Consolidation, competition, foreign presence and systemic stability in the Saudi banking industry

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1. Introduction

This paper traces aspects of consolidation, competition and systemic stability through half a century of evolution of the Saudi banking system. The banking system is characterised by strength, stability and resilience supported by consistency in government policies and strong banking supervision.

2. Growth and consolidation

The genesis of the banking system

The modern banking system in Saudi Arabia has its roots in the creation in October 1952 of the Saudi Arabian Monetary Agency (SAMA) with primary responsibility for monetary stability. Prior to this, branches of a few foreign banks and some local money changers provided all financial services to meet the needs of the trading community and pilgrims. By 1952, the inflow of royalties from increasing production and demand for oil had contributed to a sharp rise in government revenues and expenditures. As this gave a boost to the domestic economy, the demand for financial services rose sharply. The government encouraged a competitive banking environment by allowing new domestic and foreign banks in Saudi Arabia. SAMA's creation was followed by the licensing of more branches of foreign banks including Banque du Caire, Banque du Liban et d'Outremer and First National City Bank of New York. Some domestic banks were also licensed. The National Commercial Bank was licensed in 1953, and Riyad Bank started operation in 1957 and Bank Al-Watany in January 1958. Following banking problems in 1960, Riyad Bank took over the operations of Al-Watany and the government acquired 38% of the shares in the bank. In 1966, a new Banking Control Law giving SAMA broad regulatory powers was promulgated and a few more foreign banks were licensed.

Consolidation of the banking industry in the 1970s

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 infrastructure and industrial projects. There was tremendous growth in the commercial banks, with the total assets increasing 35 times from SAR 2.7 billion in 1970 to SAR 93 billion and deposits increasing over 40 times from SAR 1.6 billion to SAR 68 billion. The demand for commercial credit lagged the increasing liquidity available in the banking system and 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 45% at the end of 1980. By 1980, there were 12 banks in operation; three were branches of foreign banks and seven had substantial foreign ownership and management. The total number of bank branches had risen to 247 and covered almost the entire country.

Notwithstanding this growth, significant gaps remained in the provision of banking and financial services. Some of the key gaps were: small businesses with limited access to credit; chequing facilities limited to cash withdrawals; foreign currency transfers only available through money changers; no consumer loans and facilities for small savers; antiquated banking procedures; non-existent computer technology; and a regionally based clearing house. A major deficiency was the dependence of banks on foreign expatriates. Thus by 1980, Saudi banks and Saudi authorities had a number of deficiencies to rectify.

The trials and tribulations of the 1980s

The 1980s were a tumultuous and testing period for the Saudi banking system. In line with the tremendous increase in government revenues during 1979-81 and subsequent slow down in 1982-86, the Kingdom's commercial banks saw rapid expansion followed by a difficult period of adjustment, deterioration in asset quality and retrenchment. As oil prices tumbled from the all-time high in 1981 and continued to decline for the next five years, the resultant economic slowdown put significant pressure on the quality of banks' assets. Government revenues, which had risen to SAR 333 billion by 1981, started a rapid decline and dropped to just SAR 74 billion by 1987. Credit to the private sector, which had increased over 500% during the period 1976-81, grew only at an annual rate of less than 4% per year over the next five years. Over 20% of loans were non-performing 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 debts and the average provision for the banking system had risen to over 12% of total loans.

In terms of bank mergers and restructuring there were three major events in the 1980s. First, the United Saudi Commercial Bank was formed in 1983, to take over the branches of three remaining foreign banks, namely United Bank of Pakistan, Bank Melli Iran and Banque du Liban et d'Outremer. This completed the process of conversion of foreign bank branches into strong joint venture banks involving foreign and Saudi shareholders. Also, in 1984 Saudi Investment Bank was given a full commercial licence and in 1988 a licence was granted to Al-Rajhi Banking and Investment Corporation to convert the Al-Rajhi family's money changing business into a fully-fledged commercial bank. With these developments, by 1990 the Saudi banking system had 12 commercial banks, of which nine had substantial foreign ownership. By 1990, the number of bank branches had reached 1,036 and total employees had also risen significantly from 11,000 in 1980 to about 25,000. Another aspect of expansion was the opening of overseas branches of major Saudi banks in the United Kingdom, Bahrain, Beirut and Turkey.

The difficulties of the mid-1980s led to a significant increase in banks' capital with the encouragement of SAMA. During the period 1988-93, seven of the 12 Saudi Banks increased their capital through new share flotation. As a result, the capital and reserves for the banking system had doubled from SAR 15 billion at end-1988 to SAR 30 billion by end-1993.

The economic boom and growth of banking in the 1990s

Following the resolution of the Gulf crisis in 1991, there was a mini boom in the economy. During 1991 there was a massive surge of about 20% in the deposits of the banking system. Banks' domestic loans and advances grew 90% in 1990-95 and all other banking indicators, such as rates of return on equity and assets, continued to be very strong with many banks posting record profits. Despite difficult international conditions, the banks continued to show solid and stable growth and strong profitability during the second half of the 1990s. The trend towards increasing the banks' capital base continued and three Saudi banks went to the market during 1993-97. The capitalisation objectives were largely achieved and, with a risk/asset ratio of over 20% at end of 2000, Saudi banks are now highly capitalised by international standards (Table 1).

Table 1

Saudi banking system

	1980	1990	1998
Assets (in US$ billion)	21	69	109
Number of banks	10	12	11
Concentration (share of top five banks)	80	76	75
Number of staff (in thousands)	11	25	22
Branches	247	1,011	1,236
Return on assets (%)	1.9	1.4	1.7
Simple capital ratio	6.1	7.2	10.4

The restructuring of the banking system continued with the 1997 merger of United Saudi Commercial Bank and Saudi Cairo Bank into United Saudi Bank. In 1999, United Saudi Bank merged with Saudi American Bank to form the third largest bank in the Kingdom. This consolidation of Saudi banks is primarily driven by shareholders who wish to maximise share values and believe that size matters. The trend towards mergers may continue as banks may require more capital to invest in technology, in new products and services and in risk management systems.

Participation of foreign banks in the banking system

As described earlier, foreign bank presence in Saudi Arabia dates from the very beginning of the banking system. The government had always encouraged foreign banks to open branches within the Kingdom and consequently, by 1975, 10 international banks with 23 branches were established. 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 the participation of Saudi nationals. This policy had a number of objectives. The incorporation and floatation of these banks encouraged broad-based public participation in the banking industry and 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. They could not only exercise significant management control but could also benefit from national treatment as accorded to banks fully owned by Saudis. During the 1980s and 1990s the participation of foreign banks and foreign shareholders remained substantially unchanged. However, there was some dilution of foreign participation as a result of disinvestment or due to the mergers and consolidation of joint venture banks noted earlier. The joint foreign-Saudi owned banks had assets of SAR 218 billion at end-1998, just over half of the total.

Today, the Saudi banking system is preparing for a likely increase in the number of foreign banks, as a result of the decision of the Gulf Cooperation Council governments to permit reciprocal opening of their banking markets. In this connection, Gulf International Bank of Bahrain was granted a licence to open a branch in Saudi Arabia in September 2000. Furthermore, general and specific criteria have been developed for assessing the application of new foreign banks. By March 2001, eight of the 11 banks had substantial foreign participation. The government has encouraged foreign bank presence to promote trade, investment and economic relations and to attract expertise and technology.

3. Competition

Along with sustained growth and systemic stability, a major policy of the Saudi government has been to encourage and maintain a healthy competitive environment so that the customers are able to access a broad range of banking and financial services in an efficient and cost-effective manner. This focus on ensuring a high level of customer service and multiplicity of choice has been reflected in a number of policy decisions made during the past half century.

In the early years, the government encouraged customer service by permitting a number of foreign banks to open branches in the Kingdom and also licensed domestic banks for competition. The government was selective and licensed foreign banks from different parts of the world, with varying management cultures, systems and technologies. This diversity was conducive to broadening the choices available and creating a dynamic and competitive environment. The variety in foreign presence has been maintained over time as investors representing many countries still have a considerable stake in the Saudi banking system.

SAMA has always supported and encouraged the acceptance of the universal banking model for banks in Saudi Arabia. Consequently, Saudi banks have become the primary financial institutions for provision of all banking and financial services. This policy was to ensure systemic stability in that banks were managed by fit and proper persons and enjoyed sound capital positions. It was also to promote healthy competition as banks were able to devote sufficient funds and qualified human resources to providing a broad range of financial services, including fund management, stock brokerage, investment advice and non-interest banking. More recently, banks have been distributing life and other insurance products to their customers and investing in leasing companies. These initiatives have promoted a very competitive environment in the domestic market.

These developments need to be seen from the perspective of a fundamental government policy of freedom of movement of capital whereby customers are free to access financial services from any institution or market. This ensures that Saudi banks are constantly challenged to compete with other foreign and regional banks and financial institutions. This competition is particularly vigorous in the corporate and private banking sectors, where customers can normally choose from all domestic and international banks and financial institutions. To promote a level playing field, SAMA has also ensured that all domestic banks have equal access to the basic financial infrastructure for developing their products and services. SAMA took a leadership role in establishing all payment and settlement systems in the country, to provide a strong technical infrastructure in which banks can build their own proprietary payment systems. Also, to access these central payment systems, all banks are compelled to invest in new technologies.

4. Systemic stability

The early years

The first banking problems faced by Saudi Arabia in 1960 also led to the first merger of two domestic banks. Riyad Bank and Al-Watany Bank, which had commenced operations in 1957 and 1958 respectively, faced serious liquidity problems arising from mismanagement and improper loans by board members in both banks. By 1960, Bank Al-Watany was technically insolvent and was unable to settle the claims of local depositors. SAMA liquidated the bank and merged its operations with Riyad Bank. By 1961, SAMA required Riyad Bank to reorganise and, on behalf of the government, acquired 38% of its shares. These events tested the government's resolve to defend the stability of a nascent banking system. The government not only took action requiring mergers but also came in strongly as a shareholder to prevent a bank failure. This sent a clear signal that the Saudi authorities wanted to maintain and support a strong, stable and credible banking system.

These early banking difficulties led to a new Banking Control Law in 1966, which gave SAMA broad supervisory powers to license and regulate all banks. Banks were required to meet stringent capital adequacy, liquidity and reserve requirements as well as lending ratios. A system of on-site and off-site prudential supervision was introduced and SAMA strengthened its supervisory capabilities.

The systemic challenges of the 1980s

In 1982, SAMA faced another supervisory challenge when irregularities appeared in the operations of Saudi Cairo Bank. Two senior managers were involved in unauthorised trading in bullion, and the bank had concealed accumulated losses that exceeded its share capital. SAMA took legal action against the managers and required the bank to issue new shares and double its capital in 1986. The increase was taken up entirely by the Public Investment Fund, which in this case acted not only as an "investor of last resort" but also helped the bank with liquidity and restored it to a healthy position.

The systemic challenge faced by the Saudi banking system due to the precipitous drop in oil prices in 1982 has been detailed earlier. As oil prices tumbled and the economy slid into a long slowdown, bank profits suffered, the asset quality deteriorated and non-performing loans increased. SAMA, with the help of other Saudi authorities, took a number of steps to strengthen the banks. These included retention of capital reserves, tax write-offs for loan provisions, extension of the tax holiday for foreign investors, encouragement of bank recapitalisation, provision of liquidity through repos, and investment in new technologies.

The threat of the Gulf crisis

By the beginning of the 1990s the Saudi banking system had largely recovered from the difficulties of the mid-1980's. 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. However, the invasion of Kuwait by Iraq in August 1990 fully tested the strength of the banking system and SAMA's capability as a central bank and a banking supervisor. The crisis affected the monetary situation profoundly. Customer withdrawals of domestic deposits during the first week of 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. SAMA had ensured the availability of foreign currency to meet customer demands by providing more liquidity through repo arrangements and placing foreign currency deposits with banks.

A strong supervisory framework has banks well positioned for the new millennium

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 for licensing banks, approving their activities and taking prompt corrective action when required. It has powers to promulgate rules, regulations and guidelines to banks in all areas, including capital adequacy, liquidity, lending limits, and credit and market risk. Also, it has powers to conduct both on-site and off-site supervision. SAMA has a dual role of providing central payment and settlement services to banks and overseeing these systems. SAMA also acts as a regulator of the stock market. Over the years, these broad supervisory powers have been used effectively to ensure that the Saudi banking system continues to enjoy a high reputation for soundness and stability in the international financial markets. Looking ahead, enhancing systemic stability for the banking system continues to be a primary goal of Saudi authorities in general, and SAMA in particular.

While the history of the Saudi banking system has reflected the ups and downs of the oil market, the global economy and the geopolitical events, it has been able to maintain a stable and steady course. Saudi Arabia has been able to avoid a systemic banking crisis such as those faced by many countries in the last two decades. As Saudi Arabia enters the new millennium, technology, deregulation and globalisation are forces affecting its banking system. However, Saudi banks are well positioned to meet the challenges from a more open, liberal and competitive environment around the world, in the Gulf region and in Saudi Arabia.