Netting Success

*ISDA published new legal opinions in June that recognise the enforceability of close-out netting in Saudi Arabia under regulations published by the Saudi Central Bank earlier this year. **Yazeed Alnafjan**, the central bank's deputy governor for financial innovation, discusses the significance of netting enforceability in the Kingdom*

IQ: The Saudi Central Bank (SAMA) published netting regulations in February, which confirm that netting is enforceable under Saudi law. How important is this development?

Yazeed Alnafjan (YA): It is really important – this development is significant for Saudi Arabia's financial markets and broader economic development. The regulations and subsequent ISDA netting opinions offer both domestic and international firms greater certainty and confidence to trade derivatives with Saudi counterparties regulated by SAMA. And importantly, these regulations provide a clear legal framework, meaning that institutional risk management strategies will be legally protected.

Close-out netting regulations offer significant risk reduction and financial stability benefits. They allow financial institutions to offset mutual obligations with counterparties, leaving only the net exposures at risk. For example, consider that the gross market value of derivatives globally stood at nearly $17.6 trillion at the end of 2024, whereas the gross credit exposure, after adjusting for legally enforceable, bilateral netting agreements, stood at just $3 trillion. The result is a deepened onshore derivatives market and an enhanced financial system, which is more resilient to shocks.

IQ: Can you briefly describe the main features of the netting regulation and which entities it applies to?

YA: The key features of the netting regulations are that they provide a comprehensive legal framework for enforcement, as well as protection during bankruptcy proceedings. They cover a wide range of financial instruments, including derivatives, repos and Islamic finance instruments, protect collateral arrangements and are based on ISDA's Model Netting Act.

SAMA's netting regulations apply to all qualified financial contracts (QFCs), as long as at least one party to the contract is supervised by SAMA. Effectively, the benefit of netting is available to banks and non-banks, including finance companies and payment service providers.

In addition, the Capital Market Authority's (CMA) regulatory initiatives further broaden the scope of netting benefits to encompass QFCs where at least one party to the contract is supervised by the CMA. This helps increase the qualifying participants to include CMA-supervised entities.

IQ: Why was this a priority for SAMA? In what way do you think netting enforceability will help the development of Saudi Arabia's capital and derivatives markets?

YA: One of the main incentives for us to develop a netting framework was to enhance financial stability and resilience, especially in times of market stress or counterparty default. By allowing the netting of bilateral exposures and collateral, the framework will reduce the credit, liquidity and operational risks faced by market participants, as well as the systemic risk posed by large and interconnected derivatives positions.

The netting framework will also support the development and diversification of the domestic derivatives market by enabling more efficient pricing, hedging and risk management of financial transactions.

Having seen other Group-of-20 (G-20) jurisdictions develop their frameworks gave us an advantage in that we could benefit from their experience. In coordination with ISDA, we were able to develop a framework that is aligned with best practices and hopefully achieves the objectives we set out to accomplish, building on the momentum we have witnessed in our financial sector over the past few years.

IQ: Implementation of netting regulations aligns Saudi Arabia with international best practices in terms of credit risk management. To what extent will international alignment be a driver for further developments in the Kingdom?

YA: There are numerous initiatives underway in the Kingdom to develop our markets and the wider economy and we strive to incorporate international best practices where relevant and as expected of a G-20 member nation.

Our focus is on aligning internationally to preserve financial stability and the robustness of our financial services, especially in light of the interconnectedness of global financial systems and the important roles of institutions like the Bank for International Settlements and the Financial Stability Board. While international alignment alone will not drive all of the Kingdom's market-related initiatives, we prioritise adherence to the highest standards and adopting frameworks that are globally recognised in order to allow seamless integration between domestic and international activities.

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IQ: What do you see as being the primary benefit of a robust and liquid domestic derivatives market?

YA: An efficient and robust derivatives market allows investors and institutions to manage and transfer risk effectively. It allows you to hedge against risks that could threaten viability and focus on your core activities. In this context, a liquid derivatives market is one that allows enhanced price discovery; where a market can aggregate a large amount of information from a vast number of participants and their transactions to provide valuable signals about market expectations – for example, through forward pricing and implied volatilities. Participants can make better, more efficient decisions in a liquid market.

It is also important to recognise that a deep and liquid derivatives market contributes to financial stability and innovation in risk management practices. As investor and business confidence in their ability to hedge risks grows, they are more willing to invest and expand with enhanced capital optimisation. And the more participants, efficiency and activity in your derivatives markets, the more opportunities to innovate sophisticated products and strategies in a cost-effective manner.

IQ: How important is the participation of foreign institutions in Saudi Arabia's capital markets?

YA: If we consider the Kingdom's national objective for economic diversification, then you can think of foreign institutional participation in terms of the diversified sources of funding and investment they introduce. In addition to diversity, they also bring a larger pool of global capital, which domestic markets alone cannot supply. Longer-term, committed foreign capital can even help preserve financial stability as it supports economic growth.

These same capital pools help increase market liquidity, give rise to more sophisticated transactions and support the growth of institutional investment products.

Foreign participation in domestic capital markets also helps enhance knowledge and best practices and harmonises global governance standards and risk management practices as they evolve in line with the dynamic nature of international financial markets.

Finally, increased foreign participation generally leads to a more diverse investor base in the capital markets, and, in turn, supports domestic investor confidence and participation – it is a virtuous cycle that helps with continued financial market growth and development.