Chapter 5
The Financial Markets

When money speaks, the truth is silent.

Russian proverb

Learning Outcomes

By the end of this section, you would understand:

- *The role of the financial sector in Saudi Arabia's economic development*
- *The evolving structure of the Saudi banking sector*
- *SAMA and banking supervision*
- *The challenges faced by Saudi banking following the global financial crisis*
- *The performance of Saudi banks and non-bank players*
- *The Saudi insurance sector*
- *Growing importance of Islamic financing*

Introduction

The Saudi financial sector comprising commercial banks, the insurance sector and non-bank financing companies came out of the 2008/2009 global financial and credit crisis relatively unscathed, thanks to an accommodating policy of the Saudi Arabian Monetary Agency and a somewhat conservative Saudi banking sector compared to their international peers. Although some Saudi banks were forced to take large loan loss reserves to cover for possible domestic corporate defaults and exposure to some high-profile Saudi names, they are still in a better position when compared to the collapse of major banks and other financial institutions in the USA and Europe. Thus far only a limited number of Gulf banks have publicly admitted and quantified their exposure to the US subprime crisis. Only one Saudi part-government-owned Bahrain-based bank – Gulf Investment Bank – admitted to such exposure amounting to around $966 million and had to raise additional capital. In Saudi Arabia, SAMA was quick to announce that no serious Lehman Brothers exposure to Saudi banks existed, amid serious doubts that with time such exposure might well surface or

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might not be acknowledged. Some financial players in the Saudi market seemed to be directly affected though by events in the USA, and *Tawniya*, the leading Saudi insurance company, lost nearly two thirds of its market trading value in 2008, not because of any problems in its operating business but through possible exposure to dealings with the troubled US insurance giant AIG, which had to be bailed out by the US Treasury.

The most visible effects of the global financial crisis, thus, seem to have been caused not by direct exposure to troubled assets but in indirect form. Saudi Arabia and other GCC countries have seen some of their international cost of borrowing rise because of tightening credit, and this was also affected later by the events following the Dubai World loan standstill request, which will be analysed in fuller detail later in the chapter.

Notwithstanding current global uncertainties, the Saudi financial market stands at the threshold of a new era in its evolution, with the challenges of globalization affecting the sector. How it meets these challenges will be of critical importance, given the increasing significance of the financial sector and its intermediation role vis-à-vis the Saudi Gross Domestic Product, as illustrated in Fig. 5.1.

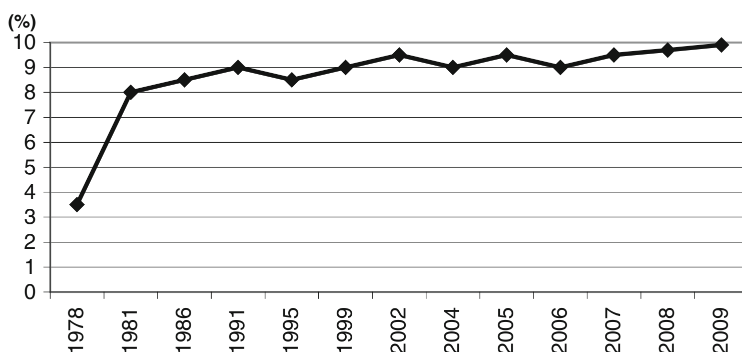

Fig. 5.1 Relative % contribution of finance and insurance sectors to non-oil GDP at current prices 1978–2009 (Source: SAMA)

By 2009, the finance and insurance sector contributed around 9.5% to the Saudi non-oil GDP, compared with around 3.5–4% in the 1970s. The opening up of the Saudi insurance sector to foreign companies and the entry of foreign banks have added an element of competition and depth to the Saudi financial sector. Implementing a Saudi mortgage law could also add depth to this sector by changing the way banks finance housing and introducing the possibility of adding non-bank mortgage financing companies into the Saudi market.

The Saudi Banking Sector

There are currently 20 banks operating in the Kingdom, a mixture of wholly owned Saudi banks and the so-called "*Saudized*" joint venture banks, which were obliged to

dilute their ownership to allow majority Saudi ownership in the early 1980s, during the so-called bank *Saudization* phase initiated by SAMA. Table 5.1 lists the status of banks already operating in the Kingdom and those institutions that have obtained licences but are not yet operational.

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

Bank ownership	Status
(A) Operational	• 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	• HSBC, UK • National Bank of Pakistan • T.C. Ziraat Bankasi • State Bank of India

Table 5.1 shows that of the 19 operational banks, six are joint venture banks, three have some government ownership while three are wholly owned by the private sector. These banks operate on the universal banking model, which provides a broad range of products and services, brokerage facilities and derivative transactions, in addition to a variety of other consumer services such as credit cards, automated teller machines (ATMs) and point-of-sale transactions. In addition, Saudi banks offer and manage an increasing number of mutual funds.

Table 5.1 also highlights a diverse number of foreign banks that have obtained licences to operate in Saudi Arabia, despite problems related to domestic terrorism. This reflects a sense of optimism in the Kingdom's long-term economic development. SAMA has welcomed these international moves, hoping that they would contribute to activating competition amongst banks in Saudi Arabia. As of 2010 there were eight wholly foreign-owned banks operating in Saudi Arabia with a diverse ownership origin ranging from France, Germany and USA to other GCC countries. Banks from India, Pakistan and Turkey have obtained licences but are not yet operational. Their focus seems to be on capturing part of the remittance business of their fellow countrymen working in Saudi Arabia. There are some indications that given the closer economic and political relationships with the emerging economic giants of the twenty-first century such as China and Brazil, it will not be too long before there are bank representations from these countries in Saudi Arabia, and vice versa from Saudi banks, in order to intermediate in the increased trade flows between them.

Economic theorists on financial development and its impact on economic growth show some disagreement on whether financial institutions grow merely in response

to the needs of society as their financial holding patterns evolve, or such financial institutions promote economic development per se by instigating changes themselves (Knight, 1998). There are suggestions in earlier literature on Saudi banking development that Saudi banking followed the passive or "demand-following" approach (Johany et al., 1986, Dukheil, 1995, Abdeen and Shook, 1984), but that more recently Saudi banks have been following a "supply-leading" approach, especially by introducing electronic banking and investment products (Abdullatif, 2002, Jasser, 2002, Fayez, 2002).

SAMA and Bank Supervision

The banking system in Saudi Arabia reflects the generally conservative social environment of the country, especially on issues relating to interest and perceptions of *riba* or usury. Under this environment, SAMA applies various rules and policies to regulate the financial markets, as we discussed in the preceding chapter. The main

Table 5.2 Saudi Arabia bank supervisory guiding policies

Guiding policy	Observation
• Maintain open and liberal financial market with minimal restriction on capital flow	• Effectively carried out, including minimal restrictions on capital flow
• Strong and healthy banking sector to maintain sustainable economic growth	• Saudi bank profitability is one of the highest in the world and its banking system has grown and adapted as the economy evolved
• Promote fair competition in financial and banking services	• More competition needed due to excessive bank concentration; foreign bank presence could promote more competition
• Benefit from participation of foreign banks and foreign shareholders so as to transfer technology, training of Saudi personnel and improve risk management practices	• 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
• Ensure Saudi financial markets are at cutting edge of communication and IT	• Achieved, for Saudi banking is one of the most technologically advanced in the world
• Pursue the adoption and implementation of global standards, principles and practices	• Achieved thorough SAMA supervision and the adoption of joint venture best banking practices
• Ensure availability of qualified Saudi finance professionals and training facilities	• Achieved through SAMA's Institute of Banking, which offers a wide range of finance training programmes including the opening of a Women's Training Centre in 2008. The institute has signed agreements with the International Finance Corporation
• Comply with latest BIS capital requirements	• Achieved and exceeded Basel capital requirements with Saudi banks averaging at 16% levels compared with prescribed 8% levels

thrust of the supervisory policies of Saudi Arabian banking throughout the evolution of the banking system to date seems to have been guided by certain objectives summarized in Table 5.2.

While there is general agreement on the relative success of the guiding regulatory principles, there is some debate on the issue of fair competition. Recent bank studies have shown that Saudi banks tend to price their products in an oligopolistic manner (Essayyad et al., 2003).

The Saudi banking sector has undergone significant evolutionary phases in a relatively short lifespan compared to other financial centres around the world. These evolutionary phases were instrumental in preparing the ground for the next evolutionary phases and have been well documented elsewhere (Dukheil, 1995, Jasser, 2002). The main features are recalled below.

The Early Years (1940s–1960s): Infancy Period

The few financial houses that existed in the pre-1950s era primarily served the pilgrim trade in Jeddah and Makkah, as well as imports and some export finance. The first branch of a foreign commercial bank, the Netherlands Trading Society (today the Saudi Hollandi Bank), was established in 1927 and concentrated on import and export finance from the city of Jeddah. These foreign banks were initially unpopular because of social and religious stigma, and there was strong resistance to paying and receiving interest. The result was effectively a *cash-oriented society* until the early 1970s. *Money-changers,* who carefully avoided the word "bank," flourished in those early days, and provided strong competition to foreign banks.

The newfound Saudi oil revenues of the 1950s brought a rise in government expenditure that resulted in an unprecedented escalation in demand for currency, outstripping supply. This oil wealth attracted foreign banks that soon opened branches in Jeddah: Banque Indochine, British Bank of Middle East, National Bank of Pakistan and Egyptian Misr Bank. The late 1950s saw yet more arrivals: Banque du Caire, First National City Bank and Banque Du Liban. In 1937, the Mahfouz and Kaki families successfully petitioned King Abdulaziz to establish the Kingdom's first locally owned bank, but it was not until 1953 that the Mahfouz-Kaki Company was transformed into what became the National Commercial Bank (NCB). In 1957, a second locally owned bank, Riyad Bank, was established.

The refusal of many depositors to receive interest meant that profits were sufficiently attractive for commercial banks to operate during this period. Banks were also able to provide loans with "service charges" being applied, without upsetting Islamic sensitivities. However, the bubble soon burst. The lack of available expertise led to incorrect loan processing and bad loan administration and some banks ran into trouble, including Riyad Bank. The government became a shareholder to restore confidence. This required more direct involvement from the de facto central bank (SAMA), which came of age in the 1960s and enacted the Banking Control Law in 1966.

The 1970s: The Adolescence Period

This was the beginning of the era of Saudi planned development with the first 5-year plan launched in 1970, as discussed in Chapter 2. The 1970s marked the start of the adolescence of the Saudi banking sector, with an increase in direct regulation and supervision.

Complementing the private sector banks, six major government lending institutions were also established during this period: the Saudi Arabian Agricultural Bank, the Saudi Credit Bank, Public Investment Fund, Contractors Fund, Saudi Industrial Development Fund and Real Estate Development Fund. Their aim was to provide medium- and long-term loans instead of the short-term loans extended by the commercial banks. Bank assets grew from SR 3 billion in 1971 to SR 93 billion in 1974. Deposits rose from SR 2 billion to SR 68 billion over the same period.

The year 1976 was a watershed year for the Saudi banking sector, as it was the year when the policy of *Saudization* of foreign banks operating in the Kingdom was first introduced, with far-reaching effects to this day. This policy required converting branches of foreign banks into publicly traded companies with majority Saudi ownership.

A primary reason for *Saudization* was that branches of foreign banks in Saudi Arabia were using policies drawn up by their foreign parent banks. These policies might not always be in harmony with local development plans, for they mostly concentrated on short-term foreign trade, with no priority for long-term loans. Foreign banks were also concentrated in Jeddah and Riyadh and provided no service in the under-banked rural areas. In addition, they were not reporting to SAMA as their final regulator, and their high profits were repatriated abroad.

Conflicts were bound to intensify as the Saudi economy expanded rapidly starting in the late 1970s, and the Kingdom saw a large part of the financial sector virtually outside its control. Given the enormous profits that foreign bank branches were making in the Kingdom – to which the author can attest from his service in this sector in those early days – there was little choice but to comply with *Saudization*, which was made palatable through long-term management contracts and tax breaks.

By 1980, *Saudization* of the major foreign bank branches had been completed. Citibank N.A. of the USA was the final one. The process boosted Saudi banks' capital base and branch expansion in other parts of the Kingdom; it also ensured an opportunity to benefit from foreign expertise and technology transfer.

The total number of bank branches rose to 247 from 145 by 1980. There were several other advantages flowing from the policy of *Saudization* of the foreign-owned bank branches. In competitive terms, the public had a wider choice of banks with which to deal, as well as receiving more competitive services at lower costs. *Saudization* helped to spread the country's new wealth among a wider section of its citizens through dividend payouts and stock ownership. This in effect laid the foundation for share ownership and its acceptance by the Saudi public.

A new and lucrative employment sector opened up for Saudis, with the opportunity to rise through the banks and manage such *Saudized* banks, as well as

"cross-fertilizing" their banking skills with wholly owned Saudi banks. The increase in capital and reserves of the newly *Saudized* banks enhanced the banking sector's ability to lend large amounts to individuals and companies. As a result, offshore lending to Saudi Arabia, mostly from Bahrain-based "*offshore banking units*" or OBUs, was less effective (Bisisu, 1984). Finally, the broader national objectives of the Saudi economy would be harmonized with the banking policies of these *Saudized* banks. This alignment of interests was quite an improvement on the pre-*Saudization* era, when foreign banks' interests were more tightly tied to those of their home countries.

As seen earlier in Table 5.1, the Saudi banking system is today preparing to welcome back foreign banks to the Kingdom. This reflects the domestic banks' self-confidence in their capacity to effectively compete. It also reflects SAMA's ability to regulate these "new-wave" foreign banks. The situation facing the new foreign banks is different this time, with an extensive branch network, a sophisticated range of banking products and a cadre of well-trained Saudi banking professionals in place. It is likely that the new foreign banks will concentrate on niche investment and merchant banking activities such as *IPOs* and mergers and acquisitions, as well as positioning themselves to provide financing for the large infrastructure project the Saudi government has planned for the years ahead.

Coming of Age in the 1980s: Young Adulthood

This period proved to be the real test of strength and resilience of the Saudi banking system and of SAMA's supervisory skills. As discussed in earlier chapters, oil prices fell sharply from the highs of the 1981 boom era; the mid-1980s was a period of sharply reduced government revenues, which fell from SR 368 billion in 1981 to SR 104 billion in 1987.

The decline in government revenues meant significant pressure on the quality of bank assets, and several banks suffered non-performing loans (Dukheil, 1995). A judicial system that seemed to side with defaulters on interest payment issues did not help either (Wilson, 1983). In 1982, SAMA successfully overcame supervisory and regulatory challenges brought about when irregularities appeared in the operations of Saudi Cairo Bank. These irregularities involved unauthorized trading in bullion, with the bank concealing accumulated losses that exceeded its share capital (Suhaimi, 2002). A new share capital was issued which was taken up by the government-owned Public Investment Fund (PIF) and this helped to restore confidence and liquidity to Saudi Cairo. This bank eventually merged with the United Saudi Commercial Bank (USCB) in 1997 to form the United Saudi Bank.

The 1980s were characterized by bank mergers. USCB itself was born in 1983 of a merger of the branches of foreign banks, namely United Bank of Pakistan, Bank Melli Iran and Banque due Liban et d'Outremer (In 1999, United Saudi Bank merged with Saudi American Bank.).

During this period, SAMA came of age and employed a number of measures in reaction to the problems the sector faced (Dukheil, 1995). SAMA required prior approval for declaration of bank dividends, extended the tax holiday period for banks, introduced tax breaks to encourage provisioning of doubtful debts and insisted on improvement in corporate governance. Finally, the monetary agency created an unofficial "blacklist" of defaulting clients through the creation of a banking disputes settlements committee.

Other significant policy changes were also introduced in this period, including legislation to control the activities of the money exchangers. Since 1982 SAMA had required that they obtain a licence to operate and that they maintain specified capital and reserves, and that they do not take deposits and issue loans. This followed the spectacular collapse of the Al Rajhi Trading Establishment in the Eastern Province in 1984 due to silver speculation.

In addition, the Saudi government, through SAMA, introduced the first public borrowing instrument – the *Bankers Security Deposit* Account (BSDA) – later replaced by bonds and treasury notes. Further, SAMA advised that prior permission was needed for Saudi commercial banks to invite foreign banks to participate in SR loan syndication. Finally, equity trading on the Saudi stock market could be conducted only through the local commercial banks.

By the end of the decade, bank branches rose from 247 to 1,036 and employees from 11,000 to 25,000 (Suhaimi, 2002). Total assets rose to SR 253 billion by 1989, a 150% increase over 1979. Saudi banks also ventured onto the international stage, with branches opened in London, Bahrain, Geneva, Beirut and Istanbul.

The 1990s and the Period of Maturity

This era started traumatically for the whole Gulf. The Iraq–Kuwait crisis of 1990–1991 was a severe external shock to the banking system, characterized by outward capital flight. SAMA, however, once again proved adept at crisis management and reacted by providing domestic banks with adequate liquidity in the form of foreign exchange swaps and deposits. Confidence was restored to the financial sector.

Following the resolution of the 1991 Gulf crisis, there was a boom in the Saudi economy. Banking activity picked up, showing its resilience despite the foreign exchange crisis sweeping other parts of the world, notably the 1994 Mexican and the 1997 South East Asian currency crisis. The 1990s saw Saudi banks begin to reap the benefit of their large investment in technology, which had been introduced in the late 1980s as an antidote to the insufficient number of qualified Saudi banking personnel. The impact of the use of new technology to deliver banking services has been enormous, the most popular being the use of ATMs for cash withdrawal and other consumer transactions such as utility payments, account transfers and general enquiries.

This period also saw the rapid spread of the use of debit cards, credit cards and stored-value cards (point of sale), and Saudi banks competed fiercely in this new

market segment. The cash-oriented society seemed to be gradually changing its transaction habits.

The technological advances made by the Saudi banks have been remarkable compared to the 1950s when the public was reluctant to use anything but silver riyal coins and foreign gold coins. Under the guidance of SAMA, Saudi commercial banks now enjoy a number of sophisticated payment and settlement systems. In 1997, the Saudi Riyal Interbank Express (SARIE) system was introduced, which is a gross settlement electronic fund-transfer system, operating in real time. It is the backbone of the Saudi payment infrastructure between banks. Other advances included the Automated Clearing House (ACH) and Saudi Payment Network (SPAN), which supported the ATMs and point-of-sales terminals, as well as the Electronic Share Information System (ESIS).

All of these systems have been linked to SARIE, enabling banks to make and receive payments directly from their accounts with SAMA on a real-time basis and to credit beneficiary accounts with transfers of funds on the same day. Another electronic share trading and information system (*TADAWUL*) has recently been enhanced to provide T+O (transaction plus zero days) settlement capability and to permit the trading of government bonds, treasury bills and mutual funds in addition to corporate shares (Suhaimi, 2002). Few countries in the developing or developed world can boast of such an array of sophisticated payment systems.

Such technological developments have contributed significantly to improving the level and quality of consumer services, reducing costs, enhancing efficiency and strengthening banking control. The Saudi banking sector had a solid base on which to meet the challenges of information technology in the new millennium.

2000 Onwards

The Saudi banking sector entered the new millennium on high hopes but major events characterized this period, bringing about some significant challenges. The new millennium saw Saudi banks faced with competitive pressures from regional and international banks who began to market the Saudi market more aggressively following the turnaround in Saudi Arabia's fiscal fortunes from 2002 onwards. At the same time, competition from foreign banks was brought nearer to home as some significant global foreign banks opened branches in the Kingdom post WTO accession in 2005, forcing some Saudi banks to reposition themselves in a more focused manner in the Saudi market. At the same time, the international environment of low interest rates in the later part of the decade affected Saudi banks' margins as the cost of funds fell faster than lending rates, eroding lending margins.

Saudi banks began to search for non-interest investment income and to diversify their product range to reduce dependency on interest income (or commission income as it is termed in Saudi Arabia). Domestic banks also faced the prospect of losing out on their lucrative brokerage commission fees, acting as brokers from share

trading, as the Saudi Capital Market Authority (CMA) started to license both local and foreign brokers and investment management companies in the later part of the decade, thus putting pressure on Saudi banks' earnings. Some reacted by creating their independent brokerage and investment advisory companies under names such as SABB Securities Ltd. Company, SAMBA Capital, Riyad Bank Capital, NCB Capital, Fransi Capital, Saudi Hollandi Capital, Al Rajhi Financial Services, Arab National Investment Company and so on.

With foreign licensed banks eyeing the investment income market in Saudi Arabia, the domestic banks realized that they needed to develop more expertise and deliver more products if they are to effectively compete in this market segment in the future. The current period was also characterized by the growth in Saudi Islamic banking services from existing market participants, as well as the entry of two new Saudi Islamic *Shariah*-compliant banks – Al Inma and Al Bilad – to cater to this fast-growing market segment. Al Bilad was the result of the amalgamation of the Saudi money brokers into a new bank and brings to a close the long history of this rather exotic money broker segment. At the same time, most Saudi banks either converted some of their retail branches to offer *Shariah*-compliant products or opened "Islamic" windows. The new millennium also saw the complete *Saudization* of SAMBA to a full Saudi ownership after Citibank sold its remaining share in the Saudi American Bank joint venture entity and forego its management licence. *Saudization* had indeed come a full circle, at least for SAMBA, indicating that local bankers and senior management felt more confident in running their banks without direct technical support from overseas joint venture partners, although many Saudi banks continue to draw upon technical, IT and training cooperation from foreign counterparts.

The period also witnessed the venturing abroad of some Saudi banks either through acquisitions or direct branch openings, the most visible being Al Rajhi Bank's acquisition in 2007 of a Malaysian bank's 12-retail-branch network to enable Al Rajhi to enter the profitable Malaysian financial market and to have access to the latest Islamic finance market instrument developments, given Malaysia's lead in this area. As of 2010, the Al Rajhi network in Malaysia increased to 20 branches. Table 5.3 illustrates the current Saudi bank's international presence.

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
• Riyad Bank	• London, Houston, Singapore
• SAMBA	• London, Dubai, Pakistan, Qatar
• Saudi Fransi	• Banque BEMO Saudi Fransi, Syria (60%)

Source*:* Bank annual reports

Saudi Bank Shareholder Concentration and Ownership

The issue of shareholder concentration is one of the major concerns for the Saudi banking sector, as it is for most other publicly listed Saudi joint stock companies (Dukheil, 1995, Abdullatif, 2002). From late 1980s to date, there has been a significant concentration of shareholders in the banking sector, as shown in Table 5.4.

Table 5.4 Shareholder concentration for selected Saudi banks

Bank	1981	1986	1998	2001
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

The increase in the number of shareholders for certain years, such as witnessed for the Saudi British Bank in 1998, was tied to capital increases, while for SAMBA in 2001 it followed the merger with United Saudi Bank in 1999. The trend towards far fewer shareholders is unmistakable and there are several implications. First, holding a higher concentration of shares in fewer hands might enable some business groups to influence day-to-day operations and bank management through board representation. Second, the concentration of shares in a few hands with block votes "de-democratizes" the role of annual general meetings in joint stock companies. Concentration eliminates transparency and leads to joint stock companies operating like partnerships.

The issue became a concern to the regulators in 2009 following the default of two prominent Saudi family groups – Saad Group owned by Maan Al Sanei, and the Al Gosaibi Group, which had large exposure to Saudi and international banks, some of loans were seemingly extended on a "name lending" basis from banks where both groups held significant share holdings. SAMA moved quickly to reinforce existing regulations that requested more transparent bank corporate governance and disclosure in cases of direct and indirect shareholder loans.

A survey was carried out by the author on the size of Saudi family ownership of "core" share blocks in the various Saudi banks using available public information from annual reports, as well as share register information and bank sources. This information is displayed in Table 5.5.

The concentration level shown in Fig. 5.4 is also reflected in other "wholly owned" Saudi banks such as Riyad Bank and the National Commercial Bank (NCB) through government major ownership participation in these banks.

Since 1961, the Saudi government has held a 38% stake in Riyad Bank, and 80% of NCB since January 2003. In 1999, the Public Investment Fund (PIF), the Saudi government's domestic investment vehicle, acquired 50% of the privately owned National Commercial Bank from the Mahfouz and Kaaki families. The PIF went on to sell 10% of its share to the government-owned General Organization for Social

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

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

Source: Author's survey

Security (GOSI) in 2001. GOSI went on to acquire Citibank's share in 2007 when that bank sold out its participation. The issue of large government ownership in banks raises concerns of possible "*moral hazard*" arising whereby banks with substantial public ownership might be tempted to take on a greater risk, knowing that they will always be bailed out. In Saudi Arabia there has been no evidence of systemic banking crises and bank failures over the last few decades, but this is due to mainly the application of either a "purchase and assume" policy of mergers and acquisitions of one institution with another (such as Saudi Cairo with United Saudi Commercial Bank when the former was having difficulties), or government direct participation in the Arab world's largest bank, the National Commercial Bank.

Table 5.5 reveals that, of the original *Saudized* banks, only the *Saudi British, Saudi Hollandi* and *Arab National banks* have maintained their original 40% foreign joint venture partner shareholding, with others, such as Saudi Fransi, Saudi Investment and Saudi American, either selling part of their holdings or being diluted through new capital increases.

The table also indicates that major shareholder concentration is more pronounced within Saudi Hollandi, SAMBA and Al Rajhi banks, with Saudi British the least concentrated of the three. Historical reasons explain the high level of Saudi bank concentration, especially for the joint venture banks. These banks usually started life through a founding group of investors who were granted a certain percentage of the founding share capital, with the remaining shares distributed between the foreign joint venture partner and the general public. Because there were few shares distributed to the smaller investors, over time they sold out to the larger investors and

founding shareholders. This also happened for the latest Saudi banks to be floated – *Al Inma* bank issued 1.5 billion shares valued at SR 15 billion, 70% of which were sold to the public in 2007. By 2010 an estimated 40% of the original shareholders had sold their shares.

The Saudi government is aware of these issues, and is encouraging wider share ownership by planning a partial privatization of its own bank holdings, especially in the Kingdom's largest bank, the National Commercial Bank (NCB). According to press reports, the government is planning to sell up to 50% of its current holding in NCB, which, if it happens, would give a large boost to the Saudi capital market.

This partial privatization sale would provide both short- and long-term benefits to the government, which would still retain a major stake in NCB. In the short run, the flotation proceeds could be used to repay part of the government's outstanding debt, while in the long run the government would see its share value appreciate on the capital markets once NCB shares are listed, while continuing to receive future dividends from NCB. No plans have been announced for selling part of the government's holdings in Riyad Bank, and it will be interesting to see what the government wants to do with its newly acquired 20% shareholding in the profitable SAMBA.

Performance of the Saudi Banks

Although some Saudi banks have been affected by the global financial crisis, specifically in some of their domestic loan portfolio, they are still in a better shape compared to many others in the world.

As we will analyse below, core banking income remains solid and has increased for many of the banks; total assets continue to grow and profitability ratios remain satisfactory with return on average assets (ROAA) standing at around 2.3% and return on average equity (ROAE) at around 18%. Furthermore, Saudi banks enjoy high levels of capitalization with their Tier 1 capital adequacy ratios at around 16% for year-end 2009, well above the 8% minimum recommended by Basel II guidelines. Table 5.6 provides a snapshot of the key banking ratios and potential risk indicators.

Potential risk remains for Saudi banks following the global and regional financial crisis of 2008/2009, some of which is reflected in Table 5.6. To the extent that some Saudi banks might have exposure to international debt and derivative markets, any further fall in asset prices might prompt banks to increase provisioning to safeguard their balance sheets. This will result in lower profits and the higher perception of financial risk, in turn manifest in tighter bank lending measures, coupled with a weakening business environment and rising non-performing loans. This was noticeable in 2009 when non-performing loans (NPLs) rose to 1.5% compared with 1.4% in the previous year, which is still far lower than the 2.3% level of 2004. Saudi banks' NPL coverage ratio is still fairly high at around 150% level and the Saudi banking sector entered the global financial crisis in a strong position with high capital adequacy ratios, ample liquidity and an enviable demand deposit ratio of around 40%, comparable with under 5% for most European banks.

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

Bank	2004	2005	2006	2007	2008	2009
Loans-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

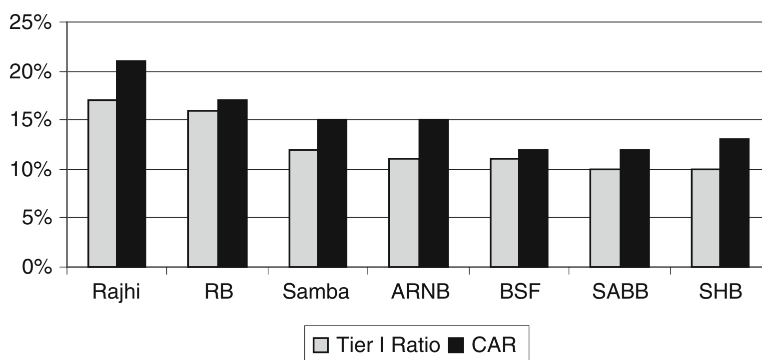

Fig. 5.2 Saudi banks: capital adequacy ratios (CAR) (Source: SAMA, Credit Suisse 2009)

Figure 5.2 sets out the capital adequacy ratios and Tier I Basel capital ratios for some selected Saudi banks.

It is noted that all seven Saudi banks maintain healthy capital adequacy ratios (CARs), with Al Rajhi Bank and Riyad Bank (RB) being the most capitalized. The Saudi Hollandi Bank (SHB) is the least capitalized bank with a Tier I ratio of 9.8%. With total assets of SR 1,370 billion as of December 2009, the Saudi banking sector is estimated to be the second largest in the GCC, just behind the UAE, growing from SR 655 billion in 5 years, or nearly 110% growth.

Of the 12 local banks that make up the Saudi banking sector, 11 are listed on the *TADAWUL* stock market with an aggregate market capitalization (excluding *Al*

Inma Bank) of SR 268 billion ($77 billion) as of December 2009, down from SR 405 billion ($108 billion) as of December 2007.

The total distribution network of the Saudi banking sector extended to 1,430 branches and 9,258 automated teller machines (ATMs) in December 2009, up from 1,060 and 1,400, respectively, as of December 1994. The growth in both is illustrated in Fig. 5.3, which demonstrates the increased popularity of ATMs.

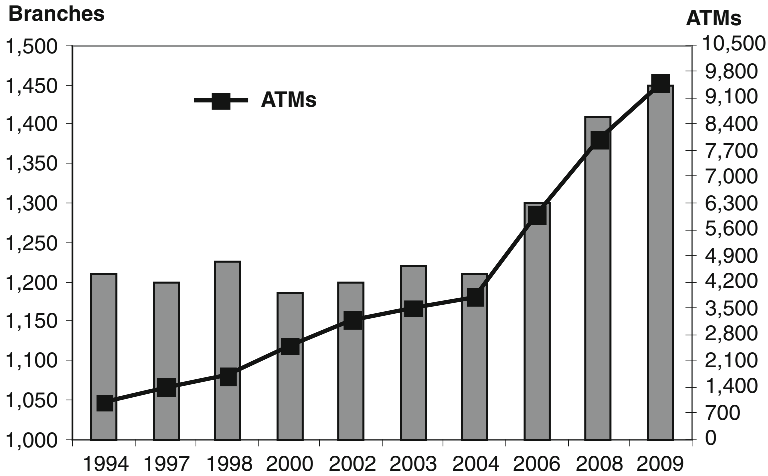

Fig. 5.3 Evolution of branches and ATMs 1994–2009 (Source: SAMA)

Most Saudi banks have found it more cost-effective to install ATMs rather than invest in a brick-and-mortar branch network. They had bet on Saudi society's acceptance of electronic banking and ATMs and points of sale becoming more accepted in what had traditionally been a cash-oriented society. Their strategy seems to have been correct, as Fig. 5.4 illustrates. While the number of ATMs has increased, so has

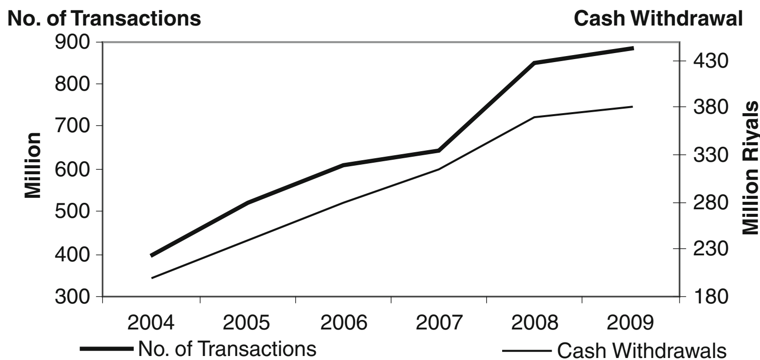

Fig. 5.4 ATM Transactions and withdrawals: 2004–2009 (Source: SAMA)

the number of transactions and point of sales over the period 2003–2009 to reach nearly 1 billion transactions in 2009, compared with under 200,000 for 2003, while the value of cash withdrawn reached SR 380 million for 2009.

The above trend has been helped by the heavy investment in technology in the financial sector since the late 1980s. Under SAMA's auspices, the Saudi banking sector is one of the world's most technologically sophisticated using advanced interbank clearing house operations in SAMA's regional branches, and *SARIE* or Saudi Arabian Riyal Interbank Express payment system introduced in 1997. SARIE's systems at SAMA and the banks have been replaced and upgraded in stages to cope with increasing volumes of payments from the existing and newly licensed banks and also to ensure compatibility with new technology. This is particularly important in such areas as information security, network technology and applications of software systems. Bill payments can now be made in Saudi Arabia using the "*SADAD*" payment system, which entered operation in 2004 and is a central system for presenting and paying of bills and other payments electronically. All forms of outlets such as ATMs' telephone banking and the Internet can be used to make *SADAD* payments.

Concentration Ratios Are Worrying for Competition

An analysis of Saudi bank performance must also address the issue of competition. Such competition has not been significant in the past, primarily because Saudi banks have experienced high profit ratios in terms of net return on assets and equity compared to other banks worldwide. Barriers to entry – at least before the new foreign bank licences were granted in 2004 – and the low cost of funds due to the large element of current/non-interest-bearing accounts help to explain this. The lack of external entry and competition has led to a high banking industry concentration level in Saudi Arabia. Table 5.7 summarizes the level of Saudi bank concentration for the periods 2001 and 2008. It is noted that three banking groups have around 50% of the banking market in both periods.

In 2001 and 2008, the same three banks, NCB, SAMBA and Al Rajhi, dominated, although Riyad Bank came a close fourth. Despite new entrants into the Saudi banking sector, the top three continued to dominate, the only erosion being seen in their loan and asset share.

Table 5.7 Saudi Arabian bank concentration levels in 2001 and 2008

Year	Number of banks	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

The effects of such concentration levels have been researched for the Saudi market (Essayyad et al., 2003). Studies conducted in the area of bank concentration and economic efficiency indicate that a high concentration ratio may induce banks to charge borrowers with higher interest rates than when there is a low banking concentration.

According to Saudi studies, the non-interventionist policy of SAMA in this area of bank regulation could hamper the growth of companies, particularly small- and medium-sized industries, due to more restrictive credit conditions by the banks within a system of imperfect competition (Essayyad et al., 2003). The scope of the problems faced by small- and medium-sized enterprises (SMEs) in Saudi Arabia, discussed later in Chapter 7, confirmed this finding.

The Rush to Segmentation

Competition in Saudi Arabia amongst banks is along various segmentation lines, and each of these is further segmented by gender. Segmentation by gender means that "ladies-only" banking operations were developed as a niche market, either in separate branches or in ladies sections within the same branch. This has proved to be both successful and profitable, and all Saudi banks today operate "ladies-only" branches.

In Saudi Arabia, segmentation also seems to follow asset size and class, like the various prestige-level card awards of hotels or airlines (blue, silver, gold, platinum). Saudi banks seemed to realize that traditional "old wealth" private banking clients (with their emphasis on wealth preservation) are not as numerous as the larger affluent segments for whom wealth creation is the main objective. The former clients seem to be the domain of international private banking financial institutions, while the latter are those who created wealth in the Saudi stock and real estate markets.

Market surveys indicate that consumer preferences are determined not by individual bank strengths, but rather by the national origin of the bank. Important too is the family tradition in dealing with "Islamic"-oriented banks or "conventional" banks, even though each Saudi bank has used the media to portray different strengths, reputations and allegiances.

While it is difficult to generalize, Table 5.8 attempts to capture the main marketing strengths and public perceptions of the different Saudi banks, which could partly explain their varying performances in separate market segments.

The perceived strengths in each bank's niche markets are also partly reflections of the different management styles, philosophies and orientations of the pure "Saudi" banks, such as NCB and Riyad Bank with their "domestic roots" on the one hand, and those with foreign affiliation and management control on the other hand. The concentration of joint venture banks, such as Saudi Fransi, Saudi Hollandi, Saudi British and Arab National Bank, on core corporate business, investment and treasury products meant that they left the consumer loan mass-market and small business lending to the "pure" Saudi banks, in order to concentrate on "big-ticket" corporate

Table 5.8 Saudi commercial banks: perception of key strengths

Institution	Perception – strengths
• 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
• Riyad Bank	• Consumer loans, trading activities, investments, government accounts, oil and agricultural sector, syndications, small business
• Al Rajhi	• Islamic investments, foreign exchange, trading activities, "safety first"
• 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, "people's bank", strength through government participation

loans. The increasing popularity of Islamic banking bas forced many to consider this target market segment and two new banks – *Al Bilad* and *Al Inma* – focus mostly on this segment, while *Al Jazira* has tried to convert most of its banking operations to *Shariah*-compliant ones. SAMBA which became a fully owned Saudi bank still concentrates on the core corporate market but has tried to differentiate itself in the investment banking sector.

The differences between national Saudi banks' and joint venture banks' "efficiency" measured in terms of loans and deposit volumes per branch is illustrated in Fig. 5.5.

The differences between joint venture banks (JVs) and the national banks go deeper than their origins and ownership structures. Their underlying banking philosophies differ, with the joint ventures targeting the upper wealth segment, both corporate and individual, and the national banks targeting the lower segments, although each national bank also has a segment for its high net worth clients.

Because of these differences, the national banks operate a larger branch network, as seen in Fig. 5.5, but joint ventures enjoy a higher loan-to-branch and deposit-to-branch ratio. The brick-and-mortar branch network of Saudi Fransi Bank and SABB has proved to be the most effective amongst local peers, although SAMBA as the latest "national" bank has done extremely well, beating all other banks as illustrated in Fig. 5.5. Such high efficiency levels indicate consistent management

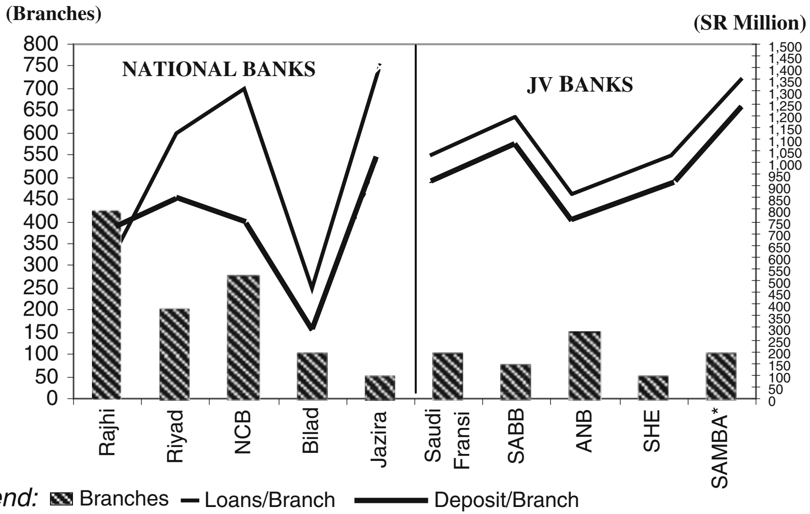

Fig. 5.5 Comparison between Saudi national banks and joint venture banks by branch loans/deposits (2008) (SAMBA became national in 2007) (Source: Bank annual reports)

efforts and investments in optimizing alternative delivery channels to maximize sales performance and provide access to a wider client base.

While joint venture banks might seem to be efficient in terms of the amount of loans and deposits per branch, the Saudi national banks tend to generally have a lower cost of funds due to their bigger demand deposit ratios and larger branch network, often in rural areas where the taking of interest-is not as widespread as in urban areas. This is illustrated in Figs. 5.6 and 5.7.

From the above figures, Al Rajhi bank which represents the Saudi national banks has the lowest funding costs compared with the joint venture banks, owing to its high

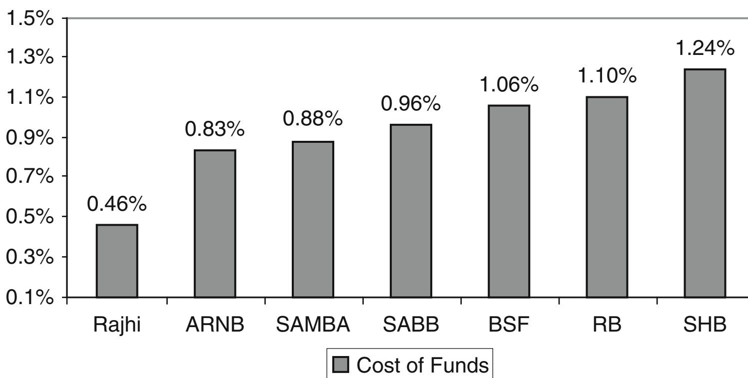

Fig. 5.6 Saudi: cost of funds (2009) (Source: Bank reports)

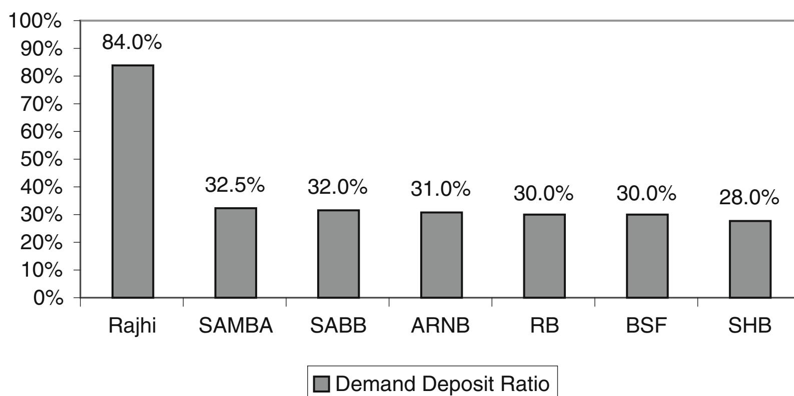

Fig. 5.7 Saudi: Demand deposit ratio (2009) (Source: Bank annual reports, Credit Suisse)

demand deposit ratio of nearly 85%, while the joint ventures averaged around 30%, with Saudi Hollandi Bank the lowest at 28%. As such, this bank had the highest funding cost at 1.24%. Over time, as we explored in the previous chapter, the relative ratio of current accounts to total deposits will come down, further putting pressure on Saudi banks to seek alternative revenues from interest-bearing products.

Saudi Banks' Lending Profile

Saudi banks have traditionally a low loans-to-deposit ratio and thus more liquidity compared to other Western institutions (Azzam, 2002, NCB, 2001b). SAMA maintains a 65% loans-to-deposit ratio level due to its requirement that commercial banks maintain liquid reserves of at least 20% of their deposit liabilities in the form of cash, gold, Saudi government bonds or qualifying assets that can be converted into cash within a period of no less than 30 days (SAMA).

During the period 2007–2008, the Saudi banks' loans-to-deposit ratio rose significantly to reach nearly 91% level by October 2008, as illustrated in Fig. 5.8, and then easing back as SAMA started to introduce monetary tools such as reserve requirements to curb on lending described in the previous chapter.

By the end of 2009, the loans-to-deposit ratio had declined to just under the 80% level as illustrated in Fig. 5.8, while Fig. 5.9 sets out the ratio for individual major banks. We note that the two largest Saudi national banks, NCB and Riyad Bank, had different ratios, with NCB being more conservative at 63% and Riyad Bank at 92%, and the joint venture banks also being more aggressive lenders.

Although SAMA's conservative ceiling on loans-to-deposit ratio has shielded the Saudi banking sector in times of global downturn, such a strict measure could undermine the industry's growth moving forward. This could be one option for SAMA as it reconsiders the effect of Saudi bank lending policies during boom periods, as

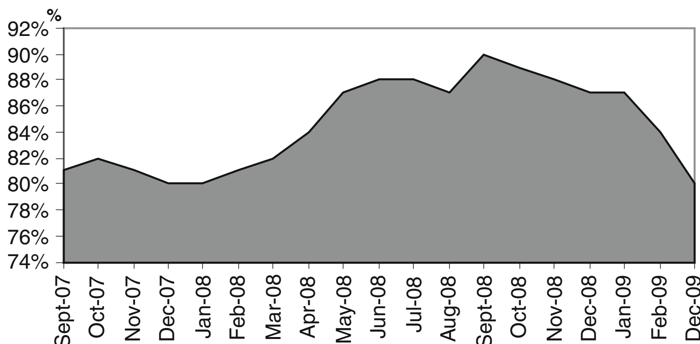

Fig. 5.8 Loans-to-deposit ratio in the Saudi Arabian banking system (Source: SAMA)

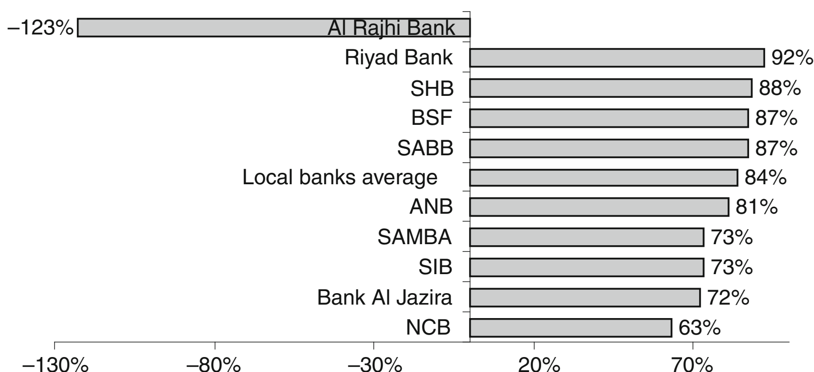

Fig. 5.9 Loans-to-deposit ratio per bank as of December 2008 (Source: SAMA, bank reports)

was the case during 2007/2008, in order to ease a liquidity pressure in the Kingdom, without having the government to pump in liquidity as a fiscal measure.

While this high-liquidity cushion of Saudi banks might be looked upon favourably from the regulatory aspect of a central bank, it raises some other issues. First, the low ratio imposes a restriction on domestic lending opportunities, and excess liquidity is absorbed through the acquisition of foreign deposits or local investments. This could be profitable when foreign interest rates are higher than domestic rates, and if domestic investment opportunities are positive. The downturn in international interest rates, specifically US dollar interest rates, as well as uncertainties in the international stock markets has prompted some repositioning of lending to the domestic markets. However, the majority of bank lending was of less than 1 year's duration.

This type of lending structure is not conducive to long-term industrial investment and planning. Filling a need for long-term investment capital was the prime reason for the Saudi government's establishment of its own lending agencies. It will be

interesting to see if some of the newly licensed foreign banks spot a market niche and establish long-term credit relationships with Saudi corporations.

By all accounts, 2009 was a watershed year for Saudi banks which saw bank credit to the private sector fall for the first time since 1990 during the tension of the Second Gulf War. This is illustrated in Fig. 5.10, which sets out the annual change in bank lending.

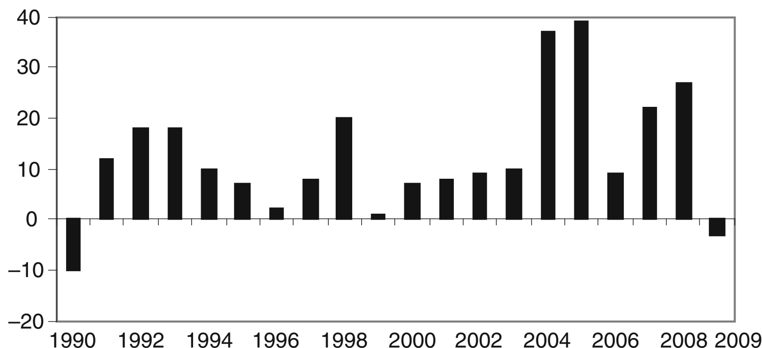

Fig. 5.10 Bank credit to the private sector (% annual change) (Source: SAMA)

Asset-Liability Management Is a Problem

Saudi banks, similar to other GCC markets, suffer from widening asset-liability maturity mismatch, raising major concerns about banks' liquidity risk as well as credit risk. Adverse global and domestic market conditions can also affect the asset-liability mismatch by having depositors opt for shorter maturities. Figure 5.11

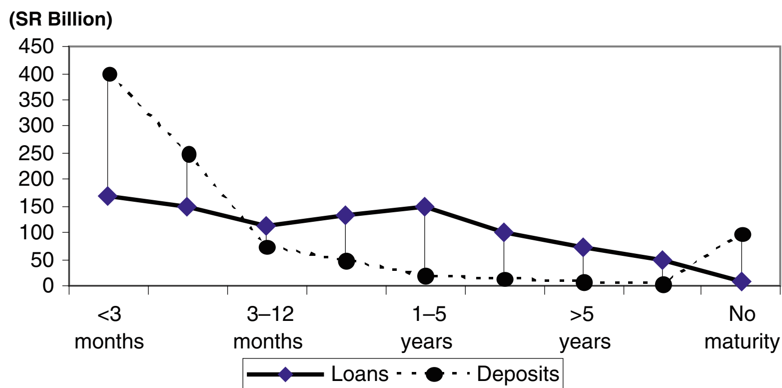

Fig. 5.11 Loans and deposits maturity gaps (December 2008) (Source: SAMBA)

highlights the significant gap between medium- and long-term loans and matched bank deposits.

The above loans and deposits maturity gap is a major impediment to the Saudi banks' ability to fulfil medium- and long-term commitments that are funded primarily by short-term deposits. Given this current reality, Saudi banks can either tap into medium- and long-term debt markets by issuing bonds, or use inter-bank liabilities as liquidity buffers to meet medium- and long-term obligations.

Due to the Saudi banks' market constraints, and cognizant that some of the major Saudi projects, especially in the basic industries and petrochemical sectors, will require long-term funding, the government-owned Public Investment Fund (PIF) announced new measures in 2008 to increase funding to such projects. The PIF raised the cap on lending for each project in which it participates from 30% to 40% of its value, and extended the loan duration from 15 to 20 years (including a 5-year grace period). Of more significance, the PIF announced raising its lending limit on each project from the current level of SR 3.8 billion (just over $1 billion) to SR 4.9 billion ($1.6 billion).

It has not only been the PIF, the Ministry of Finance's investment arm, but also other specialized government financing institutions that were set up to provide much-needed longer-term financing sources. Table 5.9 examines the outstanding loans disbursed by the five major Saudi specialized credit institutions which went a long way in assisting the modern Saudi economic infrastructure to be built up.

Besides the PIF, the largest disbursements have been carried out by the Real Estate Development Fund (REDF) and the Saudi Industrial Development Fund (SIDF). The REDF was established to provide long-term personal home-building assistance for Saudi citizens, with grants of SR 300,000 being given on 20-year terms at virtually nil interest rates. This amount remained unchanged since REDF's establishment but was raised to SR 400,000 in 2009 due to inflationary pressures and rising construction cost, but still remains insufficient to meet the needs for building an average Saudi villa which costs around SR 800,000–1,500,000. The possible introduction of a Saudi mortgage law and mortgage financing through Saudi banks

Table 5.9 Government specialized credit institutions – outstanding loans

	1987	1993	2002	2006	2008
Institution	SR billions				
Agricultural Development Fund[a]	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

[a]Formerly Saudi Arabian Agricultural Bank
Source: SAMA

aims to release funding to this sector. The SIDF provides loans to Saudi industries, joint venture companies and foreign entities operating in Saudi Arabia under the liberalized foreign direct investment laws on concessionary basis based on a project's business viability and ability to repay. SIDF is run by professionals, many of whom had completed the much sought Chase Manhattan Bank intensive credit evaluation course. SIDF applies rigorous credit evaluation procedures and standards and has a very low rate of loan default, often self financing itself from loan repayments as Table 5.9 illustrates. The recent rise in disbursements of the Saudi credit and savings bank – popularly known as the "marriage" bank for giving out marriage loans to Saudis – was due to extending loans to Saudi small- and medium-sized enterprises (SMEs), as part of the government's strategy to support the SMEs due to perceived lack of traditional bank financing and interest in this market segment.

Saudi Banks Sectoral Lending: Consumer Lending Takes Off

Table 5.10 illustrates the sectoral allocation of bank lending from 1999 to 2009 and reveals the growing importance of consumer lending.

Consumer loans represented around 27% of all private sector loans, compared with 38% in 2009. According to SAMA, the majority were for financing motor vehicles and "other" unspecified personal loans; real estate and credit-card financing remained steady. This situation is unlikely to change in the foreseeable future, at least not until Saudi banks feel they have more legal certainty over extending real estate loans. At present they cannot hold mortgages. Credit-card facilities are normally backed up by appropriate cash collateral – mostly time deposits. Given such uncertainties, foreign banks are not likely to be competing in this market segment in Saudi Arabia.

Table 5.10 Bank credit to private sector by economic activity

	1999	2003	2004	2008	2009
Sector	SR billion				
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

What is more worrying for Saudi manufacturing growth prospects is the relative decline in the share of lending to this sector, which has registered a drop from around 15% in 1999 to 11%, for current years, as set out in Table 5.10. This fall, combined with the short-term nature of lending in Saudi Arabia, is a matter of concern if the Saudi private sector is to be able to meet the challenges of diversifying the economic base of the country.

In order to protect Saudi banks from potential consumer loan losses based on asymmetrical information from borrowers – the withholding of information by borrowers from banks – the Saudi government has encouraged financial institutions to share credit information through a common credit reference bureau. In 2002, the Saudi Credit Information Company (SIMAH) was established under the supervision of SAMA. By 2008, SIMAH credit information had membership not only of the Saudi banking sector but also the automobile financing sector, telecommunications, and foreign banks operating in Saudi Arabia, besides government disbursing agencies. Insurance companies joined in late 2008 and SAMA has received applications from many other potential members and studies each request rigorously in order to protect both creditors and lenders. SIMAH has been enhanced and introduced a credit rating or "scoring" system based on the assessment of an individual's solvency and potential credit risk, while the creation of the Commercial Credit Bureau of SIMAH aims to provide the banking sector with a more scientific risk weighted assessment on lending to the medium- and small-sized companies or SMEs. Further developments included a register of checks returned without sufficient funds, and identifying risks of companies with no previous credit history.

All the developments in the Saudi financial sector points to a gradual maturing of the industry given the mix of domestic and international players, as well as the sophistication of the operating framework. At the same time, Saudi Arabia seemed to have adopted a non-interventionist free-market approach, but the approval of new foreign bank licences implies that the government is also encouraging more competition in the domestic market. Table 5.11 summarizes the emphasis of SAMA's overall regulations concerning Saudi commercial banks.

As the above table points, there was a lack of formal Saudi government safety net for bank depositors until October 2008, such as that of the US Federal insurance deposit scheme which guaranteed the first $100,000 of bank deposits but which was raised to $250,000 at the height of the 2008/2009 global financial crisis.

The Saudi move in 2008 was also in response to the acute global financial crisis and followed the action of the other GCC member states. SAMA's decision sent a strong signal that it was standing behind the Saudi financial system to restore confidence, while reiterating the soundness of the industry's liquidity situation and SAMA's willingness to pump extra liquidity into the system. SAMA had acted before to support the Saudi financial sector, and, despite no formal guarantee, it acted as a bank of "last resort" when it intervened to avert banking crisis from developing, such as those with Riyad bank in the 1960s and Saudi Cairo and NCB in the 1980s and 1990s. A major regulatory deficiency seems to be in the area of restrictions on bank holdings, as reviewed earlier in this chapter.

Table 5.11 Saudi banking regulatory checklist

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

[a]Since 2008
Source: Essayyad et al. (2003)

The Emergence of the Insurance Sector

One of Saudi Arabia's hopes for deepening the financial market lies in the insurance sector. The insurance industry in Saudi Arabia is relatively new, as the country's insurance activities in the past were mainly focused on imports and there were only foreign players or their agents in the market. Social and religious reluctance to engage in insurance activities also played a role, due to perceived restrictions imposed by Islam. In 1983, the Saudi market saw the emergence of an insurance concept called "cooperative insurance," which was Islamically acceptable.

The concept of *cooperative insurance* was based on the principle of joint and several liabilities among the insured persons who participated in compensating any of the insured individuals, and thus the insured persons within this cooperative system are the participants or owners of the insurance operations. They have a right to receive surpluses after allocations are made for reserves.

This concept is different from commercial insurance where policyholders do not share profit; it is more akin to the Lloyds of London "Names". The cooperative insurance concept was implemented by the Saudi government in 1996 through the establishment of a publicly owned joint stock company called the *National Company for Cooperative Insurance* (NCCI). The insurance market in Saudi Arabia is at its infancy stage compared to other more mature markets worldwide but has been growing the fastest over the years since WTO accession in 2005.

Despite the recent growth in the Saudi insurance sector, it is still in its infancy compared to other mature markets as Table 5.12 illustrates.

Table 5.12 Saudi and world insurance market indicators 2008

	Life premiums (US$ Billion)	Non-life premiums (US$ Billion)	Total premiums (US$ Billion)	Total premium per capita ($)	Premiums as % of GDP
Industrialized Countries	*2,219*	*1,538*	*3,757*		
United States	578	662	1,240	*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*	*4,269*		
Saudi Arabia	*0.16*	*2.75*	*2.91*	*118*	*0.62*
Saudi Arabia % of world	*0.01*	*0.15*	*0.07*	–	–

N/A = Not Available
Source: Swiss Re, 2009, SAMA

The table indicates that the premiums paid per capita in Saudi Arabia are still far lower than those in advanced countries and even below Latin American levels. The penetration ratio of insurance, defined as the level of insurance premiums to GDP, is also very low at around 0.62% in 2008, up from 0.53% in 2007 and 0.40% levels in 2002. The averages for advanced economies are over 8% levels.

Despite the small share in world market, the growth in the Saudi insurance sector has been very impressive as demonstrated by Fig. 5.12, which tracks the growth in gross premiums paid over the period 1995–2008.

In terms of premiums by type of insurance in the Saudi market, general insurance premiums represent 51% and health insurance 44%. Health insurance has grown rapidly due to the application of the compulsory health insurance regulation issued by the government on employees of the private sector. Car insurance has also risen sharply and ranks second to health insurance, also spurred on by the government's compulsory car insurance regulations for third party liability.

According to reports from NCCI, there are more than 5 million cars registered in Saudi Arabia, and demand for motor insurance has been increasing as the country suffers from one of the highest traffic accident rates in the world. According to the Saudi Ministry of Interior, there were 2.2 million accidents in the Kingdom over a 10-year period to 2005, and the situation has not improved since then with nearly 40,000 people losing their lives. In terms of economic loss to the country, the

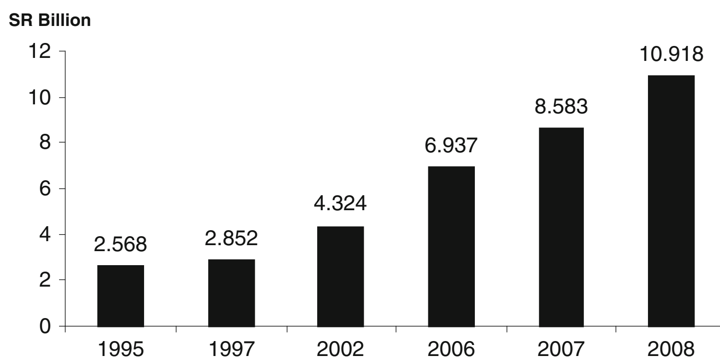

Fig. 5.12 Saudi insurance gross premiums 1995–2008 (Source*:* SAMA, NCCI)

Ministry studies indicate that accidents, loss of life and property as well as treatment charges cost Saudi Arabia around SR 21 billion annually (Arab News, 20 September 2004).

In order to ensure that only financially fit companies operate in this sector in Saudi Arabia, the *Majlis Al Shoura* passed legislation in September 2002, specifying that insurance companies intending to provide cooperative insurance services should have a minimum capital of SR 100 million. This amount was raised to SR 200 million for companies providing re-insurance (SAMA, 2009). Life insurance remains low due to religious beliefs, which frowns on taking out this type of insurance, but it has been growing over the past few years.

The significant insurance event of the past decade concerned a mandatory scheme of medical insurance for some 7 million expatriates and their families working and living in Saudi Arabia. According to reports, the Saudi Ministry of Health was giving employers up to 3 years to introduce this scheme from 2003, depending upon the number of employees. Because the impact of these decisions on the Saudi private sector would be to make the cost of hiring expatriate labour more expensive, there were attempts to postpone their implementation for smaller Saudi companies. The Kingdom is planning to introduce private sector health insurance scheme for Saudis 3 years after the completion of health sector insurance for expatriates from 2007. This could boost the Saudi insurance sector to around SR 18 billion within the next 5 years.

The implication for the Saudi economy is much wider. First, the medical insurance law will help to ease pressure on the Kingdom's budgetary outlays in the medical sector, as the Saudi government provides free medical services for all citizens and non-citizens alike, and this budgetary item had been increasing each year, as pointed out in Chapter 2.

Second, the boost in insurance services has encouraged the introduction in December 2001 of an interest-free Islamic insurance system, with some of the local banks such as Al Jazira Bank pioneering the launch of Islamic insurance or *Takaful*, and introducing *Takaful Ta'awni* or an Islamically acceptable life insurance product.

This product is the only *Shariah*-compliant insurance product approved by SAMA to date (SAMA, 2003). Recognizing the importance of this Islamic insurance market, the Saudi government endorsed a new Islamic insurance law in July 2003, and it is expected to boost the market's turnover according to reports.

A third important factor is the ability of the insurance sector to provide long-term investment funding to the Saudi capital market due to the gradual rise in liquid assets available for investments after claims are paid. Life and general insurance companies in the developed world are important players in their capital markets. The Saudi insurance sector can also play such a role by providing depth and long-term investment outlook, compared to the individual investor volatility experienced in the Saudi stock market today, which is examined in the next chapter.

Foreign Participation in the Insurance Sector

As a result of its accession to the WTO, Saudi Arabia agreed to open its insurance sector to foreign investors and to allow foreign insurance companies to operate branches in the Kingdom. Amongst foreign companies having a local Saudi presence through joint ventures or in their own names are Allianz, Bupa, Ace and AXA.

By April 2010 there were 31 licensed insurance companies operating in Saudi Arabia employing around 5,500 staff, of whom 45% were Saudis in this new financial sector. To ensure that the sector had qualified employees, SAMA's Institute of Banking designed and conducted courses specifically for the insurance market and there was coordination with King Saud University in Riyadh to introduce a Bachelor programme in Actuarial Science as well as diploma courses.

Some major obstacles for insurance companies remain, however, in complying with Saudi Arabian government requirements for insurance providers to form incorporated cooperative joint stock companies. Saudi Arabia has declared that a commercial presence will be permitted for insurance companies which operate according to the cooperative insurance system and have a paid-up starting capital of not less than SR 100 million ($26.6 million). The government is also requiring insurance companies to allocate 20% of their annual profits to be added to their reserves until the reserves equal the entire paid-up capital. Because of these conditions, all operating insurance companies in the Kingdom are in the process of transforming their business operations and structures, while some are also exiting the market.

The government is giving a 3-year transition period to existing foreign insurance companies to either convert to a Saudi cooperative insurance company or to a direct branch of a foreign insurance company. During this transition period, existing foreign insurance providers will be allowed to continue business operations, as well as to offer new products and to service new clients.

WTO accession allowed for cross-border foreign insurance companies to continue providing insurance to Saudi-based clients, especially for large ticket insurance and re-insurance premiums, which the smaller capitalized Saudi insurance

companies cannot cover. The benefits from greater foreign insurance participation in the domestic market is also claimed to bring the following:

- improvement in customer service and value,
- transfer of technological and managerial “know-how,”
- additional external financial capital,
- improvement in the quality of insurance regulation by applying international best practices, and
- creation of beneficial domestic spillover in terms of more and higher-quality local jobs.

These recent rapid developments in the Saudi insurance sector are one of the more promising features of the domestic financial market. Some commentators estimate that this liberalized and invigorated sector could create as many as 10,000 jobs, mostly for Saudis, and reach an annual turnover of SR 50 billion in another 5 years (AFP, 15 July 2003).

Islamic Finance in the Kingdom

Islamic financing, and a rapid increase in both Islamic and “conventional” institutions offering Islamic products and services, attests to the growing popularity of this market segment (Archer and Karim, 2002, Faroqui, 2002, Abdeen and Shook, 1984). The Saudi market is no exception, as evidenced by the remarkable market share that Al Rajhi Bank currently enjoys, and the conversion of a large number of the branches of the National Commercial Bank to “Islamic branches,” as well as the licensing of two new *Shariah*-compliant banks – Al Bilad and Al Inma Bank.

Despite the lack of the word “Islamic” in the title of any Saudi financial institution, there is widespread support and encouragement for Islamic financing in the Kingdom. This support is manifested in the establishment of the Jeddah-based Islamic Development Bank (IDB), with the Kingdom contributing 25% of the $8 billion capital of the largest Islamic financial institution owned by all the members of the Organization of Islamic Conference (OIC). In addition, the Islamic Investment Company (IIC), a subsidiary of the Geneva-based *Dar Al Mall* Group, has nearly 20 branches in the major cities of Saudi Arabia, operating under a “quasi-legal” status through the personal sponsorship of HRH Prince Mohammed Al Faisal Al Saud, the late King Faisal’s son. As we saw in Chapter 4, SAMA has been closely monitoring the experience of other GCC central banks in relation to controlling and supervising Islamic financial institutions.

The Bahrain Monetary Agency seems to have been the most successful one, as it served as a model of “coexistence” of conventional and Islamic banks under one regulator. SAMA’s increased confidence about regulating this sector has been mirrored by the granting of more product licences and approvals for the launch of Islamically

complaint mutual funds. There were 19 *Shariah*-compliant mutual funds listed on the Saudi stock market as of January 2010.

It is in the area of project finance that Islamic-oriented institutions such as Al Rajhi could play a developmental role in the economy. Currently, because of interest considerations, unlike other Saudi banks, Al Rajhi does not purchase government bonds or treasury notes to finance government budget deficits. However, Al Rajhi has successfully funded government projects on Islamic financing principles (lease financing, buy and sell, or buy, operate and lease) such as school construction and electricity projects. They are considering other government-related project financing. The success of such Islamically acceptable financing will open up a large market segment for the Saudi government, using Al Rajhi and other Islamic financing entities to fund the large capital projects the Kingdom needs over the next few decades. During 2004, one of the world's largest Islamic financing transactions was announced when a consortium of Saudi and Gulf banks (Al Rajhi, NCB, Abu Dhabi Islamic House, Emirates Bank, Citi group and SAMBA acting as arranger bank) concluded a $2.35 billion *murabaha* financing for Ettihad Etisalat Company, which had been awarded the second GSM licence in Saudi Arabia (Ghazanfar, 27 September 2004).

Market reports indicate that Al Rajhi is going one step further in identifying new Islamic financing instruments and is considering underwriting a multi-billion riyal Saudi government Islamic bond programme. This would represent Saudi Arabia's first Islamic bond, and would follow on the footsteps of Bahrain's successful issue of similar Islamic leasing bonds of $450 million. Such Islamic instruments would undoubtedly add breadth to the new Saudi capital market and provide Saudi investors with the choice of participating in Islamically acceptable products and, in the process, further deepen the Saudi financial system.

Conclusion

The Saudi banking sector's recent performance attests to its financial strength and efficiency. Management, risk control and cost efficiency have greatly improved, which to some extent explains the milder impact of lower oil prices on the Kingdom's financial institutions compared to previous periods of oil price downturns. The banking sector has seen a dramatic change in its operating environment, especially in the use of non-traditional banking services through the use of electronic means. The Kingdom of Saudi Arabia, after lagging behind many regional Arab countries in the use of the Internet, has seen the number of Internet users rise to about 7.7 million at the end of 2008 compared with around 1 million in 2001. The penetration ratio for the population stood at 31% for 2008 – higher than the global average of 23.5% and the Arab world average of 14% (SAMA, 2009). Such fundamental changes are forcing Saudi banks to rely on more technological delivery and "smarter" service out of home. The expansion of the insurance sector and its wider acceptance compared to earlier decades is another significant development,

but it is the wider penetration of Islamic financing that will become a major revenue source for the local banks as they compete with the new-wave foreign licensed banks. Islamic banking by its nature had avoided the high-leverage and structured packages of conventional loans and investments in such offerings, and seemed to have escaped the worst excesses of the global financial turmoil.

In the process of financial globalization, there is increased pressure for consolidation between local banks and for cross-border alliances of choice. This chapter has illustrated how some Saudi banks have begun to venture abroad, and the trend to open branches or acquire overseas banks will become more noticeable in Asia, as Saudi Arabia develops a stronger economic relationship with the Far East.

The Saudi banking sector faced some serious challenges in the first decade of the new millennium, mostly arising from deteriorating global macroeconomic conditions and financial crisis. The Saudi banks had minor exposure to Western "toxic" assets and they faced the crisis on the basis of strong capitalization ratios.

The main source of risk for Saudi banks remains credit risk and high concentration, and possible exposure of some banks to the private corporate sector and family-owned businesses, highlighted by the debt repayment difficulties of some prominent Saudi family conglomerates. The local regulator, SAMA, has acted prudently and quickly to ensure adequate liquidity is available and guaranteed local depositors but the emphasis going forward is strengthened corporate governance and transparency at bank board level to avoid lax lending standards and "name lending" from rising up again. Other challenges faced by the Saudi banking sector include the mismatch in their maturity profile of assets and liabilities, and both domestic and foreign banks will have to come up with some innovative new capital instruments to reduce the imbalance in asset-liability maturities.

The Dubai bond repayment standstill announcement in November 2008 sent shock waves globally, and although Saudi banks were not exposed to the bonds, the consequence was that credit quality assessment of sovereign and semi-government entities in the region were bound to be affected in the medium to long term. The belief however is that global investors will end up differentiating between Gulf economies who are more highly leveraged, and those like Saudi Arabia that have managed to reduce the level of their domestic debt and have raised the level of their international reserves. The Saudi financial sector has come of age and seems more than capable to meet emerging challenges, reflected by the reaffirmation and credit upgrading of some of its institutions as well as sovereign credit rating by Standard & Poor and Moody's. The stability and maturity of the Saudi financial sector has played a large part in this perception.

Summary of Key Points

- *The Saudi banking sector is one of the financially strongest and most profitable in the world, with high capitalization in excess of international required levels, advanced automation and a diversified range of banking services delivered to well-defined target market segments.*

- *Banking supervision is through SAMA control. The transformation of previously wholly owned foreign bank branches into* "Saudized" *banks, passing on technology and management skills, has been of benefit to the banking sector.*
- *The Saudi financial markets passed through several phases of evolution, each laying foundation for the next phase. Currently the banking sector is going through a phase of consolidation and mergers, preparing to face globalization threats following WTO accession as well as the granting of banking licences for wholly owned foreign banks to enter the Saudi market.*
- *Saudi banks are characterized by a high degree of shareholder concentration levels, which could be counterbalanced by partial privatization of government-held shares in some Saudi banks.*
- *Saudi banks, lending policies are still limited by their small capital base as well as SAMA-mandated loans-to-deposit ratios, but consumer lending has become a major growth sector.*
- *The insurance sector will add some depth to the financial sector because of foreign entry and government-mandated insurance laws in health and vehicle insurance.*
- *Islamic finance has acquired more importance, and both Islamic and non-Islamic banks have entered this market segment.*
- *Saudi banks have escaped relatively unscathed during the 2008/2009 global financial crisis but certain lessons have been learned, especially the centrality of credit extension.*