

# **Morgan Stanley Saudi Arabia**

**Pillar 3 Regulatory Disclosures Report**

**As at 31 December 2018**

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## **1. Morgan Stanley Saudi Arabia**

Morgan Stanley Saudi Arabia ("the Company") is a Closed Joint Stock Company incorporated, domiciled and registered in Riyadh, Kingdom of Saudi Arabia ("KSA") under commercial registration number 1010224144 dated Ramadan 18, 1427H (corresponding to 7 October 2006).

The Company is engaged in dealing, managing, arranging, providing custody and advising as authorized by the Capital Market Authority ("CMA") under license number 6044-37 dated Jumada Al-Thani 2, 1428H (corresponding to 17 June 2007).

### **The MSSA Board of Directors**

As at 31 December 2018, the MSSA Board of Directors ("The Board") was comprised of three executive directors and two non-executive directors. For further details on the MSSA Board members including detailed biographies and other directorships refer to

[https://www.morganstanley.com/pub/content/dam/msdotcom/global-offices/Saudi-Arabia/MSSA\\_Board\\_of\\_Directors.pdf](https://www.morganstanley.com/pub/content/dam/msdotcom/global-offices/Saudi-Arabia/MSSA_Board_of_Directors.pdf)

### **Background**

MSSA was established in 2007 with the acquisition by Morgan Stanley ("MS") of a majority interest in the Capital Group. On 23 June 2015, MS acquired the remaining stock and become 100% MS owned entity.

MSSA's ultimate parent undertaking and controlling entity is MS, a Delaware corporation, which, together with its consolidated subsidiaries, form the Morgan Stanley Group ("MS Group"). MS is a "Financial Holding Company" as defined by the Bank Holding Company Act of 1956, as amended, and is subject to regulation by the Board of Governors of the Federal Reserve System (the "Federal Reserve").

MSSA is a wholly owned subgroup of the MS Group. The information disclosed in this document is not necessarily indicative of the MS Group as a whole, nor is it comprehensively representative of the MS Group's activity in any particular region. Investors, stakeholders, creditors or other users seeking information on capital adequacy, risk exposure and risk management policies should consult the public disclosures of MS Group.

The MS Group and its United States ("US") Banks became subject to US Basel III requirements from 1 January 2014. For more details, see the latest MS Group Pillar 3 disclosure at <http://www.morganstanley.com/about-us-ir/pillar-us>.

MS is listed on the New York Stock Exchange and is required, by the US Securities and Exchange Commission ("SEC"), to file public disclosures, including Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K. These disclosures can be found at <http://www.morganstanley.com/pub/content/msdotcom/en/about-us-ir/sec-filings>.

## **2. Regulatory Framework**

The Basel Capital Accord provides a global regulatory framework for capital and liquidity. It is detailed in the "International Convergence of Capital Measurement and Capital Standards: A Revised Framework – Comprehensive Version" June 2006 ("Basel II"). This standard was revised in 2010 following the financial crisis through a number of reforms collectively known as Basel III, and in particular, "Basel III: a Global regulatory framework for more resilient banks and banking systems" and "Revisions to the Basel II market risk framework - updated as of December 2010".

The framework consists of three "pillars":

- Pillar 1 – Minimum capital requirements: defines rules for the calculation of credit, market and operational risk;
- Pillar 2 – The Internal Capital Adequacy Assessment Process (“ICAAP”) requires firms to self-assess the level of capital that adequately supports all relevant current and future risks in their business;
- Pillar 3 – Market discipline: requires expanded disclosures to allow investors and other market participants to understand capital adequacy, particular risk exposures and risk management processes of individual firms.

MSSA is subject to the minimum capital requirements as set out in the CMA’s Prudential Rules (“PRs”). The Pillar 3 Disclosure Report (hereinafter referred to as “Pillar 3 Disclosure”) is prepared and issued in accordance with Article 68 of the PRs. The Pillar 3 Disclosure explains the basis on which the Company complies with the capital requirements and information pertaining to the management of its risks. It has been prepared in accordance with the “Suggested Format for Pillar III Disclosure” published on 15 December 2014, which sets the minimum requirements for the annual market disclosure of information as referred to by Article 68 of the PRs. A copy of the MSSA’s Pillar 3 Disclosure can also be found at <http://www.morganstanley.com/content/dam/msdotcom/en/assets/pdfs/about-us-global-offices/saudi-arabia/MSSA-Pillar-III-Disclosures.PDF>.

### **Regulatory development**

Following an announcement by Saudi Organization for Certified Public Accountants (“SOCPA”) on 29 October 2015, all listed enterprises in KSA were required to adopt International Financial Reporting Standards (“IFRS”) effective 1 January 2017. For all other institutions, the adoption date was announced as 1 January 2018. The requirement from SOCPA was for financial statements to be prepared under IFRS 1 “First-time adoption of International Financial Reporting Standards” (“IFRS 1”) with three statements of financial position.

Effective 1 January 2018, MSSA transitioned from SOCPA to IFRS with 1 January 2017 being applied as the date of transition. The comparatives as at 31 December 2017 have therefore been updated to reflect this transition and alignment with the audited financial statements.

### **3. Capital Management**

MSSA views capital as an important source of financial strength. It actively manages and monitors its capital in line with established policies and procedures and in compliance with local regulatory requirements.

MSSA, in line with the MS Group capital management policies, manages its capital position based upon, among other things, business opportunities, risk appetite, capital availability and rate of return together with, internal capital policies, regulatory requirements and rating agency guidelines. Therefore, in the future it may adjust its capital base in reaction to the changing needs of its businesses. The appropriate level of capital is determined at a legal entity level to safeguard that entity’s ability to continue as a going concern and ensure that it meets all regulatory capital requirements.

The Company continues to achieve the following goals by implementing an effective capital management framework:

- Maintain sufficient capital to support overall business strategy;
- Integrate capital allocation decisions with the strategic and financial planning process;
- Enhance Board and senior management’s ability to understand how much capital flexibility exists to support the overall business strategy;
- Enhance the Company’s understanding on capital requirements under different economic and stress scenarios;
- Build and support linkage between risks and capital and tie performance to both of them;
- Meet the regulatory capital adequacy ratios and have a prudent buffer.

MSSA conducts an ICAAP annually to measure, monitor and report all material risks and adopt an efficient capital planning process to ensure sufficient capital is available to meet usual business activities as well as any unforeseen contingencies. MSSA will continue to hold capital to cover those risks specified by the CMA under Pillar 1 and additional capital for risks not covered under Pillar 1, in order to support its business activities while ensuring a comfortable buffer is held for future growth and unforeseen circumstances.

The ICAAP is a key tool used to inform the MSSA Board on risk profile and capital adequacy. MSSA's ICAAP:

- Is designed to ensure the risks to which MSSA is exposed are appropriately capitalised and risk managed, including those risks that are either not captured, or not fully captured under Pillar 1.
- Uses stress testing to size a capital buffer aimed at ensuring MSSA will continue to operate above regulatory requirements under a range of severe but plausible stress scenarios.
- Assesses capital adequacy under normal and stressed operating environments over the three year capital planning horizon to ensure MSSA maintains a capital position in line with internal operating targets and post stress minimum levels.

The Company's capital management is aimed at maintaining an optimum level of capital, enabling it to pursue strategies that build long-term shareholder value, whilst always meeting both minimum regulatory and internal capital requirements. The Board evaluates the levels of capital held by MSSA regularly and the possible options available for utilizing the surplus capital more efficiently.

MSSA is adequately capitalized with respect to the minimum capital requirement of the PRs of the CMA i.e. the requirements for the minimum level of capital are fulfilled and MSSA management ensures that adequate capital is retained at all times to support the risks the Company undertakes in the course of its business. Capital Adequacy indicates the ability of MSSA to ensure efficient utilization of capital in relation to its business requirements, growth and risk profile while meeting shareholder returns and expectations.

The Company recognizes that earnings are the first line of defense against losses arising from business risks. However, since capital is vital to ensure continued solvency, the Company's objective is to maintain sufficient capital such that there is a buffer above regulatory capital adequacy requirement, in order to meet risks arising from fluctuations in asset values, business cycles, expansion and future requirements. Since its incorporation, MSSA's capital has increased over years by the retention of its dividends.

The capital requirements for credit risk, market risks and operational risks in accordance with the PRs are provided in the table below (see Appendix I for details):

**Table 3.1: Capital Requirements and Capital Adequacy Ratio**

	2018 SAR '000	2017 SAR '000
<b>Total Capital Base (Ref to 4.2 table)</b>	<b>232,383</b>	<b>206,376</b>
<b>Capital Requirement</b>		
Total Credit Risk	30,552	28,755
Total Market Risk	158	643
Total Operational Risk	12,900	11,757
<b>Minimum Capital Requirements</b>	<b>43,610</b>	<b>41,155</b>
<b>Surplus/(Deficit) in capital *</b>	<b>188,773</b>	<b>165,222</b>
<b>Capital ratio (time) **</b>	<b>5.33</b>	<b>5.01</b>

\*Surplus /(Deficit) Capital = Total Capital Base less Minimum Capital Requirements

\*\*Capital Ratio (time) = Total Capital Base/Minimum Capital Requirements

#### 4. Capital Resources

MSSA has a basic capital structure consisting of share capital, statutory reserve and audited retained earnings (see table 4.1).

During the year, MSSA reduced its statutory reserve to 30% from 50% following a change in Regulations for Companies in KSA. As resolved by the shareholders in their ordinary general meeting on 13 August 2018, the excess was transferred to the Company's audited retained earnings.

**Table 4.1: MSSA Capital Structure**

Capital Items	Details
Paid up Capital	The share capital of MSSA, amounting to SAR 65,000,000, is divided into 6,500,000 shares of SAR 10 each.
Statutory Reserves	In accordance with MSSA's Article of Association and the Regulation for Companies in the KSA, the Company must have 10% of its net income after Zakat and income tax each year until the reserve equaled to 30% of the share capital. This reserve is not subject to dividend distribution.
Audited Retained Earnings	This represents the accumulated undistributed profits that are available for future dividend distributions as recommended by the Board and approved by the Audit Committee or to be eventually capitalized.

The components of capital for MSSA as at 31 December 2018 are as follows:

**Table 4.2: Tier 1 and Tier 2 Capital**

Capital Base	2018 SAR '000	2017 SAR '000
<b><u>Tier 1 capital</u></b>		
Paid up Capital	65,000	65,000
Audited retained earnings	151,191	113,630
Share premium	-	-
Reserves (other than revaluation reserves)	19,500	32,500
Tier-1 capital contribution	-	-
Deductions from Tier 1 capital	(3,308)	(4,754)
<b>Total Tier 1 capital</b>	<b>232,383</b>	<b>206,376</b>
<b>Total Tier 2 capital</b>	-	-
<b>TOTAL CAPITAL BASE</b>	<b>232,383</b>	<b>206,376</b>

The capital of MSSA is composed of only Tier 1 capital and does not have Tier 2 capital as of 31 December 2018 in its capital structure. The total capital base of the Company net of deductions as at 31 December 2018 is SAR 232,383,198 (2017: SAR 206,376,412).

## 5. Risk Management

### Risk Management Objectives

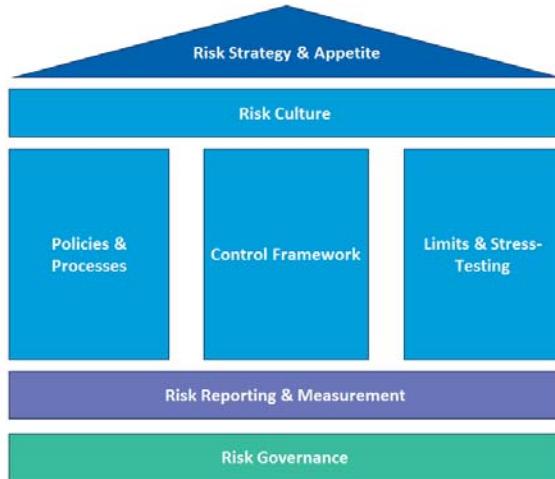
The business strategy acts as a key driver for the MSSA business model which in turn drives the risk strategy and the consequent risk profile of the Company. Business strategy and risk assessment are considered and aligned as part of the regular management meetings, Board meetings, or more frequently if necessary.

MSSA assumes a variety of risks in undertaking its business activities. The risk management objective for each area of risk is to adopt the best practices available and to adhere to the CMA requirements i.e. to identify, assess, monitor, mitigate and manage different dimensions of risk with the aim of protecting asset values and income streams. MSSA is able to maximize returns intended to optimize the Company's shareholder return, while maintaining its risk exposure within defined parameters.

### Risk Management framework

Risk of loss is an inevitable consequence of the Company's businesses activities and effective risk management is vital to the Company's success. MSSA's risk management framework is embedded and operating appropriately. The key elements of MSSA's Risk Management Framework, which are in line with that of the MS Group, are outlined in Figure 1.

**Figure 1: Risk Management Framework**



### Risk Strategy and Appetite

MSSA's Risk Appetite articulates the aggregate level and type of risk that the Company is willing to accept in order to execute its business strategy and protect its capital and liquidity resources.

The combination of qualitative risk appetite and tolerance statements and quantitative limits aims to ensure that MSSA businesses are carried out in line with the risk appetite approved by the Board, and to protect MSSA's reputation in both normal and stressed environments.

The Board is responsible for overseeing overall risk appetite of MSSA. Risk appetite is defined as the amount of risk that MSSA is willing to accept to achieve its strategy and respective returns to shareholders, while safeguarding against key sources of risk such as earnings volatility, insolvency and other non-financial risks such as reputation and corporate governance. The annual review of the MSSA Risk Appetite Statement takes into account any new risks identified through the risk identification process as a result of changes in MSSA's business strategy as well as any changes in risk appetite given changes in market conditions.

In line with the MS Group, the Company has defined conduct risk as the risk of an adverse impact on clients, markets or the Firm's reputation as a consequence of the conduct of the Firm and/or its employees. Reputational risk, sometimes referred to as Franchise Risk, describes the potential risks associated with the way in which the MS Group conducts its business and the perception of the MS Group by external parties including our shareholders, clients, regulators and the public. In line with the MS Group, MSSA has no risk appetite for conduct risk or reputational risk. It acknowledges, however, that conduct risk or reputational risk remains inherent in doing business and thus cannot be entirely eliminated.

Earnings at Risk is defined as the aim to deliver a sustainable business model that allows for a strategic presence in its core businesses/core countries, targeting stable earnings, accumulation of profits allowing for capital accretion and expense efficiency.

### **Risk Culture**

The MS Group's risk culture is rooted in five key principles: integrity, comprehensiveness, independence, accountability, and transparency. This culture is implemented through the Firm's Enterprise Risk Management Framework and multiple lines of defense.

MSSA has a sound risk culture that encourages open dialogue, effective challenge, escalation and reporting of risk to senior management, MSSA's Board and regulators as well as external disclosures of risk matters. Developing MSSA's risk culture is a continuous process, and builds upon the Firm's commitment to "doing the right thing" and its values that managing risk is each employee's responsibility.

The Board has overall responsibility for establishing the risk culture and ensuring that an effective risk management framework is in place. MSSA's Risk Appetite Statement is embedded in the MS Group's risk culture and linked to its short-term and long-term strategic, capital and financial plans, as well as compensation programs.

The Europe, Middle East and Africa ("EMEA") and MSSA Compliance Department is responsible for promoting a strong culture of compliance; defining an operating model and setting standards for compliance risk management; identifying, measuring, mitigating and reporting on compliance risks; maintaining a risk-based program for monitoring and testing compliance risk management by first line of defence across the Company; providing management and staff with advice, guidance (including policies and, where appropriate, procedures) and training concerning the laws, regulations and policies associated with their responsibilities; managing a Firmwide compliance risk reporting framework; reviewing new products and business activities; and supporting and facilitating the framework for managing significant communications with regulators and regulatory relationships. This is reinforced by the Code of Conduct which sets out the high standards of conduct and ethical behavior expected from all employees.

The EMEA Compliance Department is also responsible for the design and development of an overall Conduct Risk Framework and for the execution of Compliance's related responsibilities as set out in EMEA's Conduct Risk Management Policy. EMEA Conduct Risk Incident Procedure and EMEA Speaking up and Reporting Concerns Policy set out the procedure for identifying, escalating, investigating and reporting material conduct incidents and reporting and handling escalated concerns.

### **Risk Policies and Processes**

MS has a number of well-established policies and processes which establish the standards that govern the identification, assessment, monitoring, management and mitigation of the various types of risk involved in its business activities. Specific risk management policies have been implemented to address local business and regulatory requirements where appropriate. The Company's risk strategy, backed by appropriate limit structures and stress testing, is expressed through MS Group Risk Management policies. These policies, adopted by MSSA, provide an enterprise-wide integrated risk management framework in the Company. Where the MS Group Risk Management policies contradict any of the local laws and regulations, the local regulations supersedes the internal group policy requirements.

## Control Framework

In line with the MS Group, MSSA operates a control framework consistent with the “Three Lines of Defense” model. The MS Group believes that this structure creates clear delineation of responsibilities between the elements of risk control (1st Line – Business Unit and Support Functions), independent oversight and challenge (2nd Line – Risk Management and Legal and Compliance Department) and audit assurance (3rd Line – Internal Audit Department (“IAD”)).

Business Unit management has primary responsibility and accountability for managing all the business unit risks – including market, credit, operational, liquidity and funding risk. It implements policy and ensures compliance with applicable laws, rules and regulations. The EMEA Risk Management Division provides governance and oversight of activities carried out by the Business Units.

2nd Line independent oversight and challenge is provided by:

The EMEA Compliance Department is managed by the EMEA Chief Head of Compliance, who ultimately reports to the Group Chief Legal Officer. The EMEA Compliance Department maintains an enterprise-wide, independent compliance risk management program, under which the EMEA Compliance Department is responsible for promoting a strong culture of compliance.

The MSSA Legal and Compliance Department provides legal and regulatory advice to protect the Company’s financial well-being and reputation, and to assist the businesses and operations of the Company to understand legal risk and to comply with relevant financial services-related laws, regulations, Firm policies and standards.

The Internal Audit Department (“IAD”) are the 3rd line of defence, and are an independent source of assurance to the MSSA Board on financial, operational, and compliance controls. IAD is independent of the Business Units and Support and Control Functions and Risk Management and reports to the MSSA Audit Committee. IAD independently verifies that the Risk Management Framework has been implemented as intended and is functioning effectively, including opining on the overall appropriateness and adequacy of the framework and the associated governance processes.

## Limits & Tolerance

The Board sets the tone from the top by setting the MSSA Business Strategy, Risk Appetite and the Capital and Liquidity Adequacy Frameworks. This is translated into a suite of limits and tolerance frameworks to ensure that the business operates within these constraints. In addition to Pillar 1 risks, other risks that are monitored regularly include, conduct risk, reputational risk and earnings at risk. The performance against these targets and limits is monitored and reported to the Board annually. All risk limits are reviewed periodically, as appropriate and reviewed at least annually.

## Stress Testing

Stress testing is one of MSSA’s and the MS Group’s principal risk management tools, used to identify and assess the impact of severe stresses on its portfolios. It informs a number of processes and associated decisions. It complements other MSSA risk metrics by providing a clear and flexible approach to assessing MSSA’s resilience in the face of various scenarios over a range of severities, relevant to current market conditions and forward looking macroeconomic views. Most notably, key objectives of MSSA’s stress testing framework include:

- *Risk Management:* Identification, measurement and management of risk or vulnerabilities
- *Risk Aggregation:* Estimation of aggregate risk size of losses in adverse shocks
- *Capital and Liquidity planning:* Testing capital and liquidity plans under stressed conditions

## Risk Reporting and Measurement

The risk monitoring and reporting framework is also formalized to provide timely and periodic updates to the senior management on the risk exposures of the Company to inform decision-making and mitigating actions.

The risk reporting capabilities are supported by a well-controlled infrastructure, including Front Office risk systems and the MS Group's Risk Management systems. Key risk data are subject to several control assessments, including: self-assessments, attestations, independent validation, reconciliation and internal audit reviews.

## Risk Governance

The Board of MSSA is responsible for understanding the nature and level of risk being taken by MSSA and how this risk relates to adequate capital levels. The Board is also responsible for overseeing the strategy of MSSA and set the risk appetite for key risks that the execution of that strategy presents, or is likely to present. In addition, the Board approves the capital limits of MSSA.

The Board has appointed its Audit Committee to assist and provide guidance to the Board in respect of the Pillar 3 Disclosures and various matters. Other committees that assist the Board include the Compliance and Nomination & Remuneration Committees. The composition of the Board and its Committees is shown in Figure 2.

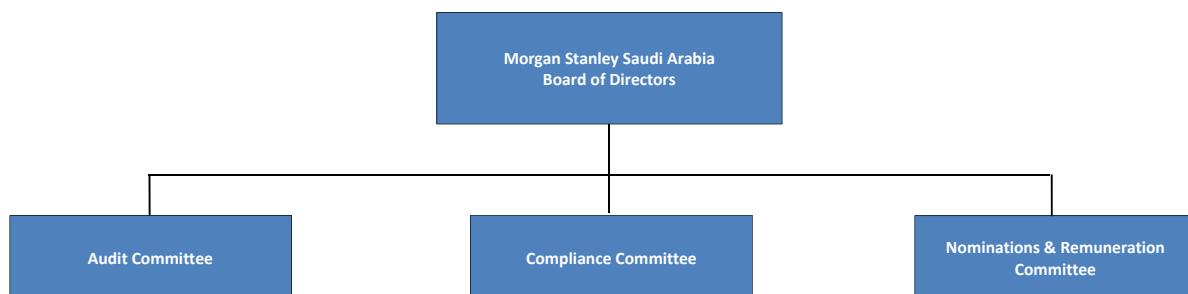
## MSSA Board Committees

The **Audit Committee** is appointed by the MSSA Board to assist and provide guidance to the MSSA Board in monitoring: (i) financial reporting; (ii) internal controls; (iii) regulatory reporting; (iv) internal audit; and (v) external auditors.

The **Compliance Committee** reports to and advises the Board of MSSA as to legal and compliance matters affecting the Company, including raising regulatory compliance issues and offering assessments of new legislation.

The **MSSA Nomination and Remuneration Committee** make quarterly representations and recommendations to the Board as to HR and remuneration matters affecting MSSA.

**Figure 2: MSSA Board Committees Structure**



## 6. Credit risk

Credit risk is one of the principal risks that the Company faces. Credit and counterparty risk refers to the risk of loss arising when a borrower, counterparty or issuer does not meet its financial obligations. MSSA's credit exposures can be categorized as:

- Risk against placement with the banks; and
- Risk against corporate and intercompany receivables;

The regulatory framework distinguishes between Credit Risk and Counterparty Credit Risk capital requirements. The Credit Risk capital component reflects the capital requirements attributable to the risk of loss arising from a borrower failing to meet its obligations and relates to investments made in the Non-Trading Book such as term deposits and other securities that MSSA holds until maturity with no intention to trade. Counterparty credit exposure arises from the risk that counterparties are unable to meet their payment obligations under contracts for traded products.

MSSA uses the Standardized Approach prescribed under the Pillar 1 requirements of the PRs to calculate regulatory capital for credit risk.

- The capital requirement for positions relating to non-trading activities, correspond to net less than 14% of MSSA's risk weighted assets ("RWA"). Each non-trading activity exposure is assigned to a range of exposures classes prescribed by the PRs.
- MSSA uses credit ratings to determine which credit quality step an exposure corresponds to. The Company uses the correspondence tables provided by the CMA to determine the agency's credit ratings and the steps in the credit quality scales. See tables 6.1(a) and 6.1(b) below:

**Table 6.1(a): Long term Ratings of counterparties**

Credit quality step		1	2	3	4	5	6
Exposure Class	<b>S&amp;P</b>	AAA TO AA-	A+ TO A-	BBB+ TO BBB-	BB+ TO BB-	B+ TO B-	CCC+ and below
	<b>Fitch</b>	AAA TO AA-	A+ TO A-	BBB+ TO BBB-	BB+ TO BB-	B+ TO B-	CCC+ and below
	<b>Moody's</b>	Aaa TO Aa3	A1 TO A3	Baa1 TO Baa3	Ba1 TO Ba3	B1 TO B3	Caa1 and below
	<b>Capital Intelligence</b>	AAA	AA TO A	BBB	BB	B	C and below

**Table 6.1(b): Short term Ratings of counterparties**

Credit quality step		1	2	3	4
Exposure Class	<b>S &amp; P</b>	A-1+, A-1	A-2	A-3	Below A-3
	<b>Fitch</b>	F1+, F1	F2	F3	Below F3
	<b>Moody's</b>	P-1	P-2	P-3	Not Prime
	<b>Capital Intelligence</b>	A1	A2	A3	Below A3

### Credit Rating

When determining the risk weights of an exposure, MSSA uses the CMA prescribed credit rating consistently and continuously. Where a credit rating is used to determine the risk weight of the exposure, the risk weight is assigned on the exposure's credit quality step in accordance with the rules for using credit rating.

### Credit Risk Disclosures

#### Past Due Claims

At MSSA, all invoices are due when issued. Due to the nature of MSSA's business and long term nature of projects, payment due dates vary for different projects. However, as a policy, MSSA considers the following for provisioning:

- Invoices issued against fees and commissions, outstanding for more than 180 days are fully provided for. A provision may be created before 180 days where the Business Units identify issues around collectability at an earlier stage.
- Provisions for the advisory unbilled expenses are based on the deal phase of the projects:
  - Active – 50% Expense Provision
  - Announced – 0% Expense Provision
  - Successful (excluding over billings) – 0% Expense Provision
  - Unsuccessful – 100% Expense Provision
  - On Hold – 100% Expense Provision

#### **Impairment of financial instruments**

From 1 January 2018, the Company recognises loss allowances for Expected Credit Loss ("ECL") for its financial assets measured at amortised cost.

##### *Measurement of ECL*

For financial assets, ECLs are the present value of cash shortfalls (i.e. the difference between contractual and expected cash flows) over the expected life of the financial instrument, discounted at the asset's effective interest rate ("EIR").

For trade receivables, a simplified approach has been adopted as permitted by IFRS 9 whereby an allowance is recognised for the lifetime ECLs of the instrument. Practical expedients have been employed to calculate the ECLs for trade receivables.

If there has been a significant increase in credit risk ("SICR") since initial recognition, the loss allowance is calculated as the ECL over the remaining life of the financial instrument. If it is subsequently determined that there has no longer been a SICR since initial recognition, then the loss allowance reverts to reflecting 12 month expected losses.

Until 31 December 2017, financial assets were stated at original invoice amounts net of allowance for doubtful debts. An allowance for doubtful debts was established when there was objective evidence that the Company would not be able to collect all amounts due according to the original terms of the receivables.

##### *Credit-impaired financial instruments*

In assessing the impairment of financial instruments under the ECL model, the Company defines credit-impaired financial instruments in accordance with MS Group Credit Risk Management Department's policies and procedures. A financial instrument is credit-impaired when, based on current information and events, it is probable that the Company will be unable to collect all scheduled payments of principal or interest when due according to the contractual terms of the agreement.

##### *Write-offs*

Trade and other receivables are written off (either partially or in full) when they are deemed uncollectible which generally occurs when all commercially reasonable means of recovering the receivables have been exhausted. Such determination is based on an indication that the counterparty can no longer pay the obligation, or that the proceeds from collateral will not be sufficient to pay the receivable. Partial write-offs are made when a portion of the receivables is uncollectable. However, financial assets that are written off could still be subject to enforcement activities for recoveries of amounts due. If the amount to be written off is greater than the accumulated loss allowance, the difference is reflected directly in the income statement and is not recognized in the loss allowance account. Any subsequent recoveries are credited to the income statement.

### Impairment of non-financial assets

Non-financial assets that are subject to depreciation or amortisation are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. An impairment loss is recognised for the amount by which the asset's carrying amount exceeds its recoverable amount. The recoverable amount is the higher of an asset's fair value less costs to sell and its value in use. For the purposes of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash flows (cash-generating units "CGU"). Such impairment losses are recognised in the income statement within 'Other expense' and are recognised against the carrying amount of the impaired asset on the statement of financial position. Non-financial assets, other than goodwill, that have suffered impairment are reviewed for possible reversal of the impairment at the end of each reporting period.

### Exposure to Credit Risk

MSSA's exposure to local banks and other MS affiliates are assigned a risk-weight according to Table 6.2 below:

**Table 6.2: Exposure Classes and Risk weight**

Credit quality Step	1	2	3	4	5	6
Risk weight	20%	50%	100%	100%	100%	150%

MSSA's exposure to corporates and other assets have no credit rating available and therefore assigned a risk weight of 714%.

### Large Exposures Requirement

MSSA has sound administrative and accounting and adequate internal control procedures to record all large exposures. The Company follows the PRs where by it ensures the entity's exposure to a single counterparty, or a group of connected counterparties does not exceed 25% of its capital base.

MSSA does not have large exposure amounts in its trading book as of 31 December 2018. The Company has only one large exposure amount in non-trading activities which relates to the cash deposited in a local bank and is considered as exempted as per the CMA PRs.

The maximum exposure to credit risk ("gross credit exposure") of the Company as at 31 December 2018 is disclosed below, based on the carrying amounts of the financial assets and the maximum amount that the Company could have to pay in relation to unrecognised financial instruments, which the Company believes are subject to credit risk. The Company has not entered into any credit enhancements to manage its exposure to credit risk. The Company does not have any significant exposure arising from items not recognised on the statement of financial position.

Total gross credit risk exposures broken down by major types of credit exposure are provided in the table below:

**Table 6.3: Total Gross Credit Risk Exposure**

	2018	2017
	SAR '000	SAR '000
<b>Total Gross Credit Risk Exposure by Major Types</b>		
<b>Type of Exposure</b>		
Authorised persons and banks	231,392	205,890
Corporates	2,525	187
Other assets	23,918	25,840
<b>Total</b>	<b>257,835</b>	<b>231,917</b>

### Geographic Distribution of Credit Risk

The Company operates solely in the KSA and does not have any investment portfolio outside KSA. There are, however, some receivables relating to fees from the MS Group. The credit risk exposure comprises mainly of intercompany receivables, placements with local banks and account receivables from corporates. The table below provides a breakdown of credit exposures by geography:

**Table 6.4: Credit Risk Exposure**

Portfolio	Geographic Area			2018	2017
	Saudi Arabia	United States	United Kingdom	SAR '000	SAR '000
Cash in hand/ petty cash	8	-	-	8	8
Deposits/ current accounts with local banks	227,208	-	-	227,208	203,002
Receivables from Authorized Persons and Banks	465	1,682	2,037	4,184	2,888
Receivables from Corporates	2,525	-	-	2,525	187
Prepaid expenses and accrued income	1,967	-	-	1,967	2,604
Other current assets	19,852	-	-	19,852	20,624
Tangible fixed assets	2,091	-	-	2,091	2,604
<b>Total</b>	<b>254,116</b>	<b>1,682</b>	<b>2,037</b>	<b>257,835</b>	<b>231,917</b>

**Table 6.5: Residual Contractual Maturity Breakdown**

Portfolio	Residual Contractual Maturity Breakdown		2018	2017
	Less than 12 months	More than 12 months	SAR '000	SAR '000
Cash in hand/ petty cash	8	-	8	8
Deposits/ current accounts with local banks	227,208	-	227,208	203,002
Receivables from Authorized Persons and Banks	4,184	-	4,184	2,888
Receivables from Corporates	2,525	-	2,525	187
Prepaid expenses and accrued income	1,967	-	1,967	2,604
Other current assets	19,852	-	19,852	20,624
Tangible fixed assets	-	2,091	2,091	2,604
Intangibles	-	-	-	279
Deferred tax asset	-	3,308	3,308	4,475
<b>Total Assets</b>	<b>255,744</b>	<b>5,399</b>	<b>261,143</b>	<b>236,670</b>
Trade and client payables	(7,613)	(379)	(7,992)	(3,246)
Accrued expenses and deferred income	(9,624)	(358)	(9,982)	(7,641)
Zakat & Income Tax	(1,554)	-	(1,554)	(1,011)
Employee's terminal benefits	-	(5,925)	(5,925)	(6,151)
Other-non current liabilities	-	-	-	(7,491)
<b>Total Liabilities</b>	<b>(18,790)</b>	<b>(6,662)</b>	<b>(25,452)</b>	<b>(25,540)</b>
<b>Net</b>	<b>236,954</b>	<b>(1,263)</b>	<b>235,691</b>	<b>211,130</b>

### Amount of Impaired Exposures

MSSA does not hold any proprietary investments and the impaired exposure relates to receivables in lieu of expenses incurred on projects which are reimbursable by clients. The impaired exposure at MSSA which is fully provided for and that relates to allowance for doubtful receivables amounts to SAR 7,439 as at 31 December 2018 (2017: SAR 559,147).

Below table provides details of movement in allowance for doubtful receivables for the year ended 31 December 2018 and 31 December 2017:

**Table 6.6: Doubtful Receivables**

Movement in the allowance for doubtful receivables account	2018 SAR '000	2017 SAR '000
Allowance - Beginning of the year	(559)	(559)
Written off during the year	559	-
Charge for the year	(7)	-
<b>Allowance – At the end of Year</b>	<b>(7)</b>	<b>(559)</b>

### Credit Risk Protection

Exposure amounts before and after credit risk protection associated with each credit quality step in regards to non-trading activities, as well as the exposure amounts that are deducted from capital are detailed in tables 'Short Term Ratings of Counterparties' and 'Credit Risk Mitigation Exposure' below:

#### *Long Term Ratings of Counterparties*

MSSA does not hold any long term on or off balance sheet exposures.

#### *Short Term Ratings of Counterparties*

**Table 6.7: Short Term Ratings of Counterparties**

	Exposure Class	Short term Ratings of counterparties						
		Credit quality step	1	2	3	4	Unrated	
		<b>S &amp; P</b>	A-1+, A-1	A-2	A-3	Below A-3	Unrated	
		<b>Fitch</b>	F1+, F1	F2	F3	Below F3	Unrated	
		<b>Moody's</b>	P-1	P-2	P-3	Not Prime	Unrated	
		<b>Capital Intelligence</b>	A1	A2	A3	Below A3	Unrated	
<b>On and Off-balance-sheet Exposures</b>								
Authorised Persons and Banks		-	227,208 *	4,184**	-	-	-	
Corporates		-	-	-	-	-	2,525	
Other Assets		-	-	-	-	-	23,918	
<b>Total</b>		-	<b>227,208</b>	<b>4,184</b>	-	-	<b>26,443</b>	

\* Deposit with local Saudi Bank

\*\* Intercompany receivables (from Morgan Stanley Group Undertakings) - A-2 rating assigned by S&P.

### *Credit Risk Mitigation Exposure*

MSSA's credit exposure mainly comprises of intercompany receivables, placements with banks and receivables in lieu of fee and commission and reimbursement of project expenses. None of the exposure is covered by collateral as detailed in table below:

**Table 6.8: Credit Risk Mitigation Exposure**

Exposure Class	Exposures before CRM	Exposures covered by Guarantee s/ Credit derivatives	Exposures covered by Financial Collateral	Exposures covered by Netting Agreement	Exposures covered by other eligible collaterals		
						2018 SAR '000	2017 SAR '000
Authorised Persons and Banks	231,392	-	-	-	-	231,392	205,890
Corporates	2,525	-	-	-	-	2,525	187
Other Assets	23,918	-	-	-	-	23,918	25,840
<b>Total On-Balance sheet Exposures</b>	<b>257,835</b>	-	-	-	-	<b>257,835</b>	<b>231,917</b>

The Company's credit exposure mainly comprises of intercompany receivables, placements with banks and receivables in lieu of fee and commission and reimbursement of project expenses. The Company's placements with banks are with reputed banks and hence the credit risk is limited. The credit risk with respect to intercompany receivables is not significant and is spread over a number of counterparties. The related party receivable is from an affiliate which is financially stable therefore the Company does not consider any risk of default on due from related party balance.

## 7. Market Risk

Market risk refers to the risk that a change in the level of one or more market prices, rates, indices, implied volatilities (the price volatility of the underlying instrument imputed from option prices), correlations or other market factors, such as market liquidity, will result in losses for a position or portfolio.

Sound market risk management is an integral part of the MS Group culture. The various business units and trading desks are responsible for ensuring that market risk exposures are well managed and monitored. The control groups help ensure that these risks are measured, closely monitored and are made transparent to senior management.

The Company enters into the majority of its financial asset transactions with other MS Group undertakings, where both the Company and the other MS Group undertakings are wholly-owned subsidiaries of the same group parent entity, MS.

Market risk includes a number of different factors including interest rate risk, foreign exchange risk, equity risk and commodity risk. A single transaction or financial product may be subject to any number of these risks.

**Interest Rate Risk** is the sensitivity of financial products to changes in the interest rates. Interest rate risk may arise from holding assets and liabilities - actual or notional - with different maturity dates or re-pricing dates, creating exposure to changes in the level of profit rates.

**Foreign Exchange Risk** is the sensitivity of financial products to changes in spot foreign exchange rates. The value of the Company's portfolio which has products based in a number of currencies may be exposed to these risks when converted back to the portfolio's base currency. Currency or foreign exchange risk arises from an open position, either long or short, in a foreign currency, creating exposure to a change in the relevant exchange rate. This may arise from holding of assets in one currency funded by liabilities in another

currency, or from a spot or forward foreign exchange trade, currency swap, currency future or currency option which is not matched with an offsetting contract.

**Equity Risk** is the sensitivity of financial products to changes in equity prices. Equity risk may arise from holding open positions, either long or short, in equities or equity based instruments, thereby creating exposure to a change in the market price of the equity or equity instrument. This exposure may arise from holding actual equities, from an equity derivative, or from an index arbitrage. In addition to Company performance expectations, equity prices are also susceptible to general economic data and sector performance expectations.

**Commodity Risk** refers to the uncertainty of future commodity prices due to a number of factors such as cost of raw materials, political and regulatory changes, seasonal changes and market conditions.

As of 31 December 2018, MSSA does not hold any interest rate, foreign exchange, equity or commodity market risk in the trading book.

MSSA's market risk exposure is restricted to holding foreign exchange exposures. MSSA manages currency risk based on the Net Open Position ("NOP") of currencies to cover MSSA operations which are not related to trading book. As MSSA has limited exposure outside the Gulf Corporation Council currencies which are already pegged to the US Dollar, volatility levels are not significant.

**Table 7.1: Business Activities**

**SAR'000**

Risk	Exposure		Capital Requirements	
	2018	2017	2018	2017
FX	5,004	32,132	158	643

The Company reviews its market risk exposures on a periodical basis. The MSSA Finance team supports the measurement of market risk, monitors and reports the exposure to the senior management.

## 8. Operational Risk

Operational risk refers to the risk of loss, or of damage to the Company's reputation, resulting from inadequate or failed processes, people and systems or from external events (e.g. fraud, theft, legal and compliance risks, cyber-attacks or damage to physical assets).

Operational risk may be incurred across the Company's full scope of business activities, including revenue-generating activities (e.g. Sales and Trading) and support control functions (e.g. information technology and trade processing).

MSSA is subject to operational risks, including a failure, breach or other disruption of operational or security systems, that could adversely affect its business or reputation.

When calculating MSSA's internal capital requirement for operational risk, MSSA uses the maximum of the capital requirement calculated under the Basic Indicator Approach ("BIA") and that under the Expenditure Based Approach ("EBA").

### Identification of Top Operational Risks ("TORs") for MSSA

The Company has established guidelines which have been classified into major factors that give rise to operational risk, including people risk, process risk, system risk and external events, and manages them accordingly.

MSSA has reviewed TORs identified by the EMEA Operational Risk Department (“ORD”) and adopted the ones applicable to MSSA and quantified these risks based on historical and available information. MSSA reviews Operational Risk data elements to form an understanding of the risk issues within the Business Units and Support Functions. These elements include, but are not limited to, internal and industry loss data; Internal Audit reports, Regulatory audits and feedback and major infrastructure initiatives. The TORs identified for MSSA are:

- Business disruption and continuity
- Employment practices
- Reporting errors due to weak data or processes
- Cyber threat
- E-trading errors
- Market conduct and integrity
- Financial crime
- Transaction lifecycle errors due to manual processes
- Theft and fraud
- Unauthorised trading
- Product design, due diligence, suitability and disclosure

### **Risk Mitigation and Control**

MSSA acknowledges that Operational Risk remains inherent in its products, activities, processes and systems and cannot, therefore, be entirely eliminated. MSSA manages its Operational Risk within the overall risk framework.

The Business Units and support functions, in consultation with EMEA Risk Management team, determine all material Operational Risks and decide whether to use appropriate procedures to control and/or mitigate the risks, or accept the risks.

In managing its risk appetite, and in line with the MS Group, MSSA remains focused on four areas to identify, measure, monitor and report Operational Risk.

Operational Risk management policies and procedures for MSSA are consistent with those of MS and include escalation to appropriate senior management personnel. Senior management oversight is one of the key requirements to demonstrate commitment to risk management by MSSA. In order to support adequate management oversight, regular, objective and independent reporting on the status of Operational Risks is mandatory.

Formal quarterly monitoring and reporting is done to keep local management and the Board appraised of the state of risks within MSSA. MSSA also reports its Operational Risks to the EMEA ORD which has oversight for all EMEA offices.

### **Capital Assessment**

#### **Pillar 1**

Capital requirements for operational risk are currently calculated under the EBA where a 25% risk capital charge is applied to the Company’s overhead expenses. As of 31 December 2018, MSSA’s EBA capital was SAR 12,899,977 (2017: SAR 11,756,801).

#### **Pillar 2**

MSSA recognises that the EBA is not a risk-based measure and therefore quantifies the identified TORs based on historical and available information. MSSA holds sufficient capital to cover the incremental capital requirement over and above the Pillar 1 requirement.

## 9. Liquidity Risk

Liquidity risk refers to the risk that the Company will be unable to finance its operations due to a loss of access to the capital markets or difficulty in liquidating its assets. Liquidity risk encompasses the Company's ability (or perceived ability) to meet its financial obligations without experiencing significant business disruption or reputational damage that may threaten the Company's viability as a going concern.

MSSA pursues a policy of maintaining a high level of liquidity through active and prudent management of assets and liabilities. MSSA has insignificant liabilities compared to total assets and the majority of the assets are highly liquid assets.

MSSA monitors the liquidity risk through liquidity and funding risk management policy framework that:

- Ensures that the liquidity profile of MSSA is managed and maintained in a manner that is commensurate with the MSSA's asset risk profile and risk tolerances.
- Formalizes the governance structure for liquidity risk oversight by specifying the roles of the MSSA's Board of Directors and Management in the liquidity risk management process.

### Regulatory Liquidity Framework

The Required Liquidity Framework establishes the amount of liquidity the MS Group must hold in both normal and stressed environments to ensure its financial condition and overall soundness is not adversely affected by an inability (or perceived inability) to meet its financial obligations in a timely manner. The Required Liquidity Framework considers the most constraining liquidity requirement to satisfy all regulatory and internal limits at a consolidated and legal entity level.

Pursuant to Article 57 of the PRs, the Company is required to manage its liquidity risks in accordance with the provisions set out in Chapter 18 and 19 and Annex 8 of the PRs.

### Funding and Liquidity Risk Strategy

The primary goal of MSSA's liquidity and funding activities is to ensure adequate liquidity over a wide range of potential stress scenarios and market environments. To ensure that MSSA is able to withstand liquidity stress, continue to fund its ongoing business, and meet its financial obligations without issuing unsecured debt, MSSA has established a Liquidity Risk Management Framework ("LRM Framework").

MSSA's LRM is based on the following key elements that are undertaken to ensure that financing is executed in a manner that reduces the risk of disruption to MSSA business operations that would result from an interruption in the availability of MSSA's funding sources.

**Liquidity Risk Assessment:** The overall liquidity risk assessment includes two sections: early indicators, and liquidity stress testing result. A liquidity risk assessment dashboard ("Dashboard") is developed to monitor and assess overall liquidity risk of MSSA. Operating environment indicators ("OEIs") are metrics that aid management in identifying early warning signs of stress due to changes in the market environment and counterparty behaviors that may signal a potential liquidity risk to the Company. OEIs are categorized as Normal, Elevated, High, and Severe.

**Tolerance:** MSSA has maintained low liquidity risk tolerance to ensure that the MSSA has sufficient liquidity to cover contractual obligations and contingencies in a liquidity stress event over one year horizon.

**Liquidity Risk Reporting:** The MSSA finance team consolidates the Dashboard which includes the updated stress testing assumptions and reports to the CEO and the Audit Committee on a semi-annual basis. The liquidity risk policy and the Dashboard are approved and signed off by the Board on an annual basis.

### Stress Testing

MSSA has a defined set of scenarios and assumptions used to measure liquidity risk over short and long term time horizon. Stress testing is an evolutional process that is reviewed and refined through time to capture the experiences of volatile markets.

MSSA uses a simplified cash flow model to evaluate and report periodically its liquidity risk exposures. The model incorporates monthly average revenues and expenses that will impact the cash flow over a time horizon of 18 to 24 months. The model will also factor in any potential non-recurring outflows in a given month (e.g. tax, bonus and rent payments). The revenues are stressed as per the scenarios mentioned in table 9.2 to indicate MSSA's liquidity position under each given scenario.

### Funding Management

MSSA manages its funding in a manner that reduces the risk of disruption to the MS Group's and the Company's operations. In the event of a liquidity stress, the Firm will endeavor to cause MSSA to conduct its operations in such a manner so as to ensure that all of its obligations to its creditors falling due within the period can be settled as they fall due and, to the extent necessary, to provide MSSA support for that purpose.

If a cash flow forecast stress testing scenario is rated high or severe in the Dashboard, MSSA finance team will:

- Escalate to regional Finance team, local Firm Management and MS Group Treasury;
- Depending on the discussions, regional Finance team and MS Group Treasury will determine if measures should be taken for injecting liquidity into MSSA, the amount of funding needed and timelines for having this achieved;
- Obtain external auditors/local tax consultants/legal & compliance advise for any local regulatory requirements;
- Update MSSA Audit Committee with steps taken by management to address the funding need of MSSA;
- Present the Board with the case to fund liquidity into MSSA and the options available for the funding for their approval;
- Obtain authorisation from MSSA General Assembly for the amount of funding before additional steps are implemented;
- Upon, MSSA General Assembly approval, MS Group Treasury, and regional Finance team will discuss steps to have the required and approved funding to take place.

### Liquidity Risk Assessment

MSSA uses the following liquidity risk assessment dashboard to assess its liquidity risk.

**Table 9.1: Liquidity Ratio**

Liquidity Ratio* (times)	Rating
> or equal to 2	Normal
> or equal to 1.5 but less than 2	Elevated
> or equal to 1 but less than 1.5	High
< 1	Severe

\*Liquidity Ratio: Current Assets / Current Liability

MSSA has demonstrated strong liquidity position during 2018. As at 31 December 2018 the liquidity ratio was 13 times, (SAR 255,744,280/SAR 19,527,050).

### Cash Position

The cash position during the last review is illustrated below. This is based on the stress scenarios performed over a 24-month period:

**Table 9.2: Stress Scenario**

Stress Scenario	2018	2017	Rating
	Cash Position* SAR '000		
Loss of 25% revenue	284,701	246,480	Normal
Loss of 50 % revenue	218,417	188,235	Normal
Loss of 100% revenue	81,574	68,238	Normal

\*Cash position at the close of 24 month period

### Criteria:

- Normal rating: Positive cash flow under any loss of revenue stress scenarios
- Elevated rating: Negative cash flow forecast under 100% loss of revenue
- High rating: Negative cash flow under a 50% loss of revenue
- Severe rating: Negative cash flow under a 25% loss of revenue

## 10. Appendix I: Capital Requirements

Exposure Class	Exposures before CRM	Net Exposures after CRM	Risk Weighted Assets	Capital Requirement
<b>2018</b>				
<b>Credit Risk</b>				
<i>On-balance Sheet Exposures</i>				
Authorised Persons and Banks	231,392	231,392	46,278	6,479
Corporates	2,525	2,525	18,030	2,524
Other Assets	23,918	23,918	153,918	21,549
<b>Total On-Balance sheet Exposures</b>	<b>257,835</b>	<b>257,835</b>	<b>218,226</b>	<b>30,552</b>
<b>Prohibited Exposure Risk Requirement</b>				
<b>Total Credit Risk Exposures</b>	<b>257,835</b>	<b>257,835</b>	<b>218,226</b>	<b>30,552</b>
<b>Market Risk</b>				
Foreign exchange rate risks	5,004			158
<b>Total Market Risk Exposures</b>	<b>5,004</b>			<b>158</b>
<b>Operational Risk</b>				
<b>Minimum Capital Requirements</b>				
<b>Surplus/(Deficit) in capital</b>				
<b>Total Capital ratio (time)</b>				<b>5.33</b>

## 11. Appendix II: Credit Risk Mitigation

Risk Weights	Authorised persons and banks	Corporates	Other assets	Total Exposure after netting and CRM	Total RWA
0%	-	-	8	8	-
20%	231,392	-	-	231,392	46,278
50%	-	-	-	-	-
100%	-	-	-	-	-
150%	-	-	-	-	-
200%	-	-	-	-	-
300%	-	-	4,058	4,058	12,175
400%	-	-	-	-	-
500%	-	-	-	-	-
714% *	-	2,525	19,852	22,377	159,773
<b>Average Risk Weight</b>	<b>20%</b>	<b>714%</b>	<b>681%</b>	<b>544%</b>	<b>544%</b>
<b>Deduction from Capital Base</b>					

\*include prohibited exposure

## 12. Appendix III: List of Abbreviations

TERM	DEFINITION
BCP	Business Continuity Plan
BIA	Basic Indicator Approach
Board	MSSA Board of Directors
CAR	Capital Adequacy Ratio
CEO	Chief Executive Officer
CMA	Capital Market Authority
CRM	Credit Risk Mitigation
Dashboard	Liquidity Risk Assessment Dashboard
EBA	Expenditure Based Approach
ECL	Expected Credit Loss
EMEA	Europe Middle East and Africa
FX	Foreign Exchange
GCC	Gulf Cooperation Council
IAD	Internal Audit Department
ICAAP	Internal Capital Adequacy Assessment Process
IFRS	International Financial Reporting Standards
IT	Information Technology
KSA	Kingdom of Saudi Arabia
LRM	Liquidity Risk Management
MSSA	Morgan Stanley Saudi Arabia
MS	Morgan Stanley
MS Group	Morgan Stanley Group
NOP	Net Open Position
OEIs	Operating Environment Indicators
ORD	Operational Risk Department
PRs	Prudential Rules
RWA	Risk Weighted Assets
S&P	Standard & Poor's
SAR	Saudi Arabian Riyal
SEC	Securities and Exchange Commission
SICR	Significant Increase in Credit Risk
SOCPA	Saudi Organization for Certified Public Accountants
TORs	Top Operational Risks
US	United States Of America
USD	US Dollar