

## Hamad Al-Sayari: Financing a changing world

Speech by His Excellency Hamad Al-Sayari, Governor of the Saudi Arabian Monetary Agency, at the Euromoney Saudi Arabia Conference 2007: Financing a Changing World, Riyadh, 8-9 May 2007.

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I am pleased to be here today at this international gathering of experts who share a common interest in the economic development of Saudi Arabia. The theme of this Conference is "Financing a Changing World" and I intend to share with you my views on the role that the Saudi Banks and the Capital Market are playing in this regard. This gives me an opportunity to recap the important contribution of our banks and our growing capital market in channeling the financial flows to and from the Kingdom. I will also outline the future direction and challenges in this regard.

In recent years, international fund flows have been affected by different phenomenon, including rising imbalances in trade balances originating from the export dominated economies in Asia, the pace of economic growth in developed economies in Europe and North America, and the volatile energy and commodity prices affecting all countries. Addressing the impact of these global phenomenon are causing significant challenges to the economies of all countries. For the Gulf region including Saudi Arabia, a major challenge is to ensure that the increased financial flows into the region are channeled efficiently to the most productive sectors of the economy and to profitable enterprises and projects. Unlike the earlier decades, when Gulf countries were obliged to recycle their additional revenues into the global economy due to limited absorptive capacity in the region; currently, existing and projected needs of this region indicate that a significant percentage of the additional flows can be invested and put to many productive uses in the local economies. Also, the Gulf countries wish to continue to be attractive to international financial flows in form of foreign direct investments to encourage partnerships and for transfer of knowledge and technology. This is essential for deepening and broadening the economies and opening of new industrial and infrastructure sectors. I will be touching upon these challenges in some detail in my speech.

Dear Audience,

As we well know, a well-developed and efficiently functioning financial system is an essential prerequisite for sustained economic growth. By intermediating between savers and borrowers, it promotes saving and investments and also induces an efficient allocation of investable funds. The global integration of financial markets over the past two decades has opened up new vistas for resource mobilization and more efficient deployment of investable funds worldwide. At the same time, however, market integration exposes domestic financial systems to new risks and vulnerabilities. Shocks that occur in one market are now easily and quickly transmitted to other markets turning into a contagion that can affect an entire region. It is, therefore, imperative that a domestic financial system is strong enough to cope with the increased risk associated with globalization in general and integration of the financial markets in particular.

Against this backdrop, we are well positioned in Saudi Arabia to have a strong financial system that is serving the economy well. The system that has evolved over the years is broad-based and has a variety of institutions providing a wide range of financial services to savers and investors. It is efficient, technologically advanced, well-supervised and working on sound principles. It has demonstrated its strength and resilience during the Gulf conflicts

in the 1990 and in 2003, and various financial crises in the past decades. On all occasions, its stability has remained uncompromised

The Saudi Arabian Monetary Agency (SAMA) is at the apex of the Saudi financial system. It has almost completed fifty years of its existence. Over these years, it has played a crucially important role in the consolidation and development of the Saudi economy, by evolving a monetary system for the country based exclusively on national currency, striving for the promotion and maintenance of domestic price and exchange rate stability, and promoting the growth and ensuring the soundness of the financial system. It has also been managing the Kingdom's foreign exchange reserves, besides acting as a banker to the government.

Before I describe the important contribution of commercial banks and deal with other sectors of the Saudi financial system to managing the domestic and international fund flows, let me mention some important achievement of SAMA. SAMA is ordained by its Charter to promote and maintain domestic price and exchange rate stability. It is gratifying that SAMA has achieved its objectives of its monetary policy. The average inflation rate has remained at less than 1 percent over the last 20 years, and these stable conditions have contributed to sustained economic growth of 3% over the period. The exchange rate of the Riyal has also been maintained over the period of Rls. 3.75 per US Dollar, while the rates of exchange against other major currencies have moved within manageable limits. These positive indicators together with the uninterrupted full convertibility of the Riyal since 1961 and no restrictions on payments from and to the Kingdom, have created a stable business environment for the private sector as also for the inflow of capital for domestic investment.

Since its establishment in 1952, a major responsibility of SAMA has been to maintain financial stability and promote growth of the national banking industry. As far as SAMA's objective of maintaining a stable financial system, its achievements have been equally remarkable. SAMA has followed prudent policies aimed at creating a sound, stable, and efficient financial system. Such a system has been characterized by freedom of capital flows, open investment climate, availability of ample liquidity, competitive environment and a modern payment system.

Over this long period, sound laws and regulations and timely supervisory actions have ensured that Saudi Banks have stayed strong with adequate capital, efficient management, fit and proper directors and managers and sound internal control systems. This is a remarkable achievement in the face of global and regional uncertainties, political and economic crises, wars and conflicts and the volatilities of the oil and currency markets.

SAMA's focus on achieving and maintaining financial stability is premised on the belief that it is a fundamental precondition for sustained and dynamic economic growth in which all market participants are able to make optimum contribution to the economy. Financial stability not only promotes efficient domestic investment activity but also creates a positive environment to attract foreign capital and foreign investors.

Dear Audience,

Over the past decade, the Saudi Arabia's financial system has been changing at an escalating pace. The banking sector, being one of the pillars of the financial system, has 20 licensed banks including 16 that are operational and 4 that are planning to become operational over the next year. The newly licensed banks include 6 regional and 3 major international banks. As for the Insurance Industry, SAMA has recently been involved in licensing of 14 Insurance companies that are now in the process of becoming operational within this year. SAMA also continues to regulate a number of money-changer organizations as well as a few lease finance and consumer finance companies.

The financial sector also includes several autonomous government financing agencies as well as the state-owned pension fund and the General Organization for Social Insurance. These institutions participate in the financial sector in pursuit of their specific objectives, and

also play an important role as institutional players and investors in deepening the financial market.

Saudi Banks have made tremendous progress in terms of products, services, technological sophistication and capitalization. SAMA has all along been keen that banks conduct their business on sound principles. The Banking Control Law, enacted in 1966, has vested SAMA with broad supervisory powers. It requires SAMA to conduct on-site and off-site supervision and has stringent provisions for capital adequacy, liquidity and reserve requirements, loan concentration, etc. The law also provides for banks to submit regular financial and statistical statements to SAMA and for SAMA to carry out on-site and off-site banking supervision.

SAMA has also set up, in cooperation with the commercial banks, a number of advanced and sophisticated payments and settlement systems, including Automated Clearing Houses, Saudi Payments Network (SPAN) which supports the ATMs and POS terminals, Electronic Share Information System. These systems have been interlinked with each other by the Saudi Arabian Riyal Interbank Express System (SARIE), an electronic fund transfer system, instituted in May 1997. These technological developments have contributed significantly to improving the level of quality of consumer services, reducing costs, enhancing efficiencies, and strengthening controls. They have created a strong and sophisticated technological platform for a quantum leap in electronic banking and financial services in the new millennium.

Together with SAMA, commercial banks still constitute the backbone of the Saudi financial system. Along with the growth of the economy, the volume of business of Saudi banks has grown at a phenomenal rate during 1997-2006, with their assets growing by about 125.5 percent, deposits by 313.5 percent and capital and reserves by 83.7 percent. Their average risk-weighted capital to asset ratio, during this period, has generally exceeded 20 percent which is considerably higher than the minimum of 8 percent recommended by the Basel Committee on Banking Supervision.

In recent year, Saudi banks have become increasingly involved in the domestic economy. During 1997-2006, they liquidated a part of their net foreign assets to meet higher domestic credit demand, thereby raising the share of domestic credit from 39.1 percent of total assets to 57.73 percent, or from 24.1 percent to 38.6 percent of GDP at current prices. Nearly 95.8 percent of domestic credit represented banks' claims on the domestic private sector which went up by 233.1 percent over this period. During this period, there was a sharp increase in the consumer loans which grew from a miniscule 6 percent in 1997 to 36.4 percent of total bank credit by 2006 reflecting the needs of a youthful population and changing risk environment. Saudi banks have also been investing in government securities, thereby contributing to the development effort of the government. However, these investments as a percentage of total assets have declined from 21.8 percent in 1997 to 14.3 percent in 2006 due to the government's recent policy of retiring some of its debt.

With the establishment of the CMA, there has been a considerable increase in the depth and breadth of the Saudi Capital Market. The trading activities of all participants relating to the Saudi Stock Exchange over the past few year have increased manifolds and, the licensing by CMA of about 40 non-bank investment, asset management, brokerage and advisory institutions, has considerably broadened the financial sector. While many of these companies are still at an early stage of evolution, they are already having an impact on the financial market due to heightened competition. These institutions are contributing significantly in terms of product innovation, introduction of new technologies and utilization of expert resources.

The contribution of the capital market to the growth of the Saudi economy has been no less significant. Over the last ten years, mobilization of funds for investment through the stock market has grown at a phenomenal pace. The number of shares traded has increased by over 175 times, value traded by more than 85 times and market capitalization by 5.5 times from Rls. 160 billion in 1997 to Rls. 1,226 billion in 2006. At the same time, the mutual funds

industry has grown significantly with assets under its management increasing by over 4 times from Rls. 21.4 billion to Rls. 84.2 billion during 1997 to 2006.

While encouraging domestic and regional savings and investment, Saudi Arabia also recognizes that foreign capital has an important role to play in accelerating economic growth. Measures to gradually open up the equity market to foreigners are also underway. In 1997, foreigners were allowed to participate in Saudi equity market through a country fund, the Saudi Arabian Investment Fund (SAIF), instituted in London. Since November 1999, foreigners have also been allowed to participate in Saudi equity market through open-ended mutual funds offered by Saudi banks. GCC citizens are permitted to directly participate in the Saudi equity market. In 2006, expatriates residing in the Kingdom have been permitted to invest directly in the stock market. There are no restrictions on foreigners' investment in government securities.

The role and participation of regional and international banks in the Saudi financial market has evolved over time. Many international banks had presence in Saudi Arabia since the 1950s and their contribution in developing the banking system has been significant. Many other regional and international banks have also been active both as borrowers and lenders to Saudi counterparties. In the 70's and 80's, their main role was to act as a conduit for transferring the surplus funds and liquidity in Saudi Arabia to international financial markets. However, with the expansion of economic activity and increasing demand for credit, many regional and international banks have participated in direct and syndicated loans to Saudi private and government sector and invested in government securities.

Looking ahead, the government has identified the expansion of Saudi economy as a major objective to meet the expectations of a rapidly growing labor force. Other priorities include the diversification of economic activity and maintenance and expansion of existing infrastructures. The government has recognized that private sector should be the engine for rapid growth. In this regard, the government has already privatized companies like the Saudi Telecommunications Company and the National Cooperative Insurance Company, and has announced schemes to privatize the Saudi Electricity Corporation, Saudi Arabian Airlines ,Ma'aden Company, etc. In the past few years, the government has also taken important initiatives including the Investment Law, the reduction of corporate taxes on foreign investments and liberalization of tourism and real estate. The government also sees significant growth opportunities for job creation in the retail trade, small enterprise, tourism and financial services.

In the past year, the government has announced the creation of size economic cities in various parts of the Kingdom. These will provide significant opportunities to the private and public sector as well as to the foreign companies to invest in many industrial and infrastructure mega projects. Besides, the investment opportunities in the petrochemical sector, these economic cities would accommodate industries in steel, plastics, glass and ceramics. Another area of potential investment is the transportation sector where the government has announced several projects affecting the Railways network, air transport and land routes. There are also projects in the pipeline in electric power generation, water desalination, natural gas as well as in knowledge based industries such as health, education and tourism.

The financing needs of these initiatives are immense and are becoming increasingly apparent. Privatization initiatives noted earlier will also require investment of tens of billion of riyals. In addition, the maintenance and expansion of infrastructure in the various sectors will require significant pools of capital. A rough estimate of the financing needs of the projects announced so far by the Government over the next 10 years exceeds USD 500 billion.

However, the way that these financing needs are met by the Banks and capital markets in future is likely to be different. First, these projects and initiatives will require longer term financing which will be difficult to finance through traditional bank loans. Second, it will require a mixture of equity and debt obligations. Third, the funding could be multi-currency

and attract multinational institutions and investors. Fourth, it could take form of various types of capital instruments, not yet seen in the Saudi and regional capital market including corporate bonds, debentures, mortgages, subordinated loans, preferred shares, etc. Also, there will be an opportunity to raise funds through Islamic finance instruments such as Sukuks and Ijara.

It is no doubt that the financing needs of Saudi Arabia will require a collaborative effort by Saudi authorities, Saudi banks, and the regional and international banks. It will also requiring tapping various investors through the domestic and regional capital markets. Each will have an important role to play in this process. Saudi authorities will need to enhance and strengthen the already strong legal and regulatory framework while banks and capital markets will need to bring together the required technology and skills for new products and services.

Looking ahead, we expect that the Saudi financial system will grow further and gain added strength and sophistication in coming years. We also expect that the institutional framework will expand, the quality of services provided by the financial institutions is bound to improve significantly.

I thank you for your attention.