Development and restructuring of the Saudi banking system

Saudi Arabian Monetary Agency

Early history of banking development and bank restructuring

The early years

The emergence of Saudi Arabia as a modern day unified state has been a development of recent origin. The consolidation of the state apparatus over a large country with a small population dispersed in far-flung pockets and the laying down of the country's physical and fiscal infrastructure on the most efficient and modern lines in a relatively short span of time has been a remarkable achievement. The simultaneous development of the legal and institutional framework of finance and commerce in a span of about four decades has been a no less onerous exercise. The basic framework was laid some time back and in recent decades the institutional framework has evolved to support the development of a modern economy.

In the early part of this century a few foreign based trading houses (including a trading arm of Algemene Bank Nederland) and money changers provided most of the finance related services to meet the needs of the trading community and pilgrims who were the major sources of finance in the economy. With the discovery of oil in 1939, the inflow of royalty revenue into government coffers started and following the Second World War, there was a surge in oil demand and production. Government revenues and expenditures rose rapidly and foreign banks started entering the market. The French Banque de L'Indochine and Arab Bank opened branches in Jeddah in 1948; followed in 1950 by the British Bank of Middle East, National Bank of Pakistan and Bank Misr of Egypt. Banking services such as deposit taking and lending were also provided by the local money changers.

Creation of the Saudi Arabian Monetary Agency

In order to achieve a stable monetary mechanism and stability of currency, in October 1952 the government created the Saudi Arabian Monetary Agency (SAMA). It opened offices in the main cities, but the government continued to use the payment service of money changer Al-Kaki and Bin Mahfouz Co. to act as its agent. In 1953 the government permitted this money changer to start the Kingdom's first commercial bank under the name of the National Commercial Bank.

Introduction of paper money

More foreign banks followed, and in 1954 Banque du Caire started operations, followed by Banque du Liban et d'Outre Mer and First National City Bank of New York. Riyad Bank started operation in 1957 and Bank Al-Watany in January 1958. During the period 1950 to 1956, there was a gradual introduction of paper money in the form of Pilgrim Receipts which were supported by precious metals and foreign currencies. By 1960 the government was able to hold down inflation, the Riyal was officially pegged to the US dollar at 3.75 and was stable, foreign currency reserves had gone up and the government had issued paper currency to replace all Pilgrim Receipts. Nearly all government debt had been repaid, an accomplishment that lasted for years to follow.

First banking problem and resolution

The first banking problems faced by SAMA took place in 1960. Riyad Bank and Al-Watany Bank, which had commenced operations in 1957 and 1959 respectively, faced serious liquidity problems arising from mismanagement and improper loans. Board members in both banks had borrowed heavily from the banks and defaulted on loan repayments. By 1960 Bank Al-Watany was technically insolvent and was unable to settle the claims of local depositors. Following the refusal of its board members to settle their debts, SAMA liquidated the bank and merged its operations with Riyad Bank. In 1961, SAMA required Riyad Bank to be reorganised. The Chairman of the bank was removed from office and a new board of directors was formed. SAMA, on behalf of the Government, acquired the shares of the directors who failed to repay their loans and thus ended up with 38% ownership in the bank.

Introduction of the banking control law

These banking difficulties led to more powers being given to SAMA to license and regulate all banks. A new *Banking Control Law* was passed in 1966, which gave SAMA broad supervisory powers. Banks were required to meet capital adequacy, liquidity and lending ratios and reserve requirements. The *Banking Control Law* also permitted SAMA, with the approval of the Minister of Finance, to recommend institutions for new licenses, issue rules and regulations, and to take actions against any violators of the Law. It also supported the concept of a "universal banking model", which permitted banks to provide a broad range of financial services including banking, investments, securities, etc. Consequently, banks became the primary licensed financial institutions and expanded rapidly, covering the entire country.

Rapid growth and restructuring in the 1970s

Conversion of foreign bank branches to joint stock banks

The 1970s were a period of rapid expansion of the banking system to keep pace with the significant rise in government revenues and expenditures and the financing of major development projects aimed at infrastructure and industry. Up to 1975, the government had encouraged foreign banks to open branches within the Kingdom and consequently ten international banks with 29 branches were present. However, with the Second Five-Year Plan, commencing in 1976, the government promoted a policy of converting foreign banks' branches into publicly traded companies with participation of Saudi nationals.

This policy had a number of objectives. It served to encourage the participation of Saudi investors in an important and rapidly expanding sector. The incorporation and floatation of shares of these banks encouraged broad based public participation which also contributed greatly to the development of a stock market in the Kingdom. Also it promoted banking activities and the formation of banking habits among the population. By encouraging foreign banks to take large shareholdings in the newly incorporated banks and by offering them management contracts, the foreign partners' position was strengthened as they could exercise significant management control while benefiting from national treatment accorded to banks fully owned by Saudis.

Role of money changers

By 1979, of the twelve banks in operation only three were non-Saudi, and the total number of bank branches had almost doubled to 140. However, many major cities, which were frequented by pilgrims, and many small remote communities were also served by over 250 branches of money changers who provided currency exchange and other financial services.

Establishment of special purpose government funds

In addition to the banks and money changers, during the 1970s the government created five major lending institutions namely; Saudi Credit Bank, Saudi Agricultural Bank, Public Investment Fund, Saudi Industrial Development Fund and the Real Estate Fund. These institutions provided medium-term and long-term development finance to supplement the short-term funds provided by commercial banks.

The 1970s boom in banking

There was tremendous growth in the financial position of the commercial banks between the period 1970 to 1979, with the total assets increasing 20 times from SR 2.7 billion to SR 53 billion. Deposits increased from SR 1.6 billion to SR 40 billion and loans from SR 1.6 billion to SR 19 billion. The demand for commercial credit lagged the increasing liquidity available in the banking system and also low cost medium to long-term credit was easily available from the government lending institutions. Consequently the foreign assets of the commercial banks grew rapidly from 11% of total assets in 1977 to 25% at the end of 1979.

The remaining gaps

Notwithstanding the growth, significant gaps remained in the provision of banking and financial services. Some of the key gaps included; small business had limited access to credit; chequing facilities were limited to cash withdrawals; foreign currency transfers were non-existent or were provided mostly by money changers; consumer loans and facilities for small savers were lacking; banking methods were antiquated; computer technology was non-existent; and the clearing house system was

regionally based. A major deficiency at that time was the dependence of banks on foreign expatriates and lack of Saudi nationals in banking business. Thus by 1980, Saudi banks and the authorities faced the challenge of rectifying these deficiencies.

Banking problems and the consolidation of the 1980's

The tumultuous 1980s

The decade of the 1980s was a tumultuous and testing period for Saudi banks and the banking system. In line with the tremendous increase in government revenues during 1979 to 1981 and subsequent slowdown from 1982 to 1986, the Kingdom's commercial banks saw rapid expansion followed by a difficult period of adjustment, deterioration in asset quality and retrenchment. During 1980 and 1981, the growth in commercial credit averaged 26%, falling to 10% from 1982 to 1989. The deposit base of banks grew rapidly from SR 68 billion in 1980 to SR 146 billion by end-1989; and the number of bank branches increased from 188 to 534 over this period.

New measures to strengthen financial sector

With the 1982 merger of three remaining branches of foreign banks into United Saudi Commercial Bank, the conversion process was complete. In 1982, following the failure of a large money-changing organisation, the government passed the *Law for Money Changing Business* that required SAMA to also license and regulate these institutions. Money changers were also prohibited from deposit taking, lending and providing any other financial services except those specified in the Law. Other major policy changes included the introduction of the Banking Security Deposit Account, a liquidity management tool, and permitting Saudi banks to invite foreign banks to join Saudi riyal loan syndications. In 1985, SAMA issued rules that permitted banks to undertake stock brokerage activities. SAMA also put pressure on Saudi banks to train Saudi nationals and to invest money in developing computer and information technology.

Difficulties faced by Saudi Cairo Bank

In 1982, SAMA faced a major supervisory challenge when irregularities appeared in Saudi Cairo Bank's operations. The Managing Director and the Treasurer were involved in unauthorised trading in bullion during the 1979–81 period. The Bank had concealed accumulated losses that exceeded its share capital. SAMA forced the board of directors to resign and prosecuted the Managing Director and the Treasurer who were convicted and gaoled. SAMA required the bank to issue new shares and double its capital in 1986. This increase was taken up entirely by the Public Investment Fund (PIF). The Bank also benefited from "cheap" deposits from the PIF. In this case the PIF had acted not only as an "investor of last resort" but also helped the Bank with liquidity and restored it to a healthy position.

The impact of falling oil prices on the quality of bank assets

As oil prices tumbled from the all time high in 1981 and continued to decline in the next five years, it put significant pressure on the quality of banks assets which deteriorated with the economic slowdown. Credit to the private sector, which had increased over 500% during the period 1976–81, only grew by 20% over the next five years. The banks incurred many non-performing loans which increased to over 20% of all loans by 1986. Banks' profits suffered significantly and loan loss provisions and loan write-offs mounted. By 1988 most banks had made sufficient provisions for doubtful accounts and the average provision for the banking system had risen to over 12% of total loans.

Problems faced by the banking system

The main causes of the problems faced by the Saudi banks were the macroeconomic imbalances created by a steep rise in government revenue from 1979 to 1981 followed by a precipitous decline in oil revenues. Government oil revenue, which had risen to SR 333 billion by 1981, dropped to just SR 74 billion by 1987. The rapid rise in bank assets and liquidity in the late 1970s and early 1980s had given rise to a sharp increase in demand for private sector credit. Some banks expanded too rapidly, and did not have adequate credit assessment and monitoring procedures. They also lacked required technical expertise, faced a shortage of qualified human resources and had inadequate technology.

Consequently when the steep decline in the economy occurred, many companies and businesses suffered from a lack of liquidity and faced a credit crunch. The construction and contracting sectors, which had boomed earlier, faced the biggest setback and many projects were affected. Banks had difficulties recovering their loans and the collateral in many cases proved to be difficult to realise.

Response to the challenge

In this period SAMA, in concert with the Ministry of Finance, took a number of steps to ensure the stability of the financial system and to help the banks to overcome the prolonged economic downturn. These include the following:

- *Dividend payments*. Banks were required by SAMA to seek its approval prior to announcing their dividends. The *Banking Control Law* requires all banks to build their statutory reserves equal to their share capital. SAMA further encouraged Saudi banks to build additional reserves to strengthen their capital base.
- *Tax holidays*. Most foreign shareholders in Saudi banks enjoyed a tax holiday for the first five years of their ownership. To encourage retention of profits, the tax holiday was extended in most cases by another five years after which a deferred tax scheme was permitted. These measures helped the foreign shareholders in Saudi banks to take advantage of eased taxes and encouraged them to retain their share of profits.
- *Tax deductibility of provisions for doubtful accounts*. In 1986 SAMA obtained a ruling from the Tax Department that permitted the tax deduction of loan loss provisions on an accrual basis. Thus banks could now receive favorable tax benefits at the time of making a provision and not just on write-off of a loan. This encouraged banks to increase their loan loss provisions for doubtful accounts.
- *Withholding tax on inter-bank transactions*. To encourage Saudi banks to increase their interbank dealings and to support the development of a riyal inter-bank market, a tax ruling was obtained which exempted foreign banks from withholding taxes when carrying out inter-bank transactions with Saudi banks.
- *Creation of banking disputes committee*. In 1987, Saudi authorities established a Banking Dispute Committee by the order of the

Council of Ministers. The creation of this Committee as the only relevant quasi-court to handle disputes between banks and their customers significantly strengthened the legal system. By law, all banking disputes had to be referred to this Committee and the rulings of this Committee were given the same enforcement support as decisions from any other court.

- *Strengthening of the technological infrastructure*. SAMA initiated a number of projects to improve the technological foundations of the banking system. In 1986, an automated Clearing House was established and in 1989 a national integrated Automated Teller Machine system was also made operational. These new systems compelled all Saudi banks to invest in technology and to improve their back and front office operations.
- *Corporate governance*. SAMA recognised the need to encourage banks to take strong steps to improve their risk management and control procedures. Consequently it took major initiatives in the area of corporate governance. Firstly, it required all banks to develop and strengthen their internal audit departments, and secondly it issued minimum internal control guidelines. Also SAMA issued accounting standards for commercial banks in Saudi Arabia which were in line with International Accounting Standards.
- *Exchange of information on large borrowers and on delinquent loans*. In the early 1980s, SAMA established a credit information service that provided information to Saudi banks on all large exposures of the banking system. This enabled banks to assess the credit position and risk of big borrowers better. Also in 1986, SAMA permitted banks to exchange information on delinquent borrowers as a means of applying collective pressure on them. These measures have proved quite effective in resolving the problem of delinquent loans.

Further bank restructuring

In addition to the above measures to strengthen the banking system, SAMA encouraged banks to restructure and recapitalise. During the 1980s, some of the main actions were as follows:

- *Formation of United Saudi Commercial Bank*. This bank was established on 5 October 1983 by taking over the three remaining branches of foreign banks, United Bank of Pakistan, Bank Melli Iran and Banque du Liban d'Outre Mer. The share capital was SR 250 million of which 40% was owned by foreigners.

- *Saudi Investment Bank*. This bank was established in 1976 as a special purpose bank. It was given a full commercial license in 1984 and permitted to offer all banking services. There were changes in its ownership at this time as some foreign shareholders sold their shares reducing foreign ownership to 25%.
- *Formation of Al-Rajhi Banking and Investment Corporation*. In 1988 the government issued a banking license to the Al-Rajhi family to create the third largest bank in the Kingdom. Al-Rajhi was previously the largest money changer in the Kingdom and had been providing a range of banking and financial services. The floatation of Al-Rajhi as a bank raised SR 750 million in new capital and brought in approximately 100,000 new shareholders. The floatation was over-subscribed by approximately ten times. In 1992, Al-Rajhi doubled its capital to SR 1.5 billion by issue of bonus shares on a 1:1 basis.

Recapitalisation of banks

- In 1988 SAMA approved Riyad Bank's request to raise its capital from SR 100 million to SR 200 million, by capitalisation of reserves. This floatation was postponed to 1992 when the bank increased its capital to SR 2,000 million by a share bonus and then by another SR 800 million by issue of new shares. It also raised share premium of over SR 3 billion on this issue.
- Saudi Cairo Bank was permitted to raise its capital from SR 150 million to SR 300 million in 1987 and then in 1988 PIF made a major investment of SR 300 million thus doubling the share capital. In 1992 the bank issued 6 million shares at SR 350 per share and increased its capital by another SR 600 million. It also raised SR 1,500 million in share premium.
- Saudi American Bank doubled its capital to SR 600 million in 1988 by issuing bonus shares to its shareholders. Also in 1991, Citibank N.A. sold ¼ of its 40% stake in the bank to two public sector agencies. In 1992 the share capital was increased to SR 1,200 million by capitalisation of its reserves.
- Saudi British Bank had increased its capital from SR 100 million to SR 300 million in 1979. In 1988, it further increased its capital to SR 400 million.

- Saudi French Bank increased its share capital from SR 100 million in 1977 to SR 200 million in 1979 and to SR 400 million in 1987. In 1992, the share capital was increased to SR 900 million through bonus shares and an offering of 2 million shares at SR 100 and a premium of SR 470 million.
- Al-Jazira Bank raised its capital from SR 100 million to SR 400 million in 1992. It also raised share premium of SR 600 million. It used this premium to provide for doubtful loans.
- The National Commercial Bank in 1992 increased its capital from SR 30 million to SR 6 billion by a cash injection. In 1997 the bank has reorganised from being a partnership bank to a limited joint-stock company as a prelude to widening its shareholder base in the near future.

The position at the end of 1980s

Despite the tumultuous economic conditions during the 1980's, the Saudi banking system grew rapidly. The number of branches, 247 in 1980, reached 1,007 by end-1989. Three new banks – Al-Rajhi Banking and Investment Corporation, Saudi Investment Bank and United Saudi Investment Bank – were added to the list. Total employees also rose significantly from 11,000 in 1980 to about 20,000 by 1989. Another aspect of expansion was the opening of overseas branches of major banks with branches in the United Kingdom, Bahrain, Beirut and Turkey.

The new banking system-wide instruments and technologies

During the 1980s Saudi authorities continued to introduce new instruments and systems to enhance and strengthen the Saudi financial markets. Significant changes were made to modernise the banking system. Specific highlights included the following:

- Introduction of the Government Development Bonds programme to provide an important investment instrument to banks and other investors in the Kingdom.
- Arrangement for repos of up to 25% of banks' Saudi Government Bond holdings with SAMA.
- Introduction of a national Automated Teller Machine System which permitted customers access to their accounts from any machine.
- Introduction of debit, credit and charge cards.
- The linking of Saudi Arabia with the SWIFT payment network.

The Gulf War

By beginning of the 1990s the Saudi banking system had largely recovered from the difficulties of the mid-80s. Banks had expanded their branch network, introduced stronger management methods and new technologies, raised new capital, improved their profitability and set aside large provisions for doubtful accounts. They were healthy and profitable and the 1990s augured well. However, with the invasion of Kuwait by Iraq in August 1990, the Saudi banking system faced its biggest challenge. The Gulf crisis fully tested the strength of the banking system and SAMA's capability as a central bank and banking supervisor. The crisis affected the monetary situation profoundly. Customer withdrawals of domestic deposits during August 1990 were 11% of total customer deposits. These were largely converted into foreign currency and transferred abroad. By September 1990 the pressure had eased and withdrawal slowed down to 1.1%. SAMA had provided banks access to additional liquidity through more liberal repo arrangements, placing additional Saudi riyal and foreign currency deposits with them and by selling foreign currency in large volumes. Banks also coped well by liquidating their foreign assets.

The post-war expansion

Following the resolution of the Gulf crisis there was a mini boom in the economy. During 1991 there was a massive surge in the deposits of the banking system of about 20%. Banks' domestic loans and advances grew 90% during the period 1990–95 and all other banking indicators such as return on equity and return on assets continued to be very positive with many banks making record profits during this period.

Strengthening the capital base of the banks

The Saudi banks, under the guidance of SAMA, used the bullish sentiments in the stock market to raise substantial amounts of capital. As noted earlier, six of the twelve banks increased their capital during 1991–92. The trend to increase the banks' capital base has continued during the second half of the 1990's, and three Saudi banks have been

to the market during the 1993-97 period. The objectives of the capital increase have been as follows:

- To strengthen the capital base of banks. This was to ensure that banks continue to meet the capital adequacy standards required by the *Banking Control Law* and the Risk Assets based Standard introduced by SAMA in 1992.
- To increase the deposit-raising potential of the banks.
- To broaden the base of shareholders. As more small investors enter the market, the floatation of bank shares provides an attractive opportunity for them to hold shares.
- To permit banks to use their additional capital to increase their provision for doubtful accounts and to ensure that they were all provided against non-performing loans.
- To provide banks with more funds to invest in computers and information technology and development of new products and services.

The capital adequacy ratio

These objectives have largely been achieved and Saudi banks at end-1998, with a Risk Asset Ratio of over 21% mostly comprising tier 1 capital, are highly capitalised by international standards. Following the Gulf crisis the banking system has coped well with the domestic economic cycles and the volatilities and turbulence of the international financial markets. Despite difficult international conditions, the banks have continued to show solid and stable growth and reasonable profitability during the 1990s.

A strong supervisory framework

The sustained long-term growth and development of the Saudi banking system has been supported by a strong and comprehensive system of banking supervision. Since the 1960s, SAMA has enjoyed broad regulatory powers of licensing banks, approving their activities and taking prompt corrective action when required. SAMA has powers to promulgate rules, regulations and guidelines to banks in all areas including capital adequacy, liquidity, lending limits, credit and market risk, etc. Also, it has powers to conduct both on-site and off-site supervision. SAMA also acts as the regulator of the stock market and has a dual role

of providing central payment and settlement services and for the oversight of these systems. Over the years, SAMA has used its broad supervisory powers effectively to ensure that the Saudi banking system continues to enjoy a high reputation of soundness and stability in the international financial markets.

Enhanced corporate governance

One of the salient features of the bank restructuring in Saudi Arabia has been the increased focus by SAMA and the Saudi banks on the area of corporate governance. SAMA has issued guidance to Saudi banks on a range of subjects including the Role of a member of the Board of Directors, Formation of Audit Committees, Minimum Internal Control Standards, Special Audit Examinations, Role of Internal and External Auditors, etc. These initiatives have inculcated a strong management control culture and risk management environment in the Saudi banking system.

Expansion and technological enhancements

The restructuring of the banking system has continued with the 1997 merger of United Saudi Commercial Bank and Saudi Cairo Bank into United Saudi Bank. In 1999, the Saudi banking system is preparing for a likely increase in the number of banking institutions, as a result of the recent decision of the Gulf Cooperation Council Prime Ministers to permit reciprocal opening of their banking markets to their institutions. The banking system is also poised to take advantage of investments in new technologies by the introduction in 1997 of a Real Time Gross Settlement Electronic Funds Transfer System. Additionally, the banks also share the benefits of a Point of Sales System and an advanced Electronic Share Trading and Settlement System which boasts same-day settlement.

New banking products and services

Another important dimension of the restructuring of the Saudi banking system has been the growth of banks' off-balance sheet and fiduciary activities. The Saudi banks now manage about 100 investment funds with investments of over SR 22 billion and offer international stock

brokerage. Given that Saudi Arabia is one of the largest private banking markets in the world, the potential for growth in this area is immense.

Well-positioned for the new millennium

The progress of the Saudi banking system over the past four decades has been solid if not spectacular. The system has faced many challenges arising from downturns in the domestic economy, turbulence and volatilities in the global financial markets, international financial crises and the Gulf War. During this period, the banking system has seen periods of rapid growth and prolonged slowdown; it has faced deterioration in asset quality and problems with delinquent borrowers; it has suffered flight of deposits and losses due to international market conditions. Nevertheless, the Saudi banks have managed to stay on course and achieve their current strong position without experiencing a serious banking crisis. At the beginning of the new millennium, they are well-positioned, in terms of capital, quality of assets and technology to play an important role in the regional and global markets.