Banking sector issues in Saudi Arabia

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I. Banks and Aggregate Credit: What Is New?

1. Aggregate Claims of Banks

During the decade from 1 January 1995 to 31 December 2004, banks' claims on the private sector (including loans and securities) increased by 177%, from SAR 113 billion to SAR 313 billion. In the same period, banks' claims on the public sector increased by 129%, from SAR 77 billion to SAR 176 billion. Consequently, claims on the public sector declined from 40.5% of total claims to 36%, while the private sector's share of claims has increased from 59.5% to 64%.

2. Claims on the Private Sector

In the private sector, bank credit increased from SAR 107 billion in 1995 to SAR 303 billion in 2004. Investment in private securities remained stable and insignificant as it grew from SAR 6.1 billion to SAR 10.9 billion during the same period. Within the loans, advances and overdraft segment, the greatest increase occurred in the area of loans to consumers and for credit cards. These were less than SAR 5 billion in 1995, and by 31 December 2004 they reached SAR 119 billion, an increase of 24 times. In the same period, credit card loans, which amounted to approximately SAR 2 billion in 1995 (40% of consumer loans) only increased to SAR 3.3 billion by 2004. Their relative percentage declined from 40% to about 3% of total consumer loans. As of end-2004, 3% of total consumer loans were for credit cards, 7% were for real estate financing, 24% for cars and equipment and 66% for miscellaneous purposes. The trend for growth in consumer loans has continued strongly in 2005, and by the end of June total consumer loans were SAR 152.7 billion, of which outstanding credit card loans were SAR 3.5 billion (2.3%), real estate financing was SAR 10.9 billion (7.1%), car and equipment loans were SAR 29.1 (19.1%) and miscellaneous loans were 109.1 (71.5%). The miscellaneous loans include loans taken for durable consumer goods, education, travel and shares trading.

3. Reasons for Growth in Consumer Loans

The underlying reasons for this rapid growth in consumer loans are as follows:

1. A youthful and rapidly growing population that wishes to finance automobiles, education, vacations, housing, shares trading, etc.
2. The ability of Saudi banks to secure an assignment of salary for consumer loans. This collateral has been designed through the creation of an interbank payment system that permits the transfer of customer salaries from employers to any bank account in the Kingdom. Thus, banks can secure their loans by a tripartite agreement between the employer, the employee and the bank which gives the bank a first right on the customer salary. This has been the key catalyst for the rapid development of consumer finance.
3. The establishment of the Saudi Credit Bureau, which provides banks with up to date information on customers' creditworthiness.
4. Banks have also introduced new types of consumer loans for margin trading (secured by shares) and loans secured by real estate.

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4. Private Sector Claims by Economic Activity

The table below shows the major areas of growth in bank credit, by economic activity.

Table 1

Bank Credit by Economic Activity

	January 1995	**December 2004**	**Increase**	**% Increase**
Agriculture and Fishing	2.7	3.8	1.1	41
Manufacturing and Processing	12.9	26.6	13.7	106
Mining	0.8	1.3	0.5	62
Electricity and Water	2.6	3.3	0.7	27
Building and Construction	14.1	23.1	9.0	64
Commerce	28.3	62.8	34.5	122
Transport and Communication	6.2	13.4	7.2	116
Finance	8.4	33.8	25.4	302
Service	3.8	12.3	8.5	223
Miscellaneous	27.3	122.8	95.5	349
Total	**107.1**	**303.1**	**196.0**	**183**

It is evident from the above that the greatest increase (349%) was in the miscellaneous category, which was 40.5% of total private sector credit, of which a substantial portion was represented by consumer loans (73%). As already noted above, this economic activity was the area of fastest growth. Another area of rapid growth (30%) was the finance sector, which, apart from the banks, now includes insurance companies, mutual funds, leasing companies and other finance sector related entities. Finance sector activities also include those related to share trading. While the service sector also showed a sharp increase of 223% in the decade, its overall volume was relatively small (about 3.5% of total credit). Other economic sectors, such as commerce, transport and communications, and manufacturing and processing, doubled in the decade, but their relative size in the overall credit extension declined. There was little growth in the agriculture and fishing sector due to the cutback in government subsidies. Also, the electricity, water and utilities sector declined due to a mature utilities infrastructure which did not require major new investments.

5. Extension of Credit to the Public Sector

During the period 1995-2004, claims on the public sector increased from SAR 77 billion to SAR 176 billion, an increase of 129%. The following table provides some details on the components of this increase.

Table 2

Bank Claims on the Public Sector

(1995-2004)

	1995	**2004**	**Increase**	**% Increase**
Total	**77**	**176**	**99**	**193**
Loans and Advances	27	29	2	7.5
Treasury Bills	11	0.3	(10.73)	(97)
Government Bonds	39	146	107	274

The Table 2 indicates that the volume of loans to public sector enterprise did not increase by much in the last decade. This could be largely attributed to the strong fiscal position of the government, which has been able to finance many of the government sector projects from its own resources.

6. Changes in Banks' Holdings of Government Securities

In terms of government securities, the popularity of treasury bills declined considerably due to the introduction of the Saudi Riyal Interbank Express System introduced in 1996. Also, there is greater flexibility in the government bonds market, where SAMA has permitted banks to repo up to 75% of their holdings. Nevertheless, government bonds were popular as an investment vehicle and increased by 274% in the decade. Their popularity can be attributed to strong yields, help in maintaining liquidity, ability to repo and the development of a secondary market. While the growth in total government securities was about 193% over the decade, their relative share in overall credit declined by about 5%. This is because in the last 3 years, the government's fiscal situation improved significantly due to a rise in oil prices and non-oil revenue, and there was a decline in the government offering of securities in the market. Part of the government surplus was targeted towards repayment of government debt, which is almost all in form of government securities.

7. Banks' Sources of Funds

During the decade 1995-2004, bank deposits increased from SAR 188 billion to SAR 422 billion, an increase of SAR 234 billion (125%), while capital and reserves increased by 109%. The table below indicates the changes:

	1995	2004	Increase	% Increase
Demand	81	203	122	151
Time and Saving	51	136	85	167
Other Quasi-Monetary	56	83	27	48
Total Deposits	**188**	**422**	**234**	**125**
Foreign Liabilities	39	46	7	18
Capital and Reserves	33	69	36	109
Other Liabilities	72	118	46	64
Total	**332**	**655**	**323**	**86**

8. Changes in Deposit Structure

In terms of funding sources, by end-2004, the relative share of demand deposits to total deposits increased to 48% (1994 - 43%) and the share of time and savings deposits also increased to 32% (1994 - 27%). There was a decline in other quasi-monetary deposits, which dropped from 30% to 20% as a percentage of total deposits. The major reasons for these changes include:

- Greater demand for Islamic (non-interest) banking services. Consequently, demand deposits showed rapid growth, increasing by 151% the decade.
- Time and savings deposits also increased, particularly as businesses and public sector entities use such deposits to generate income for their enterprise.
- A decline came about in foreign currency deposits, which indicates that Saudi banks have ample liquidity and are relying less on regional and international markets to raise liquidity. There has been a noticeable decline in foreign currency interbank activities.
- Only the outstanding remittance balances in the other deposits increased by over 200%, but they remained a small percentage (less than 2%) of total deposits.

9. Changes in Share Capital and Reserves

Apart from deposits as a source of funding, Saudi banks increased their capital and reserves by 109% during the decade. Total capital and reserves increased from SAR 33 billion to SAR 69 billion. This was done by means of new flotations of shares as well as retention of profits.

10. Long-Term Funding

A recent but growing trend which started in 2004 and is becoming increasingly popular for Saudi banks is to raise long-term funds in the international markets. These take the form of syndicated loans, Eurobonds and notes. In the past two years, almost half a dozen substantial transactions of this type have been carried out, and others are in progress. This trend will have an increasing impact on banks' activities in future years and will enable them to grow their operations.

II. An Evaluation of Major Structural Changes: Increased Role of Foreign Banks

1. Evolution of the Banking System and Foreign Banks' Participation

Foreign banks' presence in Saudi Arabia can be traced back to 1926, when the Netherlands Trading Company, later to become Algemene Bank Nederland (ABN) began operations. It enjoyed a virtual monopoly until the late 1940s. In 1947, Banque Indo Chine opened a branch, followed by the Arab Bank Limited (1949), the British Bank of the Middle East (1950) and the National Bank of Pakistan (1950). In October 1952, the Saudi Arabian Monetary Agency (SAMA) was established by the Saudi government with primary responsibility for monetary stability. Following SAMA's creation, the government followed an open and liberal policy and permitted the opening of new foreign bank branches, including Banque de Caire, Banque du Liban et d'Outremer and First National City Bank of New York. This first wave of foreign banks linked Saudi Arabia firmly with the global financial markets and encouraged a competitive domestic environment. During this period, three domestic banks were also licensed. The National Commercial Bank was licensed in 1953, Riyad Bank started operations in 1957 and Al-Watany Bank in January 1958.

2. Conversion of Foreign Bank Branches to Joint Stock Companies

By 1975, 10 international banks with 29 branches were present in the Kingdom. These institutions operated as branches of their parent companies but, in 1976, a decision was taken by the Saudi government that these should become incorporated as local banks with majority Saudi shareholdings.

The major reason for this important policy decision was that with the boom in oil revenues in the mid-1970s, the Saudi economy expanded and grew very rapidly. This led to sharp rise in demand for banking products and services which the existing banks found difficult to cope with. The government quickly recognized the need for larger and more sophisticated banks. It also observed that capital invested in the banking sector was insufficient and inhibited banks from investing in branch networks, implementing new technology and training human resources. While the government encouraged all foreign banks to invest more capital, it realized their constraints and also noted that many local investors were ready to make large capital investments for developing the banking system. Consequently, in 1976 the Council of Ministers (the final legislative authority) offered foreign banks operating in the Kingdom a chance to form joint venture banks with Saudi shareholders. This decision required foreign banks to convert their branch operations to Saudi joint stock companies in which they could retain up to a 40% shareholding. In subsequent years, all foreign banks accepted these proposals and formed joint ventures as there were a number of incentives offered, including the following:

- The new joint venture banks were accorded full national treatment at par with fully owned Saudi banks. They were permitted to rapidly expand their branch networks and to access all the benefits and privileges available to local banks.

- The foreign partners were offered and encouraged to take on Technical Management Agreements for the operation of joint venture banks. Thus, they exercised considerable management influence over the banks' affairs and continued to provide human, technical and other expertise and resources.
- All joint venture banks were given a tax-free holiday period of five years from the dates of their conversion. These tax-free periods were subsequently extended for an additional five years.
- The creation of joint stock Saudi banks whose shares were held by a large number of investors also contributed to the development of the Saudi shares market as bank shares quickly became popular among investors. This further contributed to the increase in value of investments owned by foreign shareholders.
- The conversion of foreign bank branches into joint venture banks also had prudential implications as the move permitted all banks to substantially increase their capital base. This helped banks to stay liquid and creditworthy despite the subsequent domestic and international economic turbulences they faced in the 1980s and 1990s.

Following these changes, during the period from 1982 to 2000, no new foreign or domestic banks except one were granted a license, as the government believed that the country was adequately served by the existing branch network. During the 1990s, the banking system made large investments in the payment systems infrastructure and in technology-based customer products and services. These include automated teller machines, point of sales terminals, telephone and internet banking, electronic share trading, etc. Consequently, while the banking system expanded greatly in size and scope of its activities, there was only limited expansion in the banks' branch network. Nevertheless, the Saudi banking system currently has a presence of more than a dozen foreign bank shareholders from many parts of the world. Their shareholdings range from less than 1% to 40% of a bank's total capital. In addition, there are international banks with full branch operations.

3. Recent Policy Developments for Participation of Foreign Banks

The Saudi Arabian financial system has always been open to foreign presence. The government has encouraged this policy to promote trade, investment and economic relations, and to attract expertise and technology. It already has considerable foreign investor presence as eight of the eleven banks have substantial foreign ownership. Many of the foreign partners in Saudi joint venture banks have technical management agreements. In past five years, Saudi Arabia has licensed a number of GCC (Gulf Cooperation Council) banking institutions, as a result of a decision of the GCC Summit to permit reciprocal opening of their banking markets. In this connection, Gulf International Bank of Bahrain was granted a license in September 2000 to open a branch in Saudi Arabia. This was followed by the grant of branch licenses to the Emirates Bank International, the National Bank of Kuwait, the National Bank of Bahrain and Bank Muscat. Two of these banks are already operational, while the other three are planning to commence operations over the next 12 months.

The government has also decided to allow major international banks from different parts of the world to obtain banking licenses. To this end, branch banking licenses have been granted to three major international banks: BNP Paribas, Deutsche Bank and JPMorgan Chase. These banks are now in the process of opening their branches. More recently, in August 2005, Saudi Arabia granted branch licenses to two regional banks: National Bank of Pakistan and State Bank of India, which are expected to become operational in 2006.

It should be noted that with the opening of the branches of these new foreign banks by end-2006, the number of licensed banks in the Kingdom will have doubled since 2000. The entrance of these institutions into the Saudi banking market should enhance competition, support the transfer of technology, improve financial services in all sectors and create employment opportunities. This is part of the Saudi government's vision for a dynamic financial sector which will also benefit from the participation of non-bank investment and brokerage companies under the recent Capital Market Law, and the participation of insurance companies under the new Cooperative Insurance Law.

III. Preventing Banking System Crisis: Capital Regulations and Supervisory Oversight

1. Introduction

The genesis of a 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 policy. In 1956, SAMA was granted a new charter with added responsibilities for banking supervision. The charter granted SAMA a great deal of independence and authority.

2. Growing Pains

The first banking problems faced by Saudi Arabia 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 by board members in both banks. By 1960, Al-Watany Bank was technically insolvent and was unable to settle the claims of local depositors. SAMA liquidated the bank to organize a merger with Riyad Bank, and with the government's approval, SAMA, on behalf of the government, acquired 38% of the shares of the new Riyad Bank. These events tested the government's resolve to defend the stability of the nascent banking system. The government not only took action, requiring a merger, but also came in strongly as a shareholder to prevent a bank failure. This sent a clear signal that Saudi authorities wanted to maintain and fully support a strong, stable and credible banking system. Notwithstanding the government's ownership stake, Riyad Bank continued to operate as a private sector institution with no major intervention from the authorities.

3. Strengthening of the Regulatory Framework

These 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, lending ratio and reserve requirements. A system of on- and off-site prudential supervision was introduced, and SAMA strengthened its supervisory capabilities. The law 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.

4. Trials and Tribulations

The 1980s were a tumultuous and testing period for Saudi banks and the banking system. In line with the tremendous increase in government revenues in 1979-1981 and subsequent slow-down in 1982-1986, 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 an all-time high in 1981 and continued to decline during the next five years, there was significant pressure on the quality of bank assets, which deteriorated with the economic slowdown. Credit to the private sector, which had increased over 500% during the period 1976-1981, only grew at a rate of less than 4% per year over the next five years. The banks suffered from non-performing loans, which increased to over 20% of all loans by 1986. Banks' profits suffered significantly, and loan loss provisions for doubtful accounts for the banking system had risen to over 12% of total loans.

5. Causes of the Banking Problems

The causes of the problems faced by Saudi banks arose mainly from the macroeconomic imbalances which were created by a steep rise in government revenues in 1979-1981, followed by a precipitous decline in oil revenues. Government revenues, which had risen to SAR 333 billion by 1981, started a rapid decline and dropped to just over SAR 74 billion by 1987. The rapid growth in bank assets and liquidity in 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 that 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 realize.

6. The Government's Response

During this period, SAMA, in concert with the Minister 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 included the following;

1. 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.
2. 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.
3. In 1986, SAMA obtained a ruling from the Tax Department that permitted the tax deduction of loan loss provisions on an accrual basis. This encouraged banks to increase their loan loss provisions for doubtful accounts.
4. To encourage Saudi banks to increase their interbank dealings and to support the development of a riyal interbank market, a tax ruling was obtained which exempted foreign banks from withholding taxes when carrying out interbank transactions with Saudi Banks.
5. SAMA recognized 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, requiring banks to develop internal audit departments and implement internal controls.

7. Major Supervisory Initiatives of the 1990s

Following the difficulties of the 1980s, in the next decade SAMA embarked on a policy of modernizing its supervisory system. The first objective of these policies was to create a suitable infrastructure that required sound corporate governance of banks; a second objective was to introduce international supervisory standards and best practices. In this regard, SAMA issued a range of supervisory requirements, including internal control guidelines for banks, SAMA accounting standards (these were subsequently replaced by IFRS in 1992), fraud prevention guidelines, anti-money laundering guidelines, operational risk guidelines, establishment of the role of audit committees, and external auditors, etc. All of these guidelines were aimed at inculcating a culture of sound corporate management and enhancement of internal controls. In tandem, SAMA introduced a number of supervisory standards emanating from the Basel Committee. These included the 1988 Basel Capital Adequacy Accord (1992), the large exposure standard (1994) and a number of other Basel circulars dealing with liquidity, interest rate risk, credit risk, market risk, etc.

In the 1990s SAMA also implemented an electronic (prudential) returns management system, which provides it with important and significant prudential information for use in on- and off-site supervisory functions. Also, following the pronouncement of Basel Core Principles in 1997, SAMA continued to review and evaluate its supervisory practices to ensure that these not only met but exceeded international standards.

It is noteworthy that in 1990s the quality of management in the banking sector had improved significantly due to the bad experiences of the 1980s. Consequently, despite the Russian crisis, the bond market crisis, and the Southeast Asian banking crisis in the 1990s, there was no major impact on the performance of Saudi banks. Also, the banking system coped well with the volatilities of the prices in the oil market; no bank was threatened in this period and no government support was required.

8. Capital Adequacy in the Saudi Banking System

In line with international trends, in 1992 SAMA implemented the risk-weighted Basel Capital Adequacy Accord, and established a minimum risk-weighted capital standard of 8%. Also, SAMA encouraged Saudi banks to raise their capital bases, and during the period 1988-1993, 7 of 12 banks increased their capital through new share flotations. As a result, the capital base of the banking system doubled, from SAR 15 billion to SAR 30 billion. It is worth noting that the average risk-based capital of the Saudi banking system in the 1990s hovered around the 20% level, while individual bank averages were between 12-30%. It is also notable that the banks' capital was almost entirely, composed of Tier 1 items. In this connection, SAMA has decided that Saudi banks will implement the Basel II Capital Adequacy Standard during the period 2008-2010. Banks are free to choose any Basel II approach for credit and operational risk. Work is currently underway to plan for the implementation of all three pillars of Basel II during this time frame.

9. Supervisory Initiatives in the New Decade

In the decade starting in 2001, the trend towards further enhancement of the supervisory system has continued. SAMA has developed and implemented a range of financial policies and supervisory standards to ensure that the banking system maintains its reputation, safety and soundness. Some of the major supervisory policies introduced since 2001 include the following.

- A new anti-money laundering law.
- New regulations for prevention of money laundering and for combating terrorist financing.
- Implementation of a risk-based supervisory system to support on- and off-site supervision.
- Implementation of Market Risk Amendments to the 1988 Basel Capital Accord (now part of the Basel II Capital Accord).
- Implementation of supervisory rules for consumer loans and margin trading.
- A host of other Basel circulars, including those on credit and operational risks.

10. External Assessment of Financial Policies and Supervision

These financial policies and supervisory practices have gone a long way to strengthen the Saudi financial system. In addition, since 2003 SAMA's supervisory practices and financial policies have been assessed by three independent outside expert institutions. These include:

- External rating agencies: S&P and Fitch carried out extensive work on the financial system for their sovereign rating work in 2003. SAMA scored well in their assessment of the strength of the financial sector and its supervision.
- A Financial Sector Assessment Program (FSAP) was done by an IMF/World Bank team in 2004. The results of this FSAP were comforting, in that Saudi Arabia's financial policies and supervisory practices stood up to this objective evaluation. The assessment against Basel Core Principles indicated that SAMA supervision was fully or mostly compliant with 21 of 25 Core Principles. Also as a part of the FSAP, a stress test was carried out under three different scenarios of interest rate, credit risk and liquidity shocks. This stress test confirmed the resilience of the banking system as no Saudi bank would fail under a 300% stress scenario for these individual shocks or even a combined shock.
- Also in 2004, a Financial Action Task Force study was carried out to assess Saudi Arabia against the 48 recommendations issued by FATF. The results of this study were very satisfactory as Saudi Arabia fully or mostly met 47½ of the 48 FATF recommendations.

11. The Way Forward

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 in 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- and off-site supervision. SAMA acts as the regulator of the insurance 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 for soundness and stability in the international financial markets. Looking ahead, systemic stability continues to be the primary goal of Saudi authorities in general, and SAMA in particular, for the banking system.