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The Saudi Arabian Economy

Policies, Achievements and Challenges

Second Edition



Springer

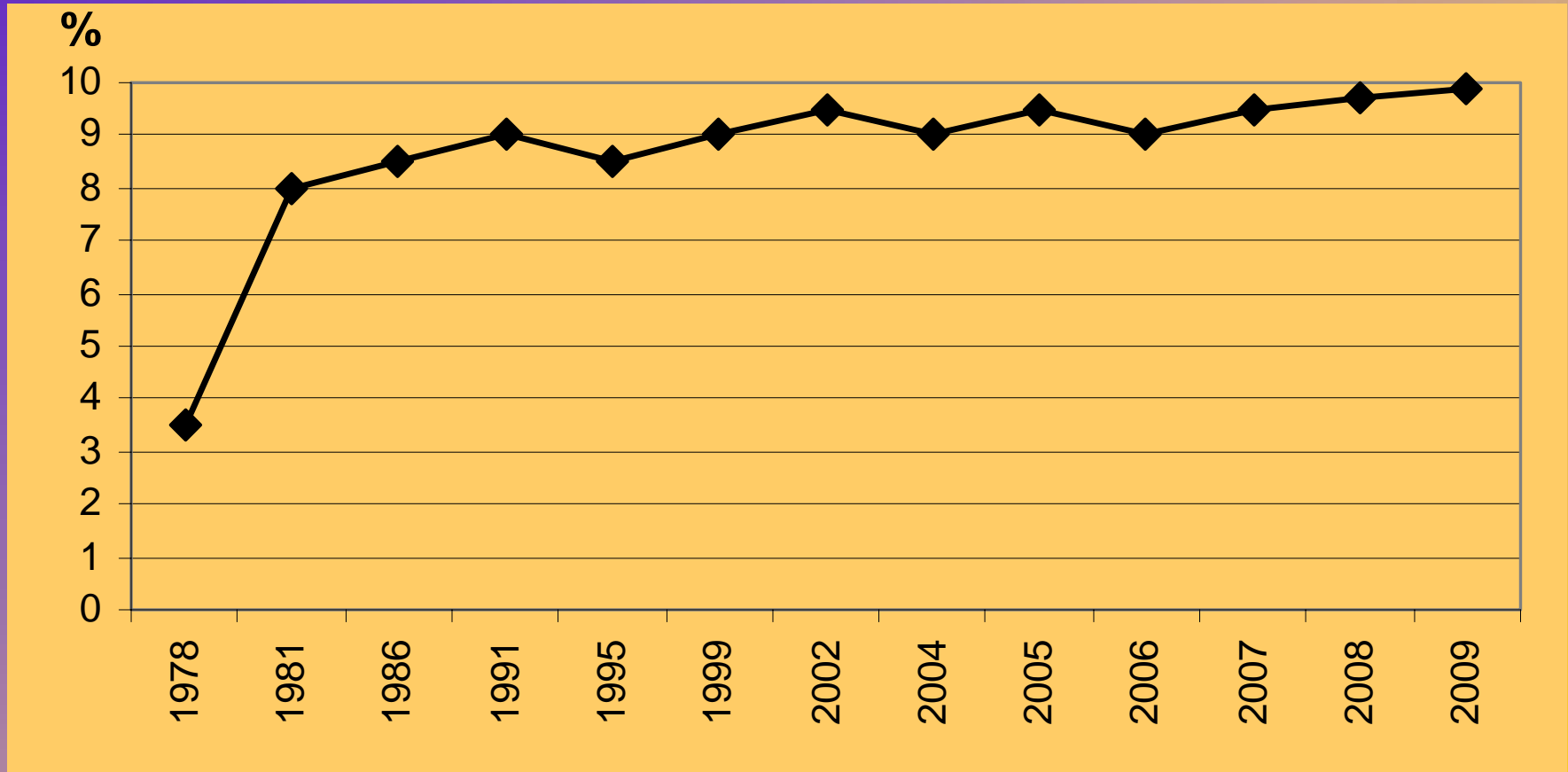
CHAPTER 5

THE FINANCIAL MARKETS

Saudi Financial Sector has come of age

- Currently comprises commercial banks, the insurance sector and non-bank financing institutions.
- Has come out **relatively unscathed** during the global credit and financial crisis of 2007/2008, despite some loan loss reserves, and some high profile domestic corporate debt defaults.
- The relative contribution of the financial sector has **risen** from around 3.5% of GDP in 1978, to around 10% in 2009.
- The opening up of the **insurance sector** to foreign competition and re-entry of wholly owned foreign banks to Saudi Arabia, has also assisted towards deepening of the financial sector.

Figure 5.1 *Relative % contribution of finance and insurance sectors to non-oil GDP at current prices 1978-2009*



Source: SAMA.

Table 5.1 Status of banks holding licences to operate in Saudi Arabia (2010)

<i>Bank Ownership</i>	<i>Status</i>
(A) Operational	<ul style="list-style-type: none"> • Wholly-owned Saudi private sector: Al-Rajhi, Al Bilad • Saudi private sector and government ownership: Riyad Bank, NCB, SAMBA, Al Inma • Joint-venture banks: Saudi Fransi, Saudi British, Arab National, Al-Jazira, Saudi Hollandi, Saudi Investment Bank • Foreign Banks: Gulf International Bank, Bahrain, Emirates International Bank, Dubai, National Bank of Kuwait, Deutsche Bank, Muscat Bank, National Bank of Bahrain, J.P. Morgan Chase, BNP Paribas
(B) Licensed but Non-Operational	<ul style="list-style-type: none"> • HSBC, UK • National Bank of Pakistan • T.C. Ziraat Bankasi • State Bank of India

SAMA and bank supervision

- Saudi banking system reflects the generally **conservative** social environment of the Kingdom, especially on issues relating to taking of interest.
- SAMA has established certain **guiding principles** for its bank supervisory policies, chief of which has been the adoption and implementation of global standards, principles and practices to install public confidence in a vital sector in Saudi Arabia.

Table 5.2 Saudi Arabia bank supervisory guiding policies

<i>Guiding Policy</i>	<i>Observation</i>
<ul style="list-style-type: none"> • Maintain open and liberal financial market with minimal restriction on capital flow 	<ul style="list-style-type: none"> • Effectively carried out, including minimal restrictions on capital flow
<ul style="list-style-type: none"> • Strong and healthy banking sector to maintain sustainable economic growth 	<ul style="list-style-type: none"> • Saudi bank profitability is one of the highest in world and its banking system has grown and adapted as the economy evolved
<ul style="list-style-type: none"> • Promote fair competition in financial and banking services 	<ul style="list-style-type: none"> • More competition needed due to excessive bank concentration; foreign bank presence could promote more competition
<ul style="list-style-type: none"> • Benefit from participation of foreign banks and foreign share-holders so as to transfer technology, training of Saudi personnel and improve risk management practices 	<ul style="list-style-type: none"> • Achieved with Saudization of banks in a smooth manner; Saudi banking personnel are in key positions and Saudi banks are positively rated by credit rating agencies
<ul style="list-style-type: none"> • Ensure Saudi financial markets are at cutting edge of communication and IT 	<ul style="list-style-type: none"> • Achieved, for Saudi banking is one of the most technologically advanced in the world
<ul style="list-style-type: none"> • Pursue the adoption and implementation of global standards, principles and practices 	<ul style="list-style-type: none"> • Achieved thorough SAMA supervision and the adoption of joint venture best banking practices
<ul style="list-style-type: none"> • Ensure availability of qualified Saudi finance professionals and training facilities 	<ul style="list-style-type: none"> • Achieved through SAMA's institute of Banking offering wide range of finance training programs including the opening of a Women's Training Centre in 2008. The institute has signed agreements with the International Finance Corporation.
<ul style="list-style-type: none"> • Comply with latest BIS capital requirements 	<ul style="list-style-type: none"> • Achieved and exceeded Basel Capital requirements with Saudi banks averaging at 16% levels compared with prescribed 8% levels.

Evolutionary phases of the Saudi financial sector

- **Early years 1940-1960's:** The infancy period. Characterized by money brokers, few foreign commercial banks and the beginnings of a formal central bank supervisory regime.
- **The 1970's:** The adolescence period. Characterized by increasing direct regulation and SAMA supervision and establishment of government lending institutions, as well as the beginning of the policy of “**Saudization**” of foreign banks.
- **The 1980's:** Young adulthood and coming of age. Period of economic retrenchment and crisis management for banks concerning quality of their assets. Period of bank mergers and government support and introduction of government debts instruments.

(Contd.....)

- ***The 1990's and period of maturity:*** Period saw the 1990-1991 Gulf War and shocks to the banking system, but strong SAMA interventionist support followed by economic boom. Period characterized by use of ATM's, debt and credit cards, point of sales technology, and significant technology investment in sector.
- ***2000 onwards:*** Period characterized by globalization pressures and new foreign bank competition, the expansion of the insurance sector and the emergence of Islamic financing, as well as the expansion of Saudi banks internationally.

Table 5.3 Saudi banks international branches (2010)

Bank	Country Location
• Al Rajhi	• Malaysia, Kuwait (Licence obtained)
• National Commercial Bank	• Turkey (60% of Turkiye Finans Bankasi), Singapore
• Arab National Bank	• London
• Riyadh Bank	• London, Houston, Singapore
• SAMBA	• London, Dubai, Pakistan, Qatar
• Saudi Fransi	• Banque BEMO Saudi Fransi, Syria (60%)

Source: *Bank's annual reports.*

Saudi bank share holder concentration and ownership structure: a major concern

- Saudi bank shareholder concentration and ownership tends to be in a **few hands** with several implications:
 - Enables some family business groups to influence day to day bank management through board representation.
 - Concentration **“de-democratizes”** the role of the annual general meetings in Joint Stock Companies (JSC’s)
 - Concentration **eliminates transparency** and leads to JSC’s operating like partnerships.
- Issue is of concern to regulators, following default of prominent Saudi business families (**Saad and Al Gosaibi**) in 2009 , who had large exposure to domestic and foreign banks, with “name-lending” being prominent.

Table 5.4 Shareholder concentration for selected Saudi banks

<i>Bank</i>	<i>1981</i>	<i>1986</i>	<i>1998</i>	<i>2001</i>
Saudi British bank	8,008	5,100	15,155	11,846
Saudi Hollandi Bank	2,850	2,600	1,033	685
SAMBA	102,594	45,000	15,171	44,600
Saudi Fransi Bank	95,600	73,000	9,668	8,185

Source: *Author's survey* based on bank annual reports and Bank Investor Relations Units.

Table 5.5 Saudi commercial banks major ownership holdings by number and percentage (2000)

<i>Institution</i>	<i>Private Individuals or Groups</i>				<i>Government or foreign ownership</i>
	<i>Under 2%</i>	<i>3-5%</i>	<i>6-9%</i>	<i>Over 10%</i>	
National Commercial Bank (NCB)	1	1	1	-	80% (Government PIF)
Saudi British SAMBA	2	2	1	-	40% (HSBC)
Saudi Hollandi	2	2	1	2	40% (Government institution)
Al Rajhi	6	3	2	1	40% (ABN-AMRO)
Saudi Investment	-	2	1	2	
Saudi Fransi	2	1	3	-	25% (Various foreign institutions)
Riyadh Bank	2	3	1	-	31.5% (Credite Agricole-Calyon)
Arab National	-	3	2	-	45% (Government)
Al Inma Bank	2	3	-	1	40% (Arab Bank)
	4	2	1	1	30% (Government-GOSI, Public Pension Agency, Investment Fund)

Source: *Author's survey.*

Performance of Saudi banks: Still a healthy sector

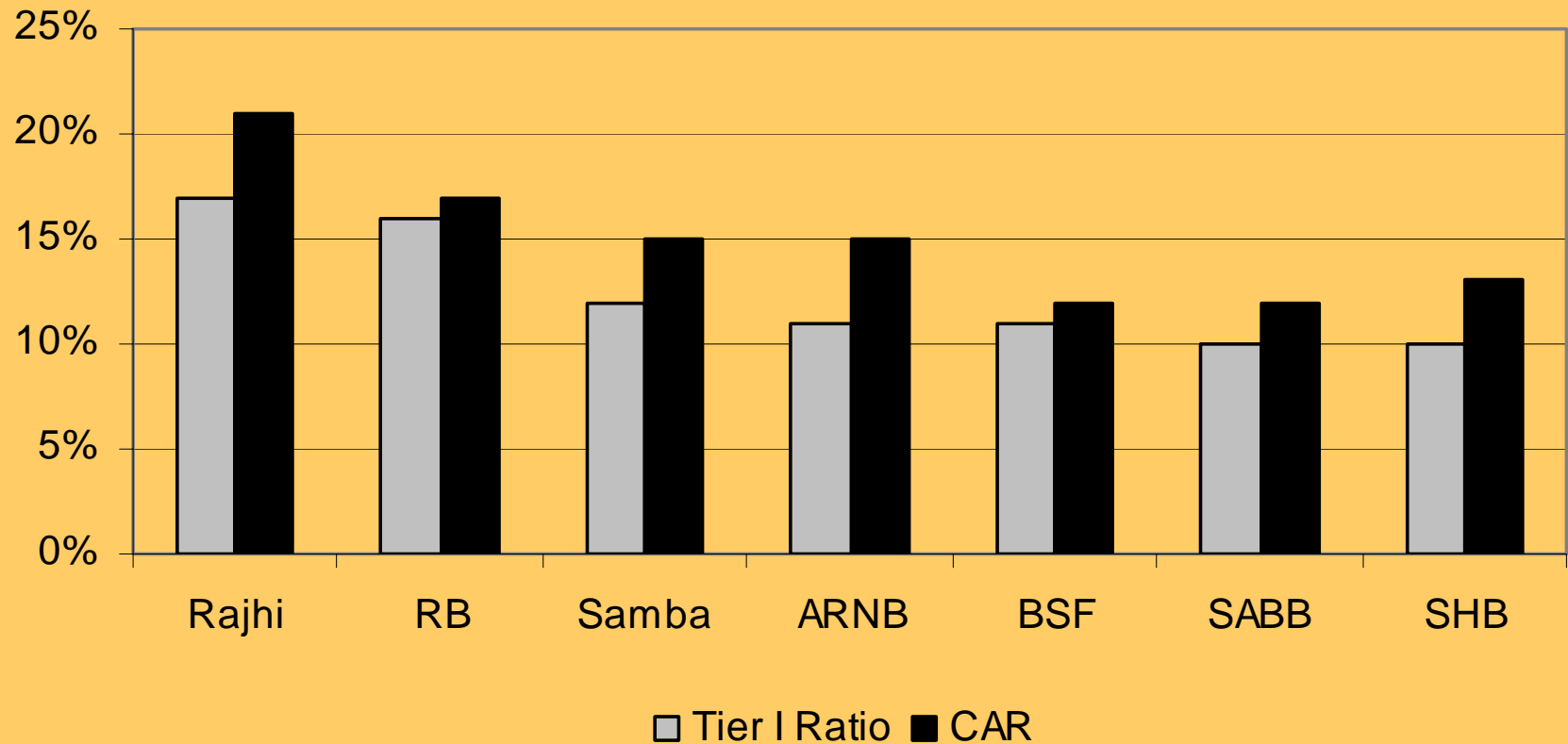
- **Core banking income** remains solid and has increased for many banks ,despite some effects of global financial crisis of 2007/2008.
- Total **assets** continued to grow to reach SR 1,370 billion in 2009, compared with SR 655 billion in 2004 with Return on Assets at 2.3% and Return on Equity at 18%.
- High **capitalization** ratios of around 16% for 2009 compared with 8% minimum recommended by Basel II guidelines.
- Fairly high **non-performing loan coverage ratio** of 148% in 2009, compared with 232% in 2004.

Table 5.6. Saudi banking sector: key sector indicators (2004-2009)

<i>Bank</i>	<i>2004</i>	<i>2005</i>	<i>2006</i>	<i>2007</i>	<i>2008</i>	<i>2009</i>
Loan-to-Deposit Ratio	72.0%	89.1%	80.5%	80.5%	86.8%	78.1%
Minimum Risk Assets/Total Assets	33.9%	28.4%	28.9%	29.8%	25.6%	26.3%
Cash and Cash Equivalents/Total Assets	4.4%	3.8%	5.4%	8.1%	5.8%	5.6%
Tier I Capital Adequacy Ratio	13.5%	17.8%	21.9%	20.6%	16.0%	15.9%
Non Performing Loan (NPL) Ratio	2.3%	1.7%	1.6%	1.6%	1.4%	1.5%
NPL Coverage Ratio	231.4%	179.0%	176.7%.	158.0%	145.0%	148%
Bank Reserves to Total Bank Deposits	7.3%	6.7%	8.8%	15.1%	11.5%	15.6%
Demand Deposits to total deposits	42.6%	39.6%	36.8%	39.4%	36.9%	39%
Total assets (SR Billion)	655.3	759.0	861.0	1,075.2	1,303.2	1,370.2

Source: *Bank annual reports.*

**Figure 5.2 Saudi banks: capital adequacy ratios (CAR)
2009**

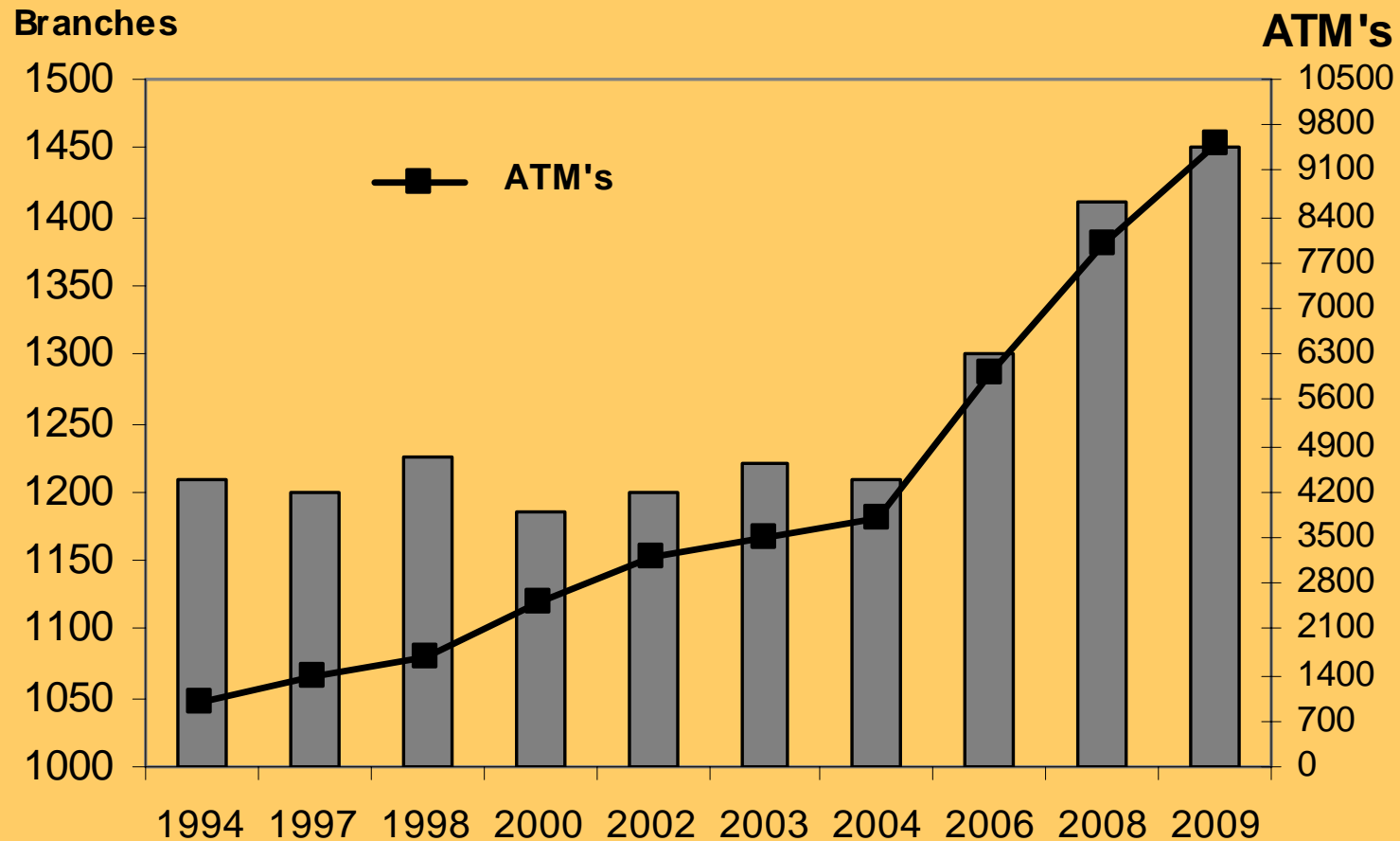


Source: SAMA, Credit Suisse 2009

The use of ATM's and bank technology has risen sharply

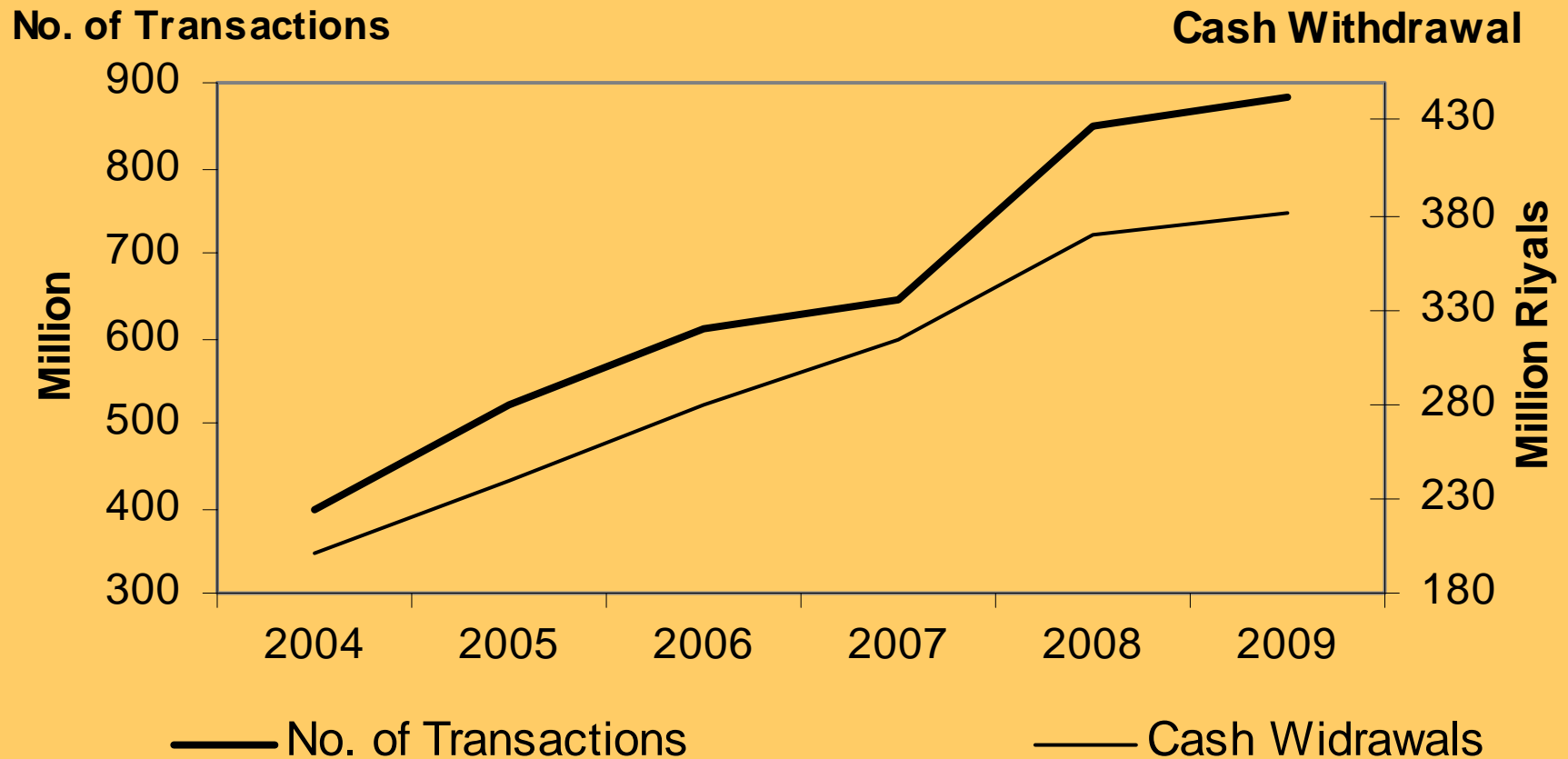
- While number of bank branches rose from 1,200 to 1,450 by 2009, the number of **ATM's** increased from less than 1,000 in 1994, to just under 10,000 by 2009.
- **Point of sale** transactions reached nearly 1 billion in 2009, compared with under 200,000 for 2003, while the value of cash withdrawn from ATM's reached SR 380 million in 2009.

Figure 5.3. Evolution of branches and ATM's 1994-2009



Source: SAMA

Figure 5.4: ATM Transactions and withdrawals: 2004-2009



Source: SAMA

Concentration ratios are worrying for competition

- While concentration issues might **not** have been significant in the past, primarily because Saudi banks experienced high profit ratios, they are **now** important issues.
- **Three banking groups** (NCB, SAMBA and Al Rajhi) have tended to dominate the Saudi banking sector with little change over the period 2001-2009, in terms of loans, deposits assets, and branches held between them.
- Studies indicate high concentration ratios may **reduce economic efficiency** and lead to higher charges. but SAMA has so far adopted a non-interventionist policy.

Table 5.7: Saudi Arabian bank concentration levels 2001,2008.

Year	Number of bank	Concentration levels
2001	9 commercial, 1 Islamic.	3 groups (NCB, SAMBA, Al Rajhi) have 54% of loans, 51% of deposits, 49% of assets, and 50% of branches.
2008	10 commercial, 2 Islamic.	3 groups (NCB, SAMBA, Al Rajhi) have 48% of loans, 49.8% of deposits, 43.2% of assets, and 54% of branches

Source: *Bank annual reports 2001, 2009.*

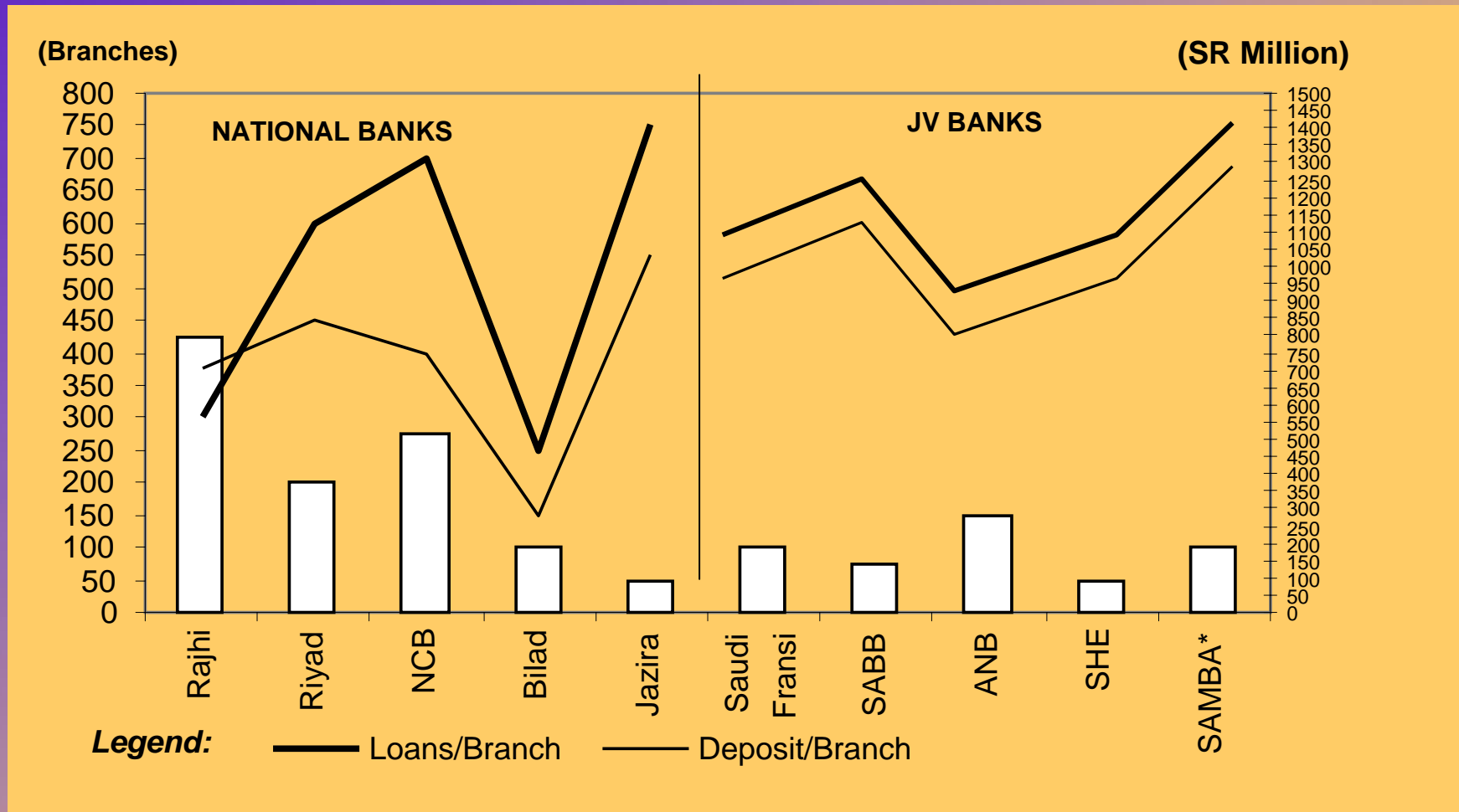
Saudi banks: market segmentation and niche strength perceptions

- **Competition** amongst Saudi banks is along various **market segmentation**, and further segmented by gender (male/female market), full Saudi banks, joint venture banks, and wholly foreign owned banks.
- **Perceived strengths** in each bank's niche market are also partly reflections of the different management styles, philosophies and ownership orientation of the banks.
- Such differences can affect the **“efficiency”** measurements of banks ,such as loans/branch and deposit/branch. The **JV banks do better** on average in such measurements than **“national”** banks.

Table 5.8. Saudi commercial banks: perception of key strengths

<i>Institution</i>	<i>Perception - Strengths</i>
• Saudi British Bank SABB	• Electronic banking, investments, treasury products, international links, medium term facilities to Saudi corporate, part of an international HSBC network and global image.
• SAMBA	• Corporate banking, treasury and investment products, electronic banking, high net worth clients, international links, syndications
• Riyadh Bank	• Consumer loans, trading activities, investments, government accounts, oil and agricultural sector, syndications, small business
• Al Rajhi	• Islamic investments, foreign exchange, trading activities, “safetyfirst”
• Arab National	• Electronic banking, mutual funds, consumer banking, small business, treasury products
• Saudi Fransi	• Corporate banking, investments, treasury products, loan syndication
• Saudi Hollandi	• International trade, medium corporate loans, international capital markets, off balance sheet products
• Saudi Investment Bank	• Corporate finance medium to long term loans, international trade, treasury products, syndications
• National Commercial Bank	• Consumer banking, small businesses, Islamic products, Corporate and government lending, foreign exchange and treasury, large ticket items.
• Al Bilad Bank	• Expertise in FX and remittance, SME friendly
• Al Jazira Bank	• Islamic investments, innovation in capital market Sukuk products.
• Al Inma Bank	• Islamic investments, “peoples bank”, strength through government participation.

Figure 5.5 Comparison between Saudi national banks and joint venture banks by branch loans/deposits (2008)



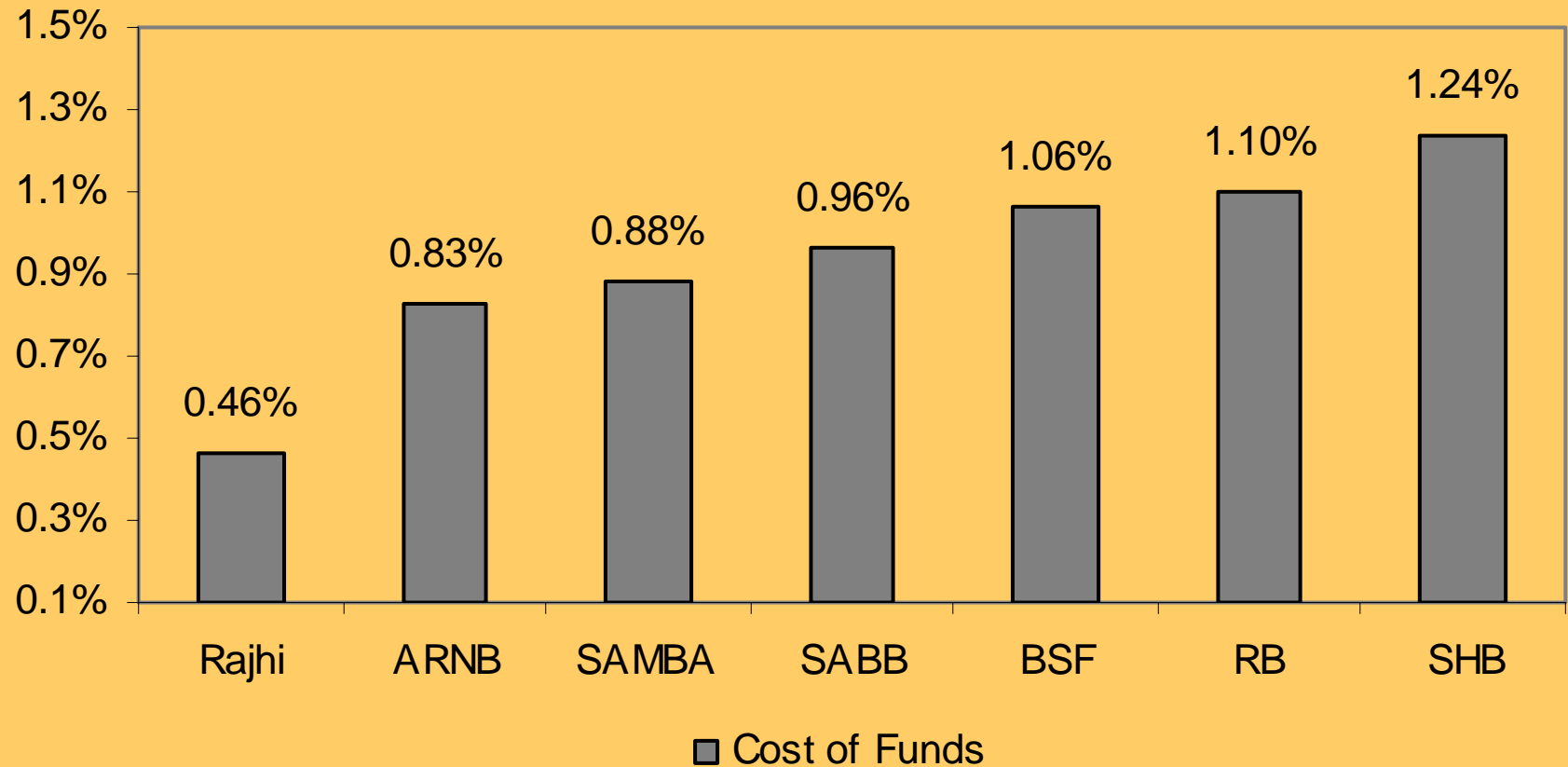
Source: Bank Annual Reports.

*SAMBA became national in 2007

National bank's branch network provides them with a lower cost of funds base

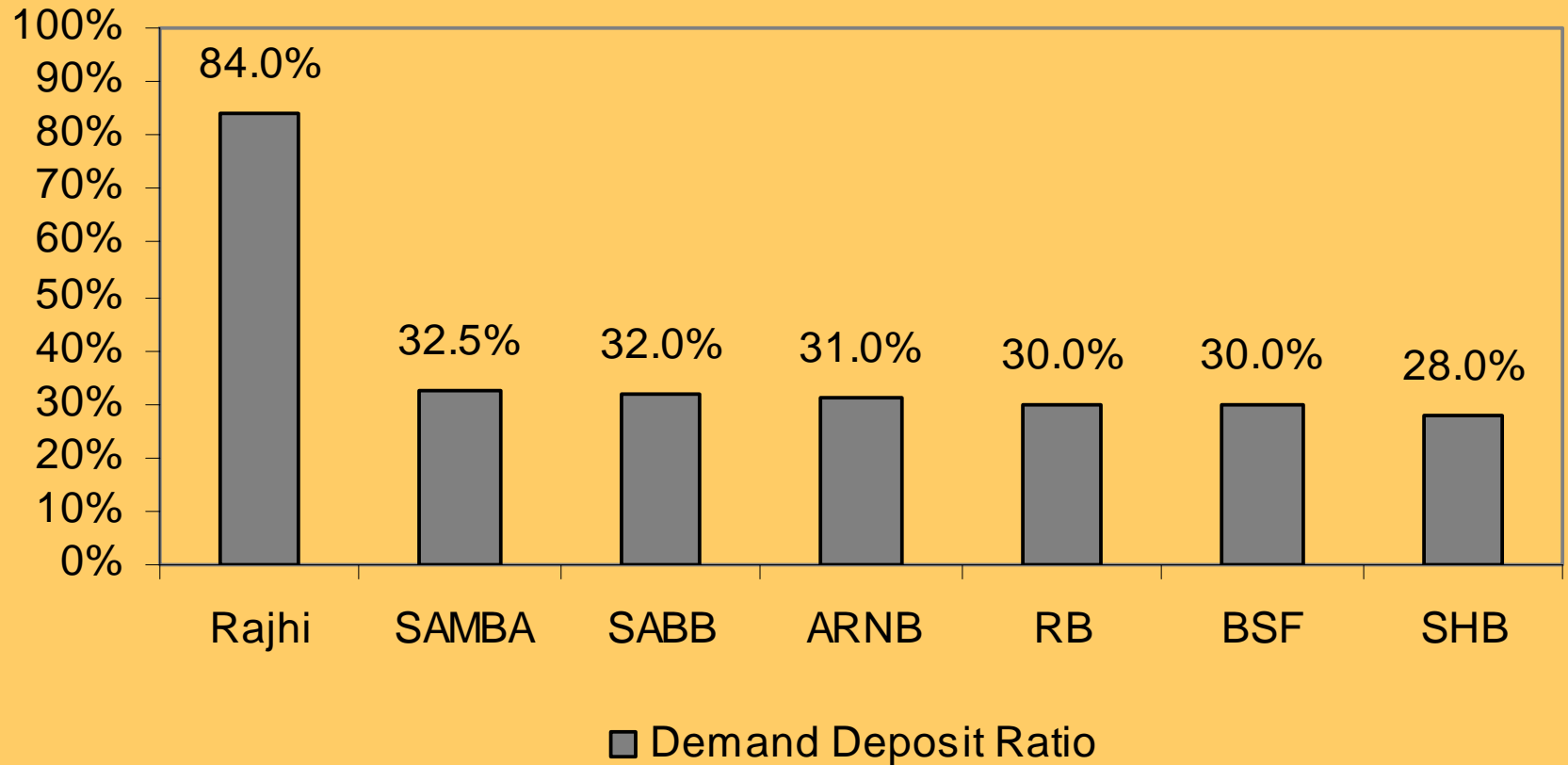
- National banks operate a larger branch network with a larger current account deposit base.
- This helps to **reduce their average cost of funds** (payments made to deposits compared to interest received from loans), especially in rural areas of Saudi Arabia.
- Al Rajhi average cost of funds is 0.46% compared with Saudi Hollandi's 1.24%
- The demand deposit ratio for most banks is around 30%, much higher than European or U.S. banks. With time, the Saudi ratio will also decline, putting pressure on Saudi bank earnings.

Figure 5.6 Saudi: cost of funds (2009)



Source: Bank reports.

Figure 5.7. Saudi: Demand deposit ratio (2009)

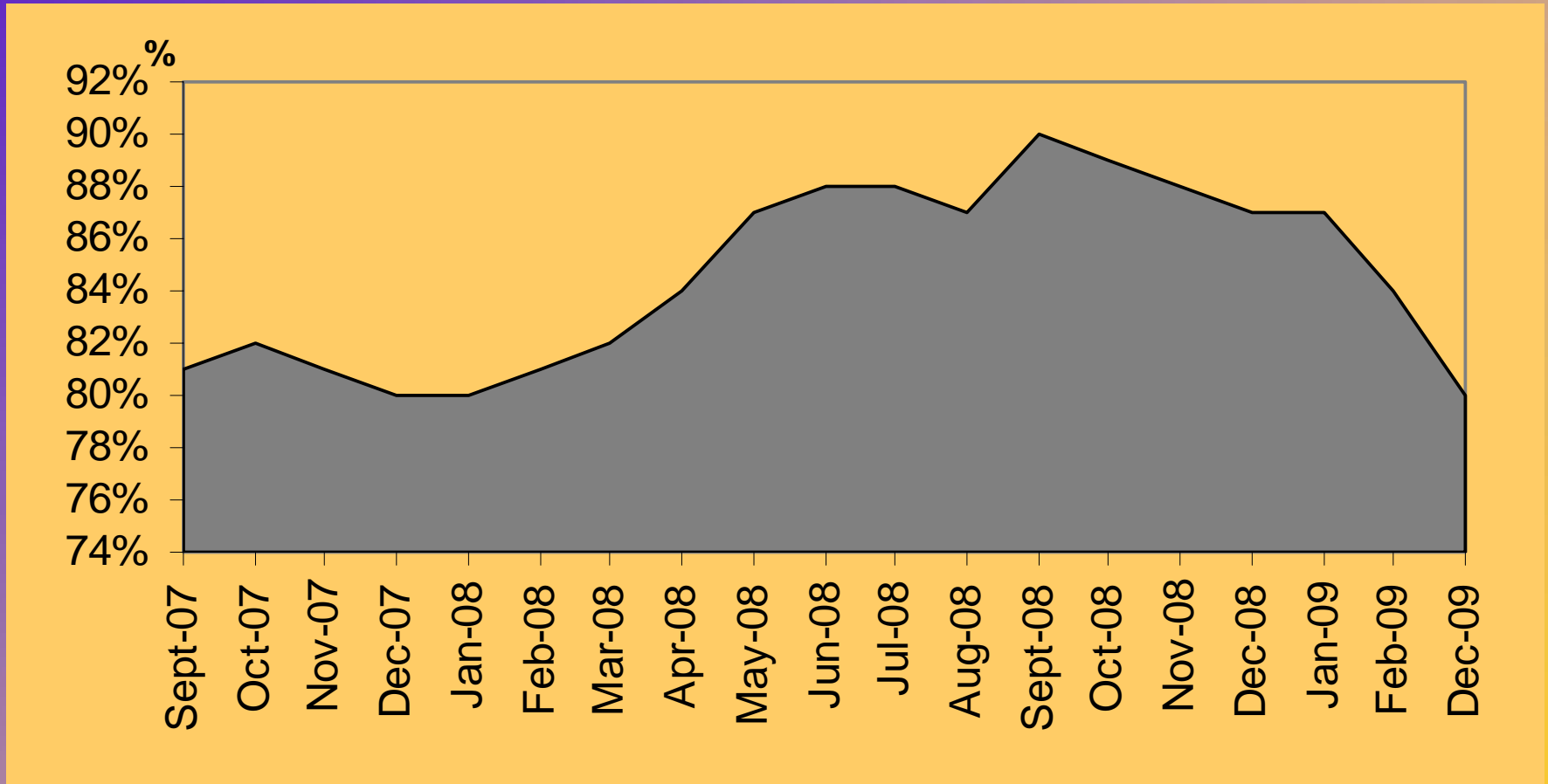


Source: Bank Annual Reports, Credit Suisse

Saudi banks lending profile

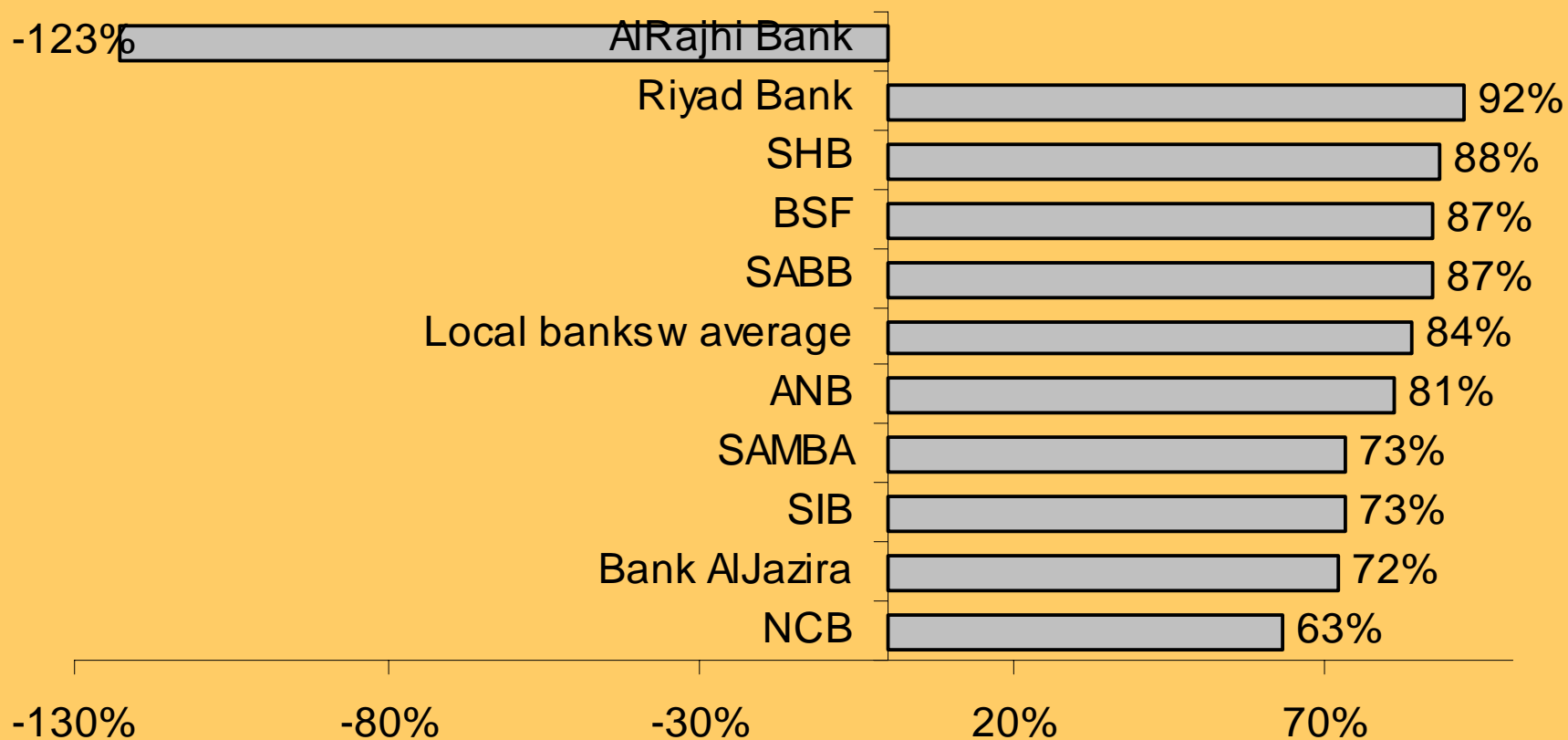
- Saudi banks traditionally have a **low loans-to-deposit ratio** and are more liquid compared with Western banks.
- SAMA maintains a **65% loan-to-deposit ratio** due to its requirements that commercial banks maintain liquid reserves of at least 20% of their deposit liabilities with SAMA.
- During 2007/2008, Saudi banks loan-to-deposit ratios rose significantly to nearly 91% levels, but then eased back when SAMA used monetary tools (**reserve requirements**) to curb on lending.
- By 2009, bank lending to the private sector had declined for the first time since 1990.

Figure 5.8 Loans to deposit ratio in the Saudi Arabian banking system



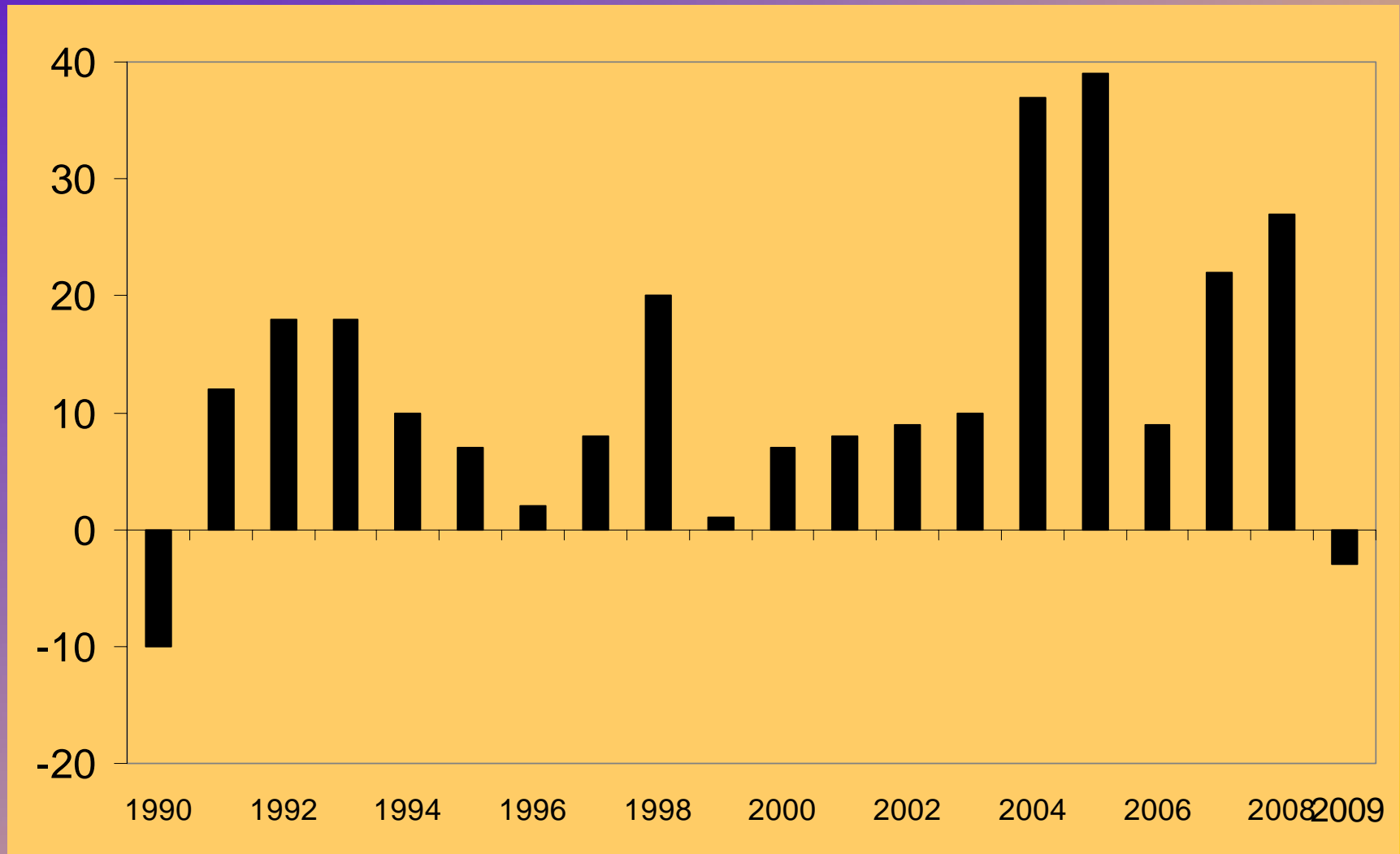
Source: SAMA

Figure 5.9. Loans to deposits ratio per bank as at Dec. 08



Source: SAMA, bank reports.

Figure 5.10. Bank credit to the private sector (% annual change)

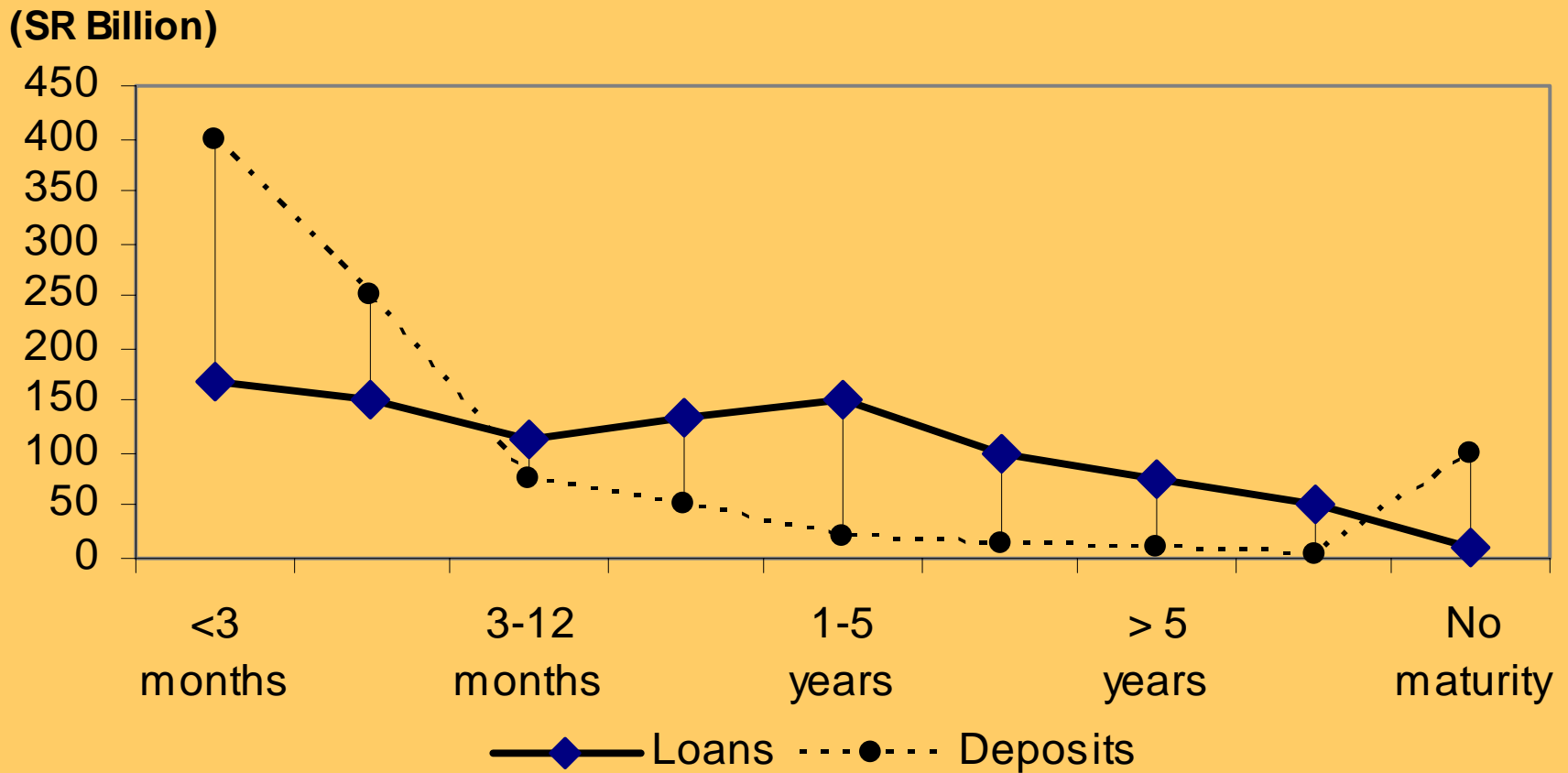


Source: SAMA

Asset-liability management is a problem

- Saudi banks suffer from **widening asset-liability mismatch** that raises concern about **liquidity risk**.
- There is a significant **gap** between short term liabilities (deposits) and medium and long term assets (loans).
- This is a major impediment to Saudi banks providing **long term loans** for projects. To do this Saudi banks can either tap into medium and long term debt market by issuing their own bonds, or use inter-bank liabilities/borrowings as liquidity buffers.
- Given above constraints, **Saudi government lending institutions have been established** to provide **long term** industrial, agricultural and real estate infrastructural loans through Saudi Industrial Development Fund, Real Estate Development Fund and Public Investment Fund as examples.

Figure 5.11 Loans and deposits maturities gaps (December 2008)



Source: SAMBA

**Table 5.9 Government specialized credit institutions – outstanding loans
(SR billions)**

<i>Institution</i>	<i>1987</i>	<i>1993</i>	<i>2002</i>	<i>2006</i>	<i>2008</i>
Agricultural Development Fund*	11.7	8.7	9.4	9.5	9.5
Saudi Credit and Saving Bank	0.5	0.7	0.8	1.3	9.8
Public Investment Fund	43.0	31.9	25.5	17.8	28.7
Saudi Individual Development Fund	42.0	5.2	9.2	11.1	17.2
Real Estate Development Fund	69.4	66.7	68.7	71.2	75.4
Total	166.9	113.2	113.6	110.9	140.6

Source: SAMA, *Formerly Saudi Arabian Agricultural Bank

Saudi Banks' sectoral lending: consumer loans predominate

- **Consumer loans** classified as “miscellaneous” represent around 38% of all private sector loans as of 2009, while lending to **manufacturing** dropped from 15% in 1999 to 11% in 2009.
- Other major lending sectors are commerce (for imports), construction and transport and communication, while lending to mining and quarrying is still negligible.
- The reduction in lending to the manufacturing sector, as well as the short term nature of lending of Saudi banks, is a matter of **concern** for the private sector to meet the challenges of diversifying the Saudi economic base.

Table 5.10. Bank credit to private sector by economic activity

SR billion

<i>Sector</i>	<i>1999</i>	<i>2003</i>	<i>2004</i>	<i>2008</i>	<i>2009</i>
Agriculture/Fishing	1,458	2,549	2,638	10,980	10,681
Manufacturing	23,753	26,604	26,149	70,333	79,090
Mining/Quarrying	1,799	650	614	4,265	4,613
Electricity/Water	1,454	1,837	2,038	10,629	12,631
Building/Construction	19,373	21,955	21,647	54,371	52,641
Commerce	38,966	51,886	50,811	176,858	179,741
Transport/Communication	6,858	12,803	11,491	37,814	43,312
Finance	6,469	11,877	17,128	16,812	13,968
Services	9,891	8,839	9,627	32,324	37,230
Miscellaneous	41,955	82,124	91,550	289,351	274,047
Total	151,976	221,123	233,692	712,737	707,953

Source: SAMA.

SAMA's regulatory framework

- SAMA has adopted a **non-interventionist** free market approach, but the arrival of **foreign banks** implies that the Saudi government is welcoming competition to upgrade domestic Saudi bank's capabilities and service offering.
- The 2007/2008 financial crisis also saw SAMA introduce a **government safety net** for local depositors for the first time in October 2008, in line with worldwide government support for depositors.

Table 5.11 Saudi banking regulatory checklist.

• <i>Category</i>	• <i>Availability</i>	<i>Non- Availability</i>	• <i>Observations</i>
• <i>Government safety net*</i>	• Available		• No formal deposit insurance scheme existed until Oct. 2008
• <i>Restriction on bank holdings</i>	•	Not available	• No restrictions, large concentration in few hands
• <i>Capital adequacy requirement</i>	• Available		• Basle BIS capital adequacy ratios exceeded
• <i>Disclosure requirements</i>	• Available		• Large loans need SAMA approval
• <i>Chartering and bank examination</i>	• Available		• SAMA makes onsite and off-site audits and approves new bank licences
• <i>Consumer protection</i>	• Available		• Maximum SAMA-imposed commissions and charges
• <i>Restriction on competition</i>		• Not available	• No formal regulatory restrictions exist as to branch network numbers or to type of banking activities to be carried out.

Source: Essayed, Ramady and Hijji, 2003.

* Since 2008

Saudi insurance: emergence of a new financial sector

- The **Saudi insurance sector** promises to add depth and widen the Saudi financial market, despite being a relatively new sector due to religious sensitivities about insurance cover.
- An Islamically acceptable “**cooperative Insurance**” market had been established in Saudi Arabia prior to the entry of foreign insurance companies following WTO accession in 2005.
- The Saudi Insurance sector is still in its **infancy** compared to other developed and emerging markets. Insurance premiums represent under 1% of Saudi GDP compared with 8.5% in the USA. However, the annual insurance premiums have **risen** to SR 10.9 billion by 2008 compared with SR 2.5 billion in 1995.

(Contd....)

- Insurance sector has been given a boost in Saudi Arabia due to **government regulations** imposing mandatory car insurance and the private health insurance for private sector employees, both foreigners and Saudis. Insurance premiums are expected to reach SR 18 billion by 2012.
- The new insurance sector has encourage Islamic insurance products to be offered such as **Takaful Ta'wini** or life insurance type products.
- The growth of this sector will deepen the Saudi capital market's ability to tap into **long term** investment funds from the insurance sector.

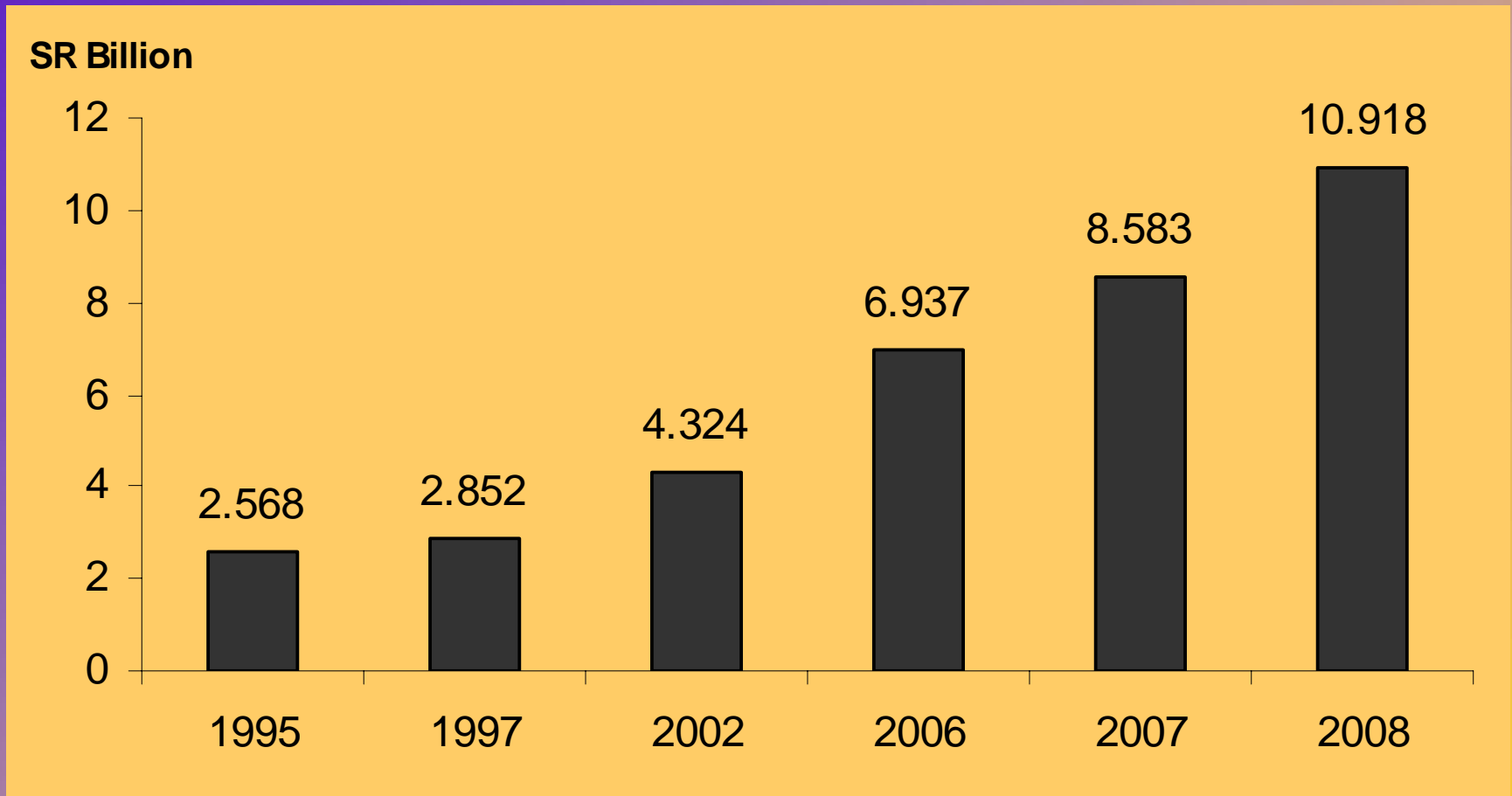
Table 5.12 Saudi and world insurance market indicators 2008

	<i>Life Premiums US\$ Bn</i>	<i>Non-life premiums US\$ Bn</i>	<i>Total premiums US\$ Bn</i>	<i>Total Premium per capita (\$)</i>	<i>Prem. as % of GDP</i>
Industrialized Countries	2,219	1,538	3,757		
United States	578	662	1,241	2,570	8.49%
Canada	48	57	105	1,543	7.37%
Japan	367	106	473	3,896	11.87%
United Kingdom	343	107	450	2,930	11.22%
Germany	111	132	243	2,800	11.94%
France	181	92	273	2,203	10.3%
Italy	83	58	141	1,740	8.4%
Australia	43	28	71	1,926	9.12%
Emerging markets	272	241	513		
Brazil	22	25	47	173	2.6%
Russia	1	38	39	N/A	N/A
China	96	45	141	N/A	N/A
India	49	7	56	N/A	1.95%
Africa	38	17	55	22	1.2%
World	2,490	1,779	4,270		
Saudi Arabia	0.16	2.75	2.91	118	0.62%
Saudi Arabia % of world	0.01%	0.15%	0.07%	-	-

Source: Swiss Re, 2009, SAMA

N/A = Not Available

Figure 5.12 Saudi insurance gross premiums 1995-2008



Source: SAMA, NCCI

Islamic finance in Saudi Arabia

- Seen a rapid increase as evidenced by the market share enjoyed by Al Rajhi Bank and the new entrants such as **Al Bilad** and **Al Inma Banks**.
- Other Islamic financial **institutions** also operate such as the subsidiary of the Geneva based **Dar Al Mal Group** – the Islamic Investment Company.
- SAMA has signaled its willingness to regulate and supervise such Islamic financing institutions and has granted approval for launch of **Islamic compliant mutual funds**, with 19 such funds operating in 2009.
- Islamic financing and the issuance of **Sukuks** is also an increasingly important market development.