Hamad Al-Sayari: World class banking sector

Speech by His Excellency Hamad Al-Sayari, Governor of the Saudi Arabian Monetary Agency, during "The Future Building" Seminar, in cooperation with Euromoney, Riyadh, 9-10 May 2006.

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Ladies and gentlemen,

It is a great pleasure for me to participate in this Symposium and share with my insights on "The Development of Banking Sector" in Saudi Arabia and have a glance over its development and role in supporting the growth of the Saudi economy to be more dynamic and attractive to domestic and foreign investments.

At first, let me briefly cover the achievements of the Saudi banking sector since the establishment of SAMA in 1952. According to SAMA's Charter, two of its most important objectives are to issue and strengthen the Saudi currency and stabilize its internal and external value, and to regulate commercial banks. On the basis of a historic review, we may judge how far these objectives have been achieved. The exchange rate has fluctuated in a very narrow band over the past six decades. This has contributed to attaining the ultimate goal of our monetary policy of achieving price stability. The inflation rate has remained very low and has generally remained, on average, below 1% per annum over the past 20 years.

These stable conditions have contributed strongly to sustained growth in the overall economy with average real GDP growth of 3.2% per annum for the last decade. Over these decades, the economic environment has been characterized by freedom of capital flows, open investment climate, low inflation, stable financial system and availability of ample liquidity. This has encouraged the rise in both domestic and foreign investment in the country. Particularly in the past two decades, the growth has been rapid in the non-oil private sector which has almost doubled and now represents over 44% of the annual GDP, while the percentage contribution of the oil sector has declined to around 33%.

As for SAMA's other major objective of supervising and regulating the financial system, SAMA has followed prudent policies aimed at creating a sound, stable, solid and efficient financial system with a modern payments system. SAMA's Charter and the Banking Control Law give it broad regulatory powers to ensure that banks are adequately capitalized, having efficient managements, run by fit and proper Directors and Managers who meet competence and integrity requirements, and that the banks have fit and appropriate operation and control systems.

Over this long period, prudent supervisory policies and timely action have ensured that banks stayed strong and solid. This is a remarkable achievement in the face of global and regional economic uncertainties, political crisis, wars and volatilities of the oil market.

Today, Saudi banks play a leading role in the financial system that also includes five large specialized government development financing institutions and leasing, investment and insurance companies and a few money changers. Saudi banks have benefited greatly from the Universal Banking Model permitted by SAMA and offer a range of financial services including investment management, mutual funds, brokerage, and other services. During the past decade, the volume of business of Saudi banks has grown at a phenomenal rate. In the ten years period 1996-2005, the banks' assets grew by 213 per cent, deposits by 224 per cent and capital and reserves by 248 per cent. During this period the profits for the banking system showed strong growth and the return on equity averaged well over 20% and return on assets was over 2%. The strength of Saudi banks is further underlined by their average risk-based capital adequacy, which has been high according to Basel capital adequacy standard, and averaged 18% during the past decade.

If we review our long history of foreign investment in the financial sector since early 1950, a number of foreign banks were granted licenses to open branches in the Kingdom. In 1976, there were 12 banks in the Kingdom including 10 foreign banks. To Saudize the banking system and benefit from foreign expertise of the banks operating in the Kingdom, the government invited foreign banks to convert their branches into Saudi-foreign joint stock companies with an equity share of 40% for the foreign partner. Technical Management Agreements were also entered into to manage the new banks by the foreign partners. Consequently, Saudi banking companies were established and became integrated with the global banking system, benefiting from its expertise and training capabilities, and coped with its developments. Eventually, the Saudi banks compare well with their counterparts in advanced countries.

During the 1990s, no new bank licenses were issued. However the year 2000 ushered in a new era of openness when a license was granted to the Gulf International Bank, a Bahraini bank, owned by the GCC countries. This was to implement a decision made by the GCC Heads of States to permit qualifying GCC-owned banks in their home markets. This has been followed by new licenses to 4 more GCC-owned banks, (namely the Emirates Bank International, the National Bank of Kuwait, the National Bank of Bahrain and the Bank Muscat). Licenses were also granted to five other major international and emerging market banks (that include BNP Paribas, Deutsche Bank, JP Morgan, State Bank of India and National Bank of Pakistan). Just during this past week Deutsche Bank has opened its branch in Riyadh and National Bank of Kuwait in Jeddah. The remaining banks are in the process of opening their branches in 2006. On 27/2/1427H, a Royal Decree was issued approving the incorporation of a joint-stock company under the name "the Development Bank", with a capital of Rls 15.0 billion. This would enhance competition and open new horizons for diversified banking services.

In view of the importance of payments and settlements systems for the efficiency and security of the banking system, these have been developed by using state-of-the-art electronic technologies and highly sophisticated and technically advanced information systems that not only meet, but often exceed, international standards. The transformation started in 1986 when SAMA installed the Automatic Cheque Clearing System. In 1989, SAMA required all Saudi banks to join the Saudi Payments Network (SPAN) which is a national ATM system. This system was subsequently extended to a point-of-sale that links customers, merchants and banks. However, the backbone of the Saudi Payment and Settlement System is the Saudi Riyal Interbank Express (SARIE). This is an interbank system that operates on Real Time Gross Settlement basis. SARIE provides an electronic link between all other payments and clearing systems which had been installed earlier. A follower of the statistical data on the payments systems, issued by SAMA, would realize the huge growth achieved in the number of ATMs, POS and transactions executed through them in addition to the transactions carried out through SAREA' System.

Of course, Saudi banks and their customers have benefited greatly from these advances in technology. Banks have been able to expand their businesses by offering a range of new products, control their costs and to enhance profitability. Consumers have benefited from access to a broader range of services and from reduction in costs. Telephone and internet banking is now rapidly expanding, and in 2006, the Saudi Payment System is well poised for further enhancement by SADDAD which provides the ability to pay major companies' bills electronically by debiting the accounts of their customers. This will further enhance efficiency and reduce costs.

Currently, SAMA, in cooperation with the banks, is working to upgrade and streamline the Saudi Payments Network to permit the continued expansion in the installation of ATMs and POS. so that it could provide more advanced banking services with high confidentiality and full security. SAMA is also in the process of upgrading the Cheque Clearing System to carry out transactions electronically and in real time. This is in to meet present and future expansion requirements of the growth of the capital market and to promote customer services and to provide same through electronic channels in a way that will cope with the large expansion in the growth of the domestic economy.

During the past decade there has been prominent diversification in the banking business which included the following:

1. Banks were able to meet the increasing demand by the different categories of customers for various modern banking services. This made banking services provided in the domestic market compete well with their counterparts in developed countries. But in the past year there occurred subsequent developments leading to a substantial demand for banking services that included payment of salaries, payment of public utilities bills and fees through banks, more subscription to public offering of companies' shares, increase of demand on share trading, as well as enforcement of some security controls required as measures for protecting the banking system against money laundering operations. All this occurred in a very short period, leading to rising complaints of inefficient services provided by some bank branches. Banks managed and they are still working to overcome such shortcomings by employing and training more staff, opening new branches, and providing alternative channels to perform banking services, with employment rising during twelve months by 20%.

2. Banks have made significant strides in provision of asset management services such as investment portfolio accounts, mutual investment funds aimed at domestic, regional and

international shares and bonds markets, money market instruments and real estate investment. Assets under management increased 8 times from Rls 17 billion to Rls 132 billion during the period 1996-2005.

3. Since 1998, consumer loans have increased dramatically. This can be largely attributed to the SARIE system which permits loans to be secured by salary assignments. These loans have provided access to banking system liquidity to a large segment of customers to meet their consumer and investment needs, thereby, supporting the pace of economic activity.

4. Another important development has been the rapid growth in the provision of Islamic Shariah compliant services to cater to the increasing demand by customers for such services. All Saudi banks offer a range of Islamic products including Murabaha, Mudaraba, Musharaka, Baie Ajel, etc.

The significant growth, diversification and profitability of the Saudi banking system has been underpinned by a strong and and advanced regulatory system. Over the past two decades SAMA has introduced many modern supervisory standards compliant with international standards including risk based capital adequacy, liquidity, large exposures, risk management and others. In the past two years alone, SAMA has developed regulations relating to market risk, loan classification and provisioning, controls of consumer lending and updated the requirements for appointment in senior posts of banks.

On the corporate governance front there is a heightened awareness in the world with standards emanating from OECD, Basle Committee and others. SAMA has been since the early 1980s inculcating these concepts in the Saudi Banks. In 1981, it issued a guidance document to the Directors of Saudi Banks defining the general framework of their roles and responsibilities. This was followed by regulations on Internal Controls in 1989, Prevention of Fraud (1994), Prevention of Money Laundering (1995) and the Role of the Audit Committee (1996). Furthermore, SAMA has promoted proper accounting standards to be followed by the Saudi banks in order to ensure more transparency in their financial statements. Saudi Arabia was among the first countries in 1992 to adopt the International Financial Reporting Standards by the Banking Industry.

Another important subject relevant to banking supervision is the Basle II Capital Adequacy Accord. SAMA has previously implemented the First Basle Capital Accord in 1992. Accordingly, Saudi banks have maintained high capital adequacy ratios of more than 18% throughout the period from 1992 to 2005. Also it is worth noting that 90% of the capital is of the tier-1 quality. Currently, banks are working closely with SAMA in the implementation of the Basle II Capital Accord. We expect all banks operating in Saudi Arabia to implement the standardized approach for credit risk by 1 January 2008 and then continue to move towards more sophisticated Internal Rating Based approaches. For operational risk all banks are likely to move to standardized approach with one or two banks experimenting with the Advanced Management approaches. SAMA is also encouraging banks to consider a National Data Pooling initiative to help them in credit risk management. All in all Saudi banking system is well on its way to the implementation of Basel II and we expect that banks will remain highly capitalized under the new standard. It is worth mentioning that SAMA's approach in applying Basel (II) Accord is an integrated one aimed at raising the level of risk management in order to maintain the continued strength of the banking system.

One of the issues that has preoccupied the supervisors of the banking system and security organs is combating money laundering and financing of terrorism. Over the past years a number of steps have been taken including:

- In 1990, the Kingdom ratified the UN Convention against Illicit Traffic in Narcotics and Psychotropic Substances.
- In 1995, SAMA issued a manual containing “Guidelines for Prevention and Control of Money Laundering Activities”. These required Saudi banks to implement “Know Your Customer” rules, maintain records of suspicious transactions and report any suspicious activities to law enforcement agencies and SAMA.
- In 2003, SAMA issued revised AML-CTF Rules that updated previous requirements and provided a comprehensive framework for KYC requirements, according to the 40+8 FATF Recommendations and the Basel Recommendations. These Rules provide for strong sanctions to be imposed on banks and individuals that fail to implement these requirements.

- In August 2003, the Council of Ministers approved a Law for Combating Money Laundering. Subsequently, a Financial Intelligence Unit was created in the Ministry of Interior and was staffed with expert resources.
- Also in 2004, the Financial Action Task Force carried out a review of the implementation of its 40 plus its 8 special recommendations. This review indicated that Saudi Arabia was fully or largely compliant with almost all FATF recommendations.
- Finally, in 2005 Saudi Arabia became a member of FATF Regional Body for Middle East and North Africa (MENAFATF) and a Saudi official from SAMA was elected and appointed as the Executive Secretary of this regional body.

Finally, another important supervisory development has been the adoption, in 2004, of a risk based supervisory approach by SAMA. This has significantly strengthened and made more efficient the on-site and off-site supervision practiced by SAMA. This approach is proactive and requires enhanced and frequent communication with banks at all levels. It brings SAMA supervision fully in line with the new international standards.

In recent years, the strength of the Saudi banking system and SAMA's sound banking supervision practices have been recognized by a number of important international institutions. One of the findings of the Financial Sector Assessment Program by an IMF/WB Team in 2005 indicated that the SAMA Banking Supervision, fully or largely met the 25 Basle Core Principles. On the other hand, external rating agencies including S&P, Fitch and Capital Intelligence in 2004 and 2005 have issued favourable reports on the Saudi Banking system. The recent external rating upgrade by S&P to A+ reflects the inherent strength of the domestic banking system.

The developments of the banking sector have been reflected positively on the performance of the Saudi economy. Over the preceding three years, GDP (at current prices) have increased by an annual average growth rate of 18.1%, and private sector GDP by 6.7%. Money supply has grown by an annual average rate of 12.9%, providing adequate liquidity to growth requirements of the economy.

Looking ahead, the financial system and the banking sector will benefit from the state's efforts to diversify the economy and improve the investment environment through regulatory and structural measures taken in the various sectors. A number of new laws and regulatory guidelines have been enacted to enhance economic growth and achieve further opening of domestic markets. The laws included the Foreign Investment Law, the Capital Market and Cooperative Insurance Laws and a new Labour Law. Another important development is the Kingdom's accession to WTO.

Turning to the Capital Market, its contribution to the growth of the Saudi economy has been clearly evident. Over the preceding few years, the market has witnessed remarkable development, and its role as a financial intermediary between savors and investors has been boosted. It would be appropriate to indicate that the recent market correction witnessed by the market has had no adverse consequences on the banks and banking system. This is because SAMA, through its supervisory functions, has undertaken measures necessary for safeguarding banks and customers against any unfavorable developments in the market. The measures included tightening prudential limits related to lending for trading in the market, issuing controls for consumer loans and other measures which would protect customers and banks against expansion in consumer loans which may end with trading in the equity market. Consequently, Saudi Banks have managed to do well in the first quarter of 2006. As the shares market stabilizes and continued good performance by banks is maintained, it is expected that the financial system will greatly benefit from the efforts of the authorities to deepen and broaden the capital market. Now let me briefly touch upon the opportunities for the Saudi banks over the medium term.

1. The Saudi economy is undergoing unprecedented boom era based on a well- developed and diversified base covering all sectors of the economy, including oil and gas, heavy, medium and light industries; banking, investment and insurance services; and transport and tourism, within a population demographic structure which indicates an expected growth in the segment that would need banking services. These entire factors make the banking and financial services market poised to grow exponentially, with great opportunities for banks to expand in the provision of their conventional services in addition to the expansion in the area of investment banking. Banks will benefit greatly from their expertise and experience to provide advisory services in the area of underwriting and covering of new IPO's, corporate finance, financing projects, particularly mega projects (in the fields of petroleum and gas, petrochemicals, water, electricity, housing, education and health), mergers and acquisitions,

securities advisory services and domestic and international brokerage, private wealth management and asset management businesses. This may require banks restructure their business to cope with new regulations.

It is expected that the financial market will both broaden and deepen, and the competitive edge will be with banks that can innovate and harness new technologies. The great expansion in demand for investment services will tempt international institutions to compete domestic banks in the provision of such services to the various economic sectors.

2. Shariah compliant banking services have recorded continued phenomenal growth in the area of retail, corporate services, and assets management. This area is demand driven and banks that offer new Shariah compliant solutions in response to the market need will benefit which will boost their growth and competition. There is also room to innovate and develop adequate products that would meet customer various financing and investment needs. Domestic banks are playing a leading role in this sector and will continue to maintain their leadership role.

3. In view of the present and expected growing demand, commercial and residential housing financing is poised for exponential growth. This constitutes a great opportunity for banks to develop products that provide a balance between risks and rewards, and meet customers' needs. This will be a very satisfactory development.

4. Company's issuance of bonds and SUKUKs which is a financing tool not yet implemented by Saudi companies. It has a potential for banks and companies that offer and issue it.

These are the opportunities, but banks will also face many challenges. The most significant are the following:

1. Attracting, training and maintaining skilled staff, as the present and future expansion in the national economy in its various sectors, particularly, the financial sector, will generate a strong demand for financial skills of all specializations. There will also be a sharp competition for the existing skills, and staff rotation may occur at the financial institutions. Hence, all banks and financial institutions should make great efforts to attract and train employees and should invest generously in this area. It is an exaggeration to expect that the number of employees in the financial sector may double over the next five years.

2. Saudi banks will face a more competitive environment both domestically and in the region. This is because with open policies in the Kingdom, the number of banks operating in Saudi Arabia would almost double to 20 by the end of 2006. These will include the best group of regional and international banks, apart from the possibilities which modern technology provides for offering cross-border services. The banks will also compete, in the area of financial and advisory services, with non-banking financial institutions licensed by the Capital Market Authority. These institutions will compete in providing a number of financial and advisory services.

3. In view of the expected increase in demand for bank financing for a number of economic projects in the economic sectors, and the different financing methods, as well as the great development in the field of modern technology, banks will be required to develop methods for risk management and should be aware of the new risks included in these methods. So, qualifications capable of managing such risk to minimum level should be developed. It is also important to continue to comply with international standards in the area of supervision and accounting. The ability to measure and manage risks will require continued awareness of the dynamic nature of banking business in the context of changing markets with renewed risks which require development of outstanding skills, application of secure technology and following an advanced approach in risk assessment.

4. It is expected that banks will face increased demand for the provision of advanced banking services and products to meet the requirements of the era. Therefore, work should focus on creativeness and innovation so that banks can cater to future needs of the different types of their customers. High levels of baking services should be maintained. There should also be expansion in the number of branches, ATMs, telephone banking and other channels.

I wish to conclude with the observation that the Saudi economy is currently undergoing a phase of accelerated growth in the various sectors and activities unprecedented in the preceding decades. This is due to the great regulatory steps taken recently by the state which helped establish a solid base for sustained growth. What we have heard recently of huge initiatives and projects in the oil, gas, petrochemical, mining, transport, electricity water sectors and infrastructure projects in housing, education, and health, would indicate the size and momentum of the coming economic expansion which will be accompanied by a notable rise in the per capita income. It is expected that the private sector will have a greater role in these projects and in the pace of the overall activity. Thus, the financial and banking sector is entering a very dynamic and exciting phase with acceleration in all areas. There are new players, new market opportunities, a range of new products and services, and significant growth in traditional services. The financial sector should be able to fully leverage its tradition of openness and liberalization, its large investment in technology infrastructure, internal control, and development of its manpower. It is entering a new era of increased consumer participation and awareness, greater competition, enhanced transparency and strong supervision and corporate governance. The financial sector is in a strong position to rise up to these challenges and meet the demands of a rapidly growing economy and consumer expectation. I emphasize my wishes and expectations that the Saudi Financial Sector will continue to be a leader and a major player in the domestic and regional economic activity.

I thank you for your attention.