complex securitisations. Requires banks to conduct more rigorous credit analyses of externally rated securitisation exposures.</p> <p><b>Trading book</b> Significantly higher capital for trading and derivatives activities, as well as complex securitisations held in the trading book. Introduction of a stressed value-at-risk framework to help mitigate procyclicality. A capital charge for incremental risk that estimates the default and migration risks of unsecured credit products and takes liquidity into account.</p> <p><b>Counterparty credit risk</b> Substantial strengthening of the counterparty credit risk framework. Includes: more stringent requirements for measuring exposure; capital incentives for banks to use central counterparties for derivatives; and higher capital for inter-financial sector exposures.</p> <p><b>Bank exposures to central counterparties (CCPs)</b> The Committee has proposed that trade exposures to a qualifying CCP will receive a 2% risk weight, and default fund exposures to a qualifying CCP will be capitalised according to a risk-based method that consistently and simply estimates risk arising from such default fund.</p>	<p><b>Leverage ratio</b> A non-risk-based leverage ratio that includes off-balance sheet exposures will serve as a backstop to the risk-based capital requirement. Also helps contain system wide build up of leverage.</p>	<p><b>Supplemental Pillar 2 requirements.</b> Addresses firm-wide governance and risk management; capturing the risk of off-balance sheet exposures and securitisation activities; managing risk concentrations; providing incentives for banks to better manage risk and returns over the long term; sound compensation practices; valuation practices; stress testing; accounting standards for financial instruments; corporate governance; and supervisory colleges.</p>	<p><b>Revised Pillar 3 disclosures requirements</b> The requirements introduced relate to securitisation exposures and sponsorship of off-balance sheet vehicles. Enhanced disclosures on the detail of the components of regulatory capital and their reconciliation to the reported accounts will be required, including a comprehensive explanation of how a bank calculates its regulatory capital ratios.</p>	<p><b>Global liquidity standard and supervisory monitoring</b></p> <p><b>Liquidity coverage ratio</b> The liquidity coverage ratio (LCR) will require banks to have sufficient high-quality liquid assets to withstand a 30-day stressed funding scenario that is specified by supervisors.</p> <p><b>Net stable funding ratio</b> The net stable funding ratio (NSFR) is a longer-term structural ratio designed to address liquidity mismatches. It covers the entire balance sheet and provides incentives for banks to use stable sources of funding.</p> <p><b>Principles for Sound Liquidity Risk Management and Supervision</b> The Committee's 2008 guidance <i>Principles for Sound Liquidity Risk Management and Supervision</i> takes account of lessons learned during the crisis and is based on a fundamental review of sound practices for managing liquidity risk in banking organisations.</p> <p><b>Supervisory monitoring</b> The liquidity framework includes a common set of monitoring metrics to assist supervisors in identifying and analysing liquidity risk trends at both the bank and system-wide level.</p>
SIFIs	<p>In addition to meeting the Basel III requirements, global systemically important financial institutions (SIFIs) must have higher loss absorbency capacity to reflect the greater risks that they pose to the financial system. The Committee has developed a methodology that includes both quantitative indicators and qualitative elements to identify global systemically important banks (SIBs). The additional loss absorbency requirements are to be met with a progressive Common Equity Tier 1 (CET1) capital requirement ranging from 1% to 2.5%, depending on a bank's systemic importance. For banks facing the highest SIB surcharge, an additional loss absorbency of 1% could be applied as a disincentive to increase materially their global systemic importance in the future. A consultative document was published in cooperation with the Financial Stability Board, which is coordinating the overall set of measures to reduce the moral hazard posed by global SIFIs.</p>					

**Figure 2** Summary of Reforms in Basel III Source: BIS (2011)

#### Pillar 1 - Capital Requirements

This pillar in Basel III comprises of three major areas namely the capital adequacy; risk coverage and market discipline (BIS 2011). Pillar 1 of the Basel III Accord, as adopted and implemented by SAMA, covers the minimum regulatory capital requirement that a bank is expected to maintain to cover credit, market and operational risks stemming from its business operations.

### **a. Capital**

Basel III proposes increased significance of common equity and the minimum requirement has been set as 4.5% of the RWAs (risk-weighted assets). There will be a clause for the inclusion of capital instruments that would require a relevant authority to convert them into common shares in case the bank becomes non-viable. In this way, the private sector will play an increased role in bailing off the banks in times of crisis. There is a new requirement of capital conservation buffer in the form of common equity that must be 2.5% of the risk-weighted assets. Another provision of counter cyclical buffer has been imposed that comprises of 0-2.5% at the discretion of the authorities. the capital ratio Tier 1 has been increased from 4 to 6%. The minimum capital requirements has to be more than 8%. the capital structure required as per Basel III is summarised in Table . The constituents of Tier 1 capital are the common shares, minority interests, and retained earnings. Since January 2013, the banks are required phase-out those instruments that do not meet the criterion.

**Table 1** Basel III Capital Structure

<b>Common Equity</b>	<b>%</b>
Minimum	4.50
Stabilizing	2.50
Total Required	7.0
<b>Tier 1 Capital</b>	
Minimum	6
Total Required	8.50
<b>Total Capital</b>	
Minimum	8
Total Required	10.50

**Source:** Adapted from Vouisnas (2015)

### **b. Risk Coverage**

Another constituent of Pillar 1 is the risk coverage that requires banks to undergo strict analyses of externally rated securitisation exposures. Schwerter (2011) describes in detail how the Basel III standards will help in greater mitigation of the risks. The banks are required to maintain higher capital for trading and derivatives activities. The norms introduce a value at risk framework for mitigating the incidence of procyclicality. There is also the introduction of a capital charge for the excess risk for the unsecuritised credit products. The counterparty credit risk framework established by Basel III requires stringent measurement of exposure, incentives for central counterparties and higher capital required for the exposure in the inter-financial sectors. The Committee has also proposed details on the capitalisation of trade exposures to a qualifying central counter parties. Equity risk has also been covered in this element of Pillar 1.

### **c. Containing Leverage**

Basel III requires the enforcement of the leverage ratio for the banks. It is proposed that a leverage ratio of 3% implying that the ratio of capital to total assets should exceed this limit. The new ratios related to leverage and liquidity propose a non-risk-based measurement in order to maintain adequate capital in times of stress. Liquidity coverage ratio has been introduced that aims to measure the unencumbered assets of the banks (BIS 2010). Another advantage of the leverage ratio is to reduce the lending limit of the banks.

### **Pillar 2: Risk Management and Supervision**

The Basel III propose that this pillar should address " Address firm-wide governance and risk management; capturing the risk of off-balance sheet exposures and securitization activities; managing risk concentrations; providing incentives for banks to better manage risk and returns over the long term; sound compensation practices; valuation practices; stress testing; accounting standards for financial instruments; corporate governance; and supervisory colleges". The pillar also includes the supervisory review process called the Internal Capital Adequacy Assessment (ICAAP). There should be the credit assessment by external credit rating agencies (CRA). The detailed qualifications of the CRA have also been stipulated by Basel III.

### **Pillar 3: Market Discipline**

This pillar deals with the transparency by the banking institutions. The transparency must exist in the "capital structures, risk exposures, risk mitigation and the risk management process". The new norms require disclosures related to securitisation, sponsor of off-balance sheet vehicles, components of regulatory capital, and details of the calculation of capital ratios.

### **Liquidity and Supervision**

Basel III proposed detailed regulations called "**Global liquidity standard and supervisory monitoring**". The Basel document describes the role of liquidity coverage ratio. This standard aims to ensure

that a bank maintains an adequate level of "unencumbered, high-quality liquid assets" so that the bank can have adequate reserve for 30 days. The Committee assumes that a bank may be able to implement corrective action within this period. For this purpose, two main ratios have been recommended by Basel III. These ratios are- Liquidity Coverage Ratio (sufficient high quality liquid assets) and Net Stable Funding Ratio (for managing liquidity mismatches). The liquidity framework also imposes a set of monitoring metrics to supervise the liquidity risk at the bank and system level.

#### **IV. Basel III And Saudi Banking Sector**

Saudi Arabia along with many other countries in the Middle East are implementing the Basel III regulations (Diemers, et al 2014). Saudi Arabia is the only member in the Basel Committee from the Middle East. The central bank of Saudi Arabia, Saudi Arabian Monetary Agency (SAMA) is the first central bank in the region to meet the capital adequacy as early as in 1966. As a member of the Basel Committee, SAMA has been actively involved in developing these standards and it fully supports the package of reforms announced by the BCBS. Basel I and Basel II were adopted in 2002 and 2008 respectively. SAMA has also issued the framework and guidelines for the implementation of Basel III. The final rules related to risk-based capital were issued in December 2012. IMF (2013) provides an assessment of the supervisory structure in Saudi Arabia. The Saudi central bank has always encouraged the banks to keep higher capital adequacy resulting in a high capital adequacy ratio of 18-20% by many banks. In fact there are several areas where SAMA adopts a stricter approach. A comprehensive assessment of the compliance of Saudi Banks with Basel III was undertaken by the Bank for International Settlements (BIS 2015). The report of this assessment called the Regulatory Consistency Assessment Programme (RCAP) provides the detailed status of compliance of the banks with each pillar and their constituents. It was reported that the banks in Saudi Arabia comply with the Basel III standards. The RCAP reported that several elements of Basel capital framework had not been adopted till the report was completed. It was observed that the 85% of the banks' regulatory capital is composed of Common Equity Tier 1 (CET 1).

#### **V. Case Of Banque Saudi Fransi**

##### **5.1 About the bank**

Banque Saudi Fransi (BSF the Bank) is a Saudi Joint Stock Company established by Royal Decree No. M/23 dated Jumada Al Thani 17, 1397H (corresponding to June 4, 1977). The Bank formally commenced its activities on Muharram 1, 1398H (corresponding to December 11, 1977), by taking over the operations of the Banque de l'Indochine et de Suez in the Kingdom of Saudi Arabia. The bank has a total of 82 branches. The bank has an active supervisory board that looks after its shariah compliance. The BSF group comprises of several entities fully owned and some partially owned. The wholly owned entities are Saudi Fransi Capital, Saudi Fransi Leasing, Saudi Fransi Insurance Agency, and Sofinco Saudi Fransi. The group has minority investments in Banque BEMO Saudi Fransi, Banque BEMO, and Saudi Fransi Cooperative Insurance Company.

##### **5.2 Financial Condition**

The bank prepares its financial statements in accordance with the Accounting Standards for Financial Institutions promulgated by the Saudi Arabian Monetary Agency (SAMA) and International Financial Reporting Standards (IFRS). The Bank prepares its consolidated financial statements to comply with the requirements of Banking Control Law and the Regulations for Companies in the Kingdom of Saudi Arabia. The authorised, issued and fully paid share capital of the Bank consists of 1,205.3 million shares of SAR 10 each (Source). The ownership structure of the bank is presented in Table 2.

**Table 2** Ownership of Bank's share capital

SAR '000	%	2014	2013
Saudi shareholders	68.9	8,303,572	6227,679
Credit Agricole Corporate and Investment Bank (CA-CIB)	31.1	3,750,000	2,812,500
Total			
	100	12,053,572	9,040,179

The capital structure of the bank is presented in Table 3. As on 31 December 2014, the banks maintained a total Tier 1 capital of SAR 26 Billion and the total eligible capital was SR 30.8 Billion.

**Table 3** Capital Structure of the Bank (as on 31 December 2014)

	Components of Capital	SAR '000
<b>A</b>	<b>Core Capital - Tier I</b>	
	Eligible paid-up share capital	12,053,572
	Statutory and general reserves	9,919,264
	Retained earnings	3,905,557
	Other reserves	592,944
	Cash flow hedge reserve	(98,159)
	<b>TOTAL Tier 1</b>	<b>26,373,178</b>
<b>B</b>	<b>Supplementary Capital – Tier 2</b>	
	Qualifying general provisions	1,209,556
	Subordinated Loan Capital	3,216,000
	<b>Total Eligible Capital (A+B)</b>	<b>30,798,734</b>

Source: Financial Report 2014-15

### 5.3 Compliance with Basel III

In order to assess the compliance of the bank with Basel III standards, the financial disclosures of the banks were examined. These reports were not audited by an external auditor. The Qualitative and Quantitative Disclosures regarding the Basel III form the main sources of information for the assessment. The summarized form of the compliance on all standards is presented in Table 4. The bank has been disclosing reports in accordance with Basel norms since 2008. In the current year 2015-16, the bank has published reports for three quarters. The bank separately publishes reports regarding Capital Structure, Liquidity Coverage Ratio and Leverage Ratio. The bank also publishes an annual report comprising of quantitative and qualitative disclosures. The main findings regarding the Bank's performance in terms of Basel III are listed below:

- The tier 1 capital as percentage of risk weighted assets was reported as 14.78%. Tier 1 capital as on Sept 30, 2015 - 28,102,840. Basel III Leverage Ratio - 12.23%
- The bank has started reporting the liquidity coverage ratio and leverage ratio from 2015.
- The bank has allocated risk weights of 1250% and 250% to the significant minority investments that were deducted from 50% from tier 1 and 50% from tier 2.
- The bank ensures that the transfer of dividend is done only after 25% of the net profit is transferred to the statutory reserves.
- The Risk Management Division of the bank is the department mainly responsible for the management of risks. The division plays a major role in policy formulation.
- The banks has applied a dedicated capital measurement system procured from a global vendor. The credit risk adjudication process is done at the central level.
- The Bank uses an internal rating methodology for classification of counterparty risk and in the management of the underlying exposures appropriately.
- The Bank also follows SAMA's guidelines for asset classification, particularly those relating to past due /non-performing loans.
- For the purpose of determining counterparty risk weights, the Bank uses external credit assessments from Standard and Poors, Moodys, and Fitch.
- The applicable financial collateral for credit risk mitigation under Basel III is restricted to pledge of cash margins and deposits held with the Bank. Guarantees used for risk transfer purposes are mainly bank guarantees that meet the requirements stipulated in the Accord.
- The Market Risk Department within the Risk Management Division is responsible for measurement and controls involved in management of market risks. Market risk activity at the bank is governed by the bank's Market Risk Committee which meets regularly, and is closely supervised by a dedicated Market Risk Department that reports independently to the bank's Chief Risk Officer.
- A comprehensive bank-wide Risk and Control assessment for risk identification
- There is an Operational Risk & Permanent Control Department that studies the status of control implementation, areas of risk and required actions for various business entities to the Internal Control Committees. It is also the central repository for operational loss data of the Bank.
- The Bank has also implemented a robust Business Continuity Plan to ensure continuity of critical operations.
- Board Risk Committee at the Board level and Internal Control Committees at the executive level oversee bank wide implementation of Board approved policies and processes in this regard.
- The Bank's nature of the equity risk exposure includes: Investment in associates; Available for sale equity investment; Investment in subsidiaries.

- The Bank has formulated a policy of transferring the interest rate risk positions from all business lines to central management. The short term positions are managed by the Bank's Treasury department and long term positions by the Asset & Liability Management department

A. Capital				B. Liquidity (Global liquidity standard and supervisory monitoring)
Pillar 1	P1.1	Quality and level of capital	Pillar 1	B1. Liquidity coverage ratio
	P1.2	Trading book	P1.2	
	P1.3	Counterparty credit risk	P1.3	
	P1.4	Countercyclical buffer	Market Discipline	
Pillar 2	P2.1	Capital loss absorption at the point of non-viability	Pillar 2	B2. Net stable funding ratio
	P2.2	Capital adequacy for market risk	P2.2	
	P2.3	Capital adequacy for market risk	P2.3	
	P2.4	Capital conservation buffer	Market Discipline	
Pillar 3	P3.1	Securitizations	Pillar 3	B3. Principles for Sound Liquidity Risk Management and Supervision
	P3.2	Trading book	P3.2	
	P3.3	Counterparty credit risk	P3.3	
	P3.4	Countercyclical buffer	Market Discipline	

Figure 3 Summary of the compliance of Banque Saudi Fransi with Basel III

## VI. Conclusion

Saudi Arabia holds a significant position among the Gulf countries in the implementation of Basel III regulations. Saudi Arabian Monetary Agency being a member of the Basel Committee has been actively formulating framework for the full and timely implementation of Basel III by all the banks. The external assessments of the compliance indicate that the level of compliance is good. It is important to note that the implementation of Basel III will have significant impacts on the profitability of the banks. Another issue is the banks' resistance because the Arab Banks were not exposed to the risks that led to the financial crisis. Therefore the banks are wary of being penalized for wrong done by others. The new norms are more complex and requires substantial intervention from both technology and procedural dimensions. Saudi Arabia was able to implement Basel II completely and the implementation of Basel III will require more synchronized efforts, continuous communication and feedback between SAMA and the banks. This study tried to check the compliance of the individual bank with Basel III. The results show that the bank has been actively implementing the new standards. However the limitation of the findings is complete reliance on the financial disclosures by the bank. At the next level of the study involving three banks, multiple sources of information will be analyzed to check the extent of compliance. Still, the results of this study are significant for the researchers and policy makers who are interested in finding the compliance of banks with Basel III in Saudi Arabia.

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