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EXECUTIVE SUMMARY

Global economic output trended downwards by the end of 2018. Both Emerging and Advanced economies have converged to slowing growth; this is further emphasized by the significant deceleration in global trade activity by the end of the year. 2018 was also marked by growing global uncertainty, which has materialized in short-lived market volatility by the end of year.

In contrast to global developments, the Saudi Arabian economy recovered to 2.2 percent growth by 2018 following a contraction in 2017. This recovery was mainly attributed to the oil sector, which increased by 2.9 percent. The non-oil sector grew modestly by 1.7 percent in 2018 compared with 1 percent in the previous year. Despite the pick-up in economic growth, the returns across listed companies have continued to decrease, and the number of companies recording losses has increased. The risk stemming from the relatively weak performance of companies is mitigated as leverage remains comfortably low across all sectors.

Inflation witnessed a significant jump during 2018 to 2.5 percent mainly due to the introduction of several fiscal measures such as the Value-added tax and energy price reforms. Given these macroeconomic developments, the fiscal stance continued to improve as the budget deficit decreased to 4.6 percent compared to the 9.3 percent in the previous year and the government revenues increased significantly by 30 percent compared with the previous year.

The outlook of Saudi economy has improved. It is expected to pick up further during 2019, given the expansionary fiscal policy. However, the downside risks for Saudi economy comes from the global economic slowdown and its potential impact on the global oil market.

The slight pick-up in economic activity has helped reinforce the resilience of the banking system, which has witnessed an upturn in 2018. Asset growth was driven mainly by private sector credit expansion, as opposed to growing exposures to domestic sovereign debt. There was, however, a commerce sector driven contraction of corporate credit towards the end of the year.

The NPL ratio for the banking sector has increased, though still well below other economies. Profitability and liquidity indicators show a highly-liquid and well-capitalized system that is resilient to withstand external shocks. It is expected that the banking system will continue to meet credit demand, as the economic growth continues.

A number of regulatory reforms were introduced in the insurance market during 2018. These included implementation of Risk-based Supervision Framework for all insurance companies, significant enhancement of the no-claims discount framework for motor insurance policies, issuance of regulation to allow foreign insurance companies to enter Saudi insurance market via establishing branch operations, significant strengthening of the supervisory framework to monitor the technical provisions set aside by the insurance companies.

In terms of the business underwritten, the insurance market contracted by 4.6 percent during 2018; despite this, the growth rate over the last five years stood at 6.8% per annum. The decrease was driven mainly by the motor line of business, where average cost of an insurance policy reduced materially, as intended by the regulatory reforms. It is expected that the reduced motor insurance cost and regulatory emphasis on fair pricing will encourage higher insurance uptake going forward. The reduction in motor insurance premium was partly offset by an increase in health insurance premium, which was driven mainly by health cost inflation, enhancement of minimum benefits by the regulator, and improvement in underwriting discipline in response to regulatory monitoring.

In terms of the underwriting performance, despite reduction in the average cost of a motor insurance policy, motor insurance business improved its loss ratio for the fifth consecutive year. On the other hand, the loss ratio for health insurance, the biggest segment by volume of premium, continued to increase during 2018, thus putting pressure on the overall profitability of the insurance companies during 2018.

In aggregate, the insurance market posted a net profit of SR 0.6 billion during 2018, producing Return-on-Investment and Return-on-Equity of 0.54% and 2.12% respectively. The market demonstrated strong technical reserves and solvency position at year-end 2018. In addition, the insurance market showed less reliance on reinsurance arrangements and on insurance intermediation services in 2018.

In view of the strengthened regulatory framework, possible entry of foreign branches of large sophisticated multinational insurance companies, expected revival of economic activities attributable to improved oil prices, and impetus provided by Vision 2030, it is expected that the performance of the insurance sector will improve going forward.

The finance companies sector did not witness any significant changes in 2018, compared to 2017. Lending by finance companies continued to moderate, influenced by the slowdown in the domestic economy. In contrast to trends in total credit, real estate credit indicated some positive developments. In 2018, profitability posted a healthy growth despite prevailing uncertainty. Finance companies recorded high NPL rates although high capital buffers and reserves provide a considerable buffer in most companies.

Finally, in regards to Capital Market developments, Capital Market activities slightly picked-up during 2018, along with an improvement in Authorized Person's profitability. In terms of the domestic equity market, liquidity remains subdued

relative to historical trends, however stock market liquidity is expected to improve with the continued phased-in inclusion in global indices.

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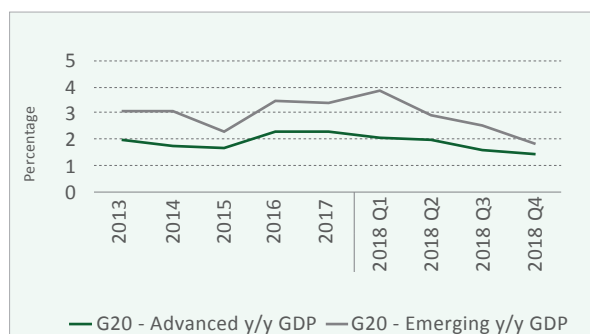
GLOBAL ECONOMIC DEVELOPMENTS

Global Economic Developments

1.1 Economic Growth Developments

Growth across major economies trended downwards during 2018. The analysis in this section focuses on G20 countries as they account for roughly 70 percent of the global economy. On the whole, growth subsided in both advanced and emerging G20 economies during the second half of 2018¹.

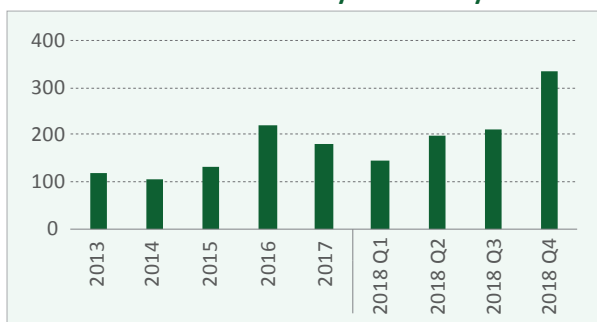
Chart 1.1: GDP Growth



Source: OECD, Author's Calculations

The United States was an exception to this trend, while some emerging countries faced sharp contractions. Growth in the US continued to trend upwards in 2018, in part boosted by the tax stimulus in 2018². Argentina and Turkey faced sharp slowdowns in economic growth amid depreciating currencies and continued budget deficits. Economic powerhouses such as China and India stand at odds; the latter appears to be growing higher than its 5-year average, while China has slowed down somewhat compared to historical trends.

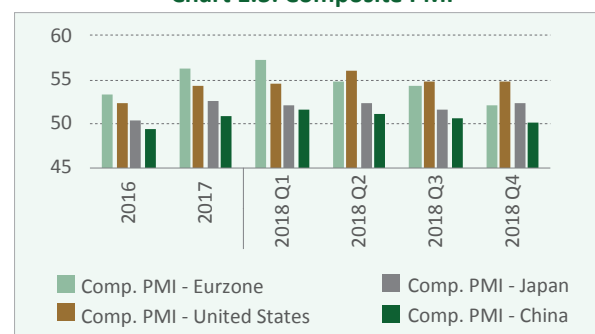
Chart 1.2: Economic Policy Uncertainty Index



Source: Baker, Bloom, Davis

Economic uncertainty ended the year at an all-time high. Baker, Bloom & Davis have developed a sentiment approach to assess uncertainty based on key economies. Their Economic Policy Uncertainty Index (EPI) measure correlates highly with both country-specific macroeconomic variables and equity market volatility (Chart 1.2). Slowing economic growth and the prospect of more protectionist trade policies are likely factors behind the increased uncertainty.

Chart 1.3: Composite PMI



Source: Bloomberg, Markit

Activity indicators were relatively stable throughout 2018. Chart 1.3 is a composite of the manufacturing and services purchasing managers index (PMI), and is often used as a proxy for economic activity. It can be noted that while most regions remained stable throughout 2018, there was a clear reversal in the Eurozone, where the PMI decreased somewhat during the latter part of the year.

China's PMI remained flat during 2018, but Chinese consumption has begun to decrease. A marked slowdown in China would have consequences for the Saudi economy. China is one of Saudi Arabia's largest trading partner and while it is still enjoying relatively high growth, it has been decreasing over 2018. The slower growth is further reflected in the sharp drop in automobile sales that occurred during 2018 (Chart 1.4), possibly indicating waning Chinese consumption growth.

¹ Based on IMF's WEO Classification.

² IMF 2018 GFSR

Chart 1.4: Chinese Automobile Sales y/y



Source: Bloomberg

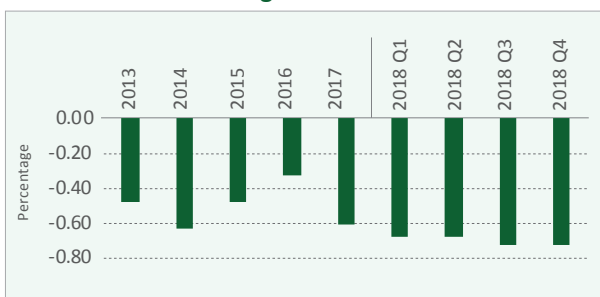
Chart 1.5: BBG Euro-Area Lending Index



Source: Bloomberg

Credit conditions in both Europe and the US remain accommodative. The slight slowdown in Eurozone growth has not resulted in a tightening of lending conditions. Banks' willingness to lend, as measured by the Bloomberg's Lending Index (Chart 1.5), was largely stable compared to 2017. The Chicago Fed Credit Sub-Index (Chart 1.6), which aggregates various indicators of credit conditions in the US, remained negative throughout 2018, indicating looser than average credit conditions.

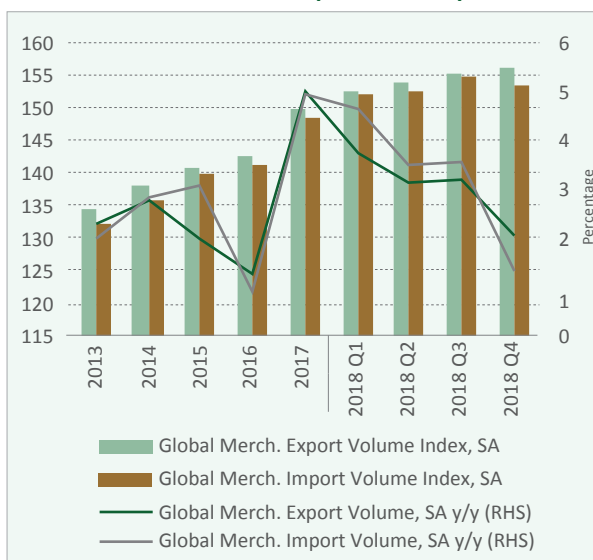
Chart 1.6: Chicago Fed Credit Sub-Index



Source: Chicago Fed

1.2 Trade and Inflationary Trends

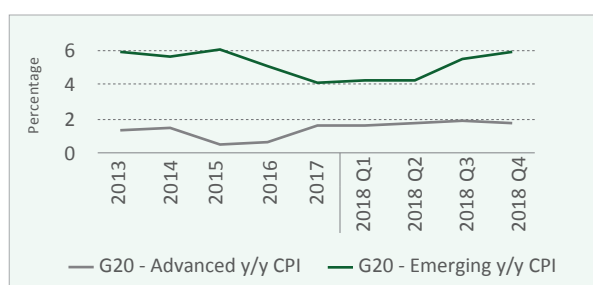
Chart 1.7: Global Exports and Imports



Source: WTO

Trade volumes continued to grow during 2018, but with a notable deceleration by the 4th Quarter (Chart 1.7). The uptick in trade growth during late 2017 through early 2018 may very well be a response to the growth in economic uncertainty, i.e. companies building up their inventories. If the deceleration in 2018 continues into the next year, this may prove to be an Additional headwind to EMEs.

Chart 1.8: Global Inflation y/y



Source: OECD, Author's Calculation

Both Emerging Markets (EMs) and Advanced Economies (AEs) reported an increase in inflation rates by the end of 2018. It is important to differentiate between structural and temporary factors, where the former involve tightness in labor and product markets and the latter exchange rate corrections or regulatory measures such as import taxes. Saudi Arabia is exposed to inflationary trends

in the US, and major trading partners.

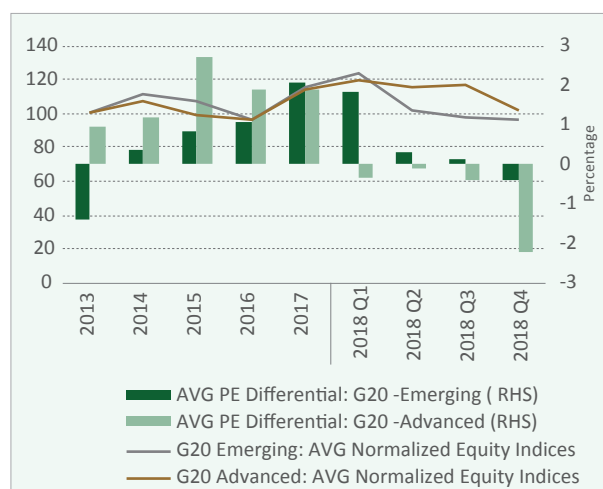
1.3 Global Markets

1.3.1 Equities

There was a notable repricing of equity assets in 2018. Chart 1.9 combines all G20 member countries classified by type of economy. Equities in emerging markets on average are now below their valuation in 2013, driven by steep stock market declines in some countries. Equity indices in most advanced economies also declined in 2018, following a very strong 2017.

As measured by the PE differential, stocks are largely valued in line with historic averages. The PE differential compares the current price-to-earnings ratio with its historic average. Emerging countries recorded a slightly positive differential by end of 2018, indicating a slight overvaluation despite the recent fall in prices.

Chart 1.9: Equity Valuations



Source: Bloomberg, Author's Calculation

1.3.2 Fund Flows

Exchange Traded Funds (ETFs) track a variety of indices and asset classes. This facilitates the study of movement of funds, which in turn may shed some insight into global investment behavior.

For the purpose of the analysis, ETFs that track the following were selected:

Equities

- Emerging Economies.

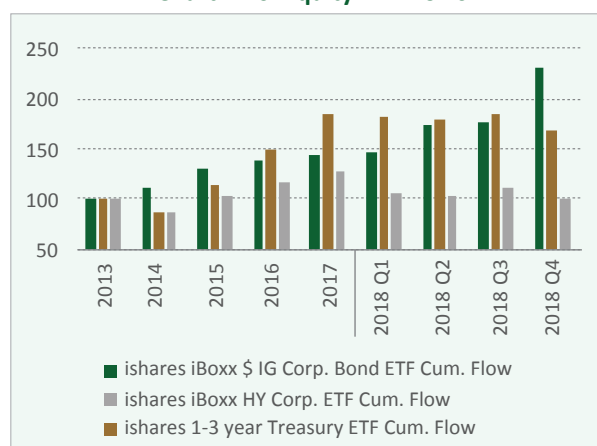
- Advanced Economies.

Bonds

- Short-term US T-Bills.
- Investment Grade US Corp. Debt.
- High Yield US Corp. Debt.

For each of the above categories, the most popular ETF in the market was considered. Fund flows were then analyzed on a cumulative basis, going back to year 2013.

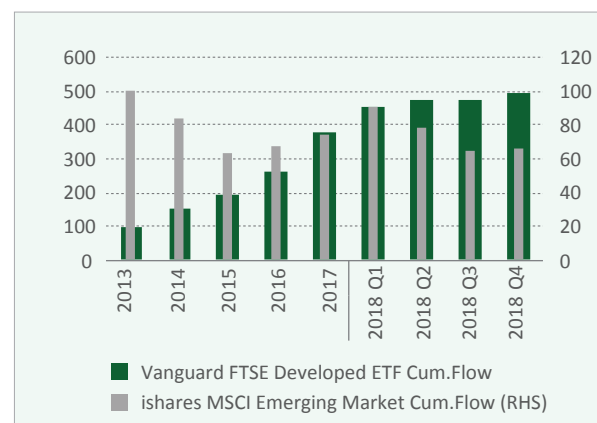
Chart 1.10: Equity ETF Flows



Source: Bloomberg, Author's Calculation

The notable decline in average EM indices mentioned earlier is reflected in the movement of funds out of ETFs that track MSCI EM index. The volume of funds have persistently declined throughout 2018 (Chart 1.10), while funds that track advanced economies have held relatively steady.

Chart 1.11: Fixed Income ETF Flows



Source: Bloomberg, Author's Calculation

Bond markets experienced an increasing flight to safety over 2018. ETFs that track relatively liquid and safe instruments, such as United States Treasuries recorded a significant inflow of funds throughout the year (Chart 1.11). The change in investor behavior was further highlighted in the increased yield spread between junk bonds and investment grade bonds. Any sharp deteriorations in global markets has limited impact on the Saudi Arabian banking system, due to the relatively small share of foreign assets in the banking system.

1.4 Developments in Global Interest Rates

Advanced economies reported a notable uptick in short-term interest rates during 2018, yet they remain relatively low. The uptick in rates largely stemmed from the United States as short-term rates in many European jurisdictions remained negative, reflecting the continuation of monetary accommodation. Rates in emerging markets remained stable overall but at elevated levels (Chart 1.12). As mentioned above, some EMs have had to tighten their monetary policy significantly to rein in inflation and currency depreciation.

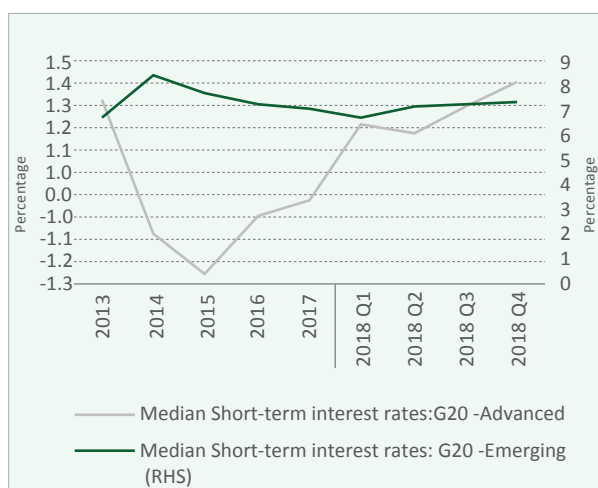
2019 Outlook

2018 ended at an all-time high in terms of uncertainty, most notably captured by equity movements. Growth in the upcoming year hinges on successful resolution of trade conflicts and other geopolitical issues.

Although trade threats have featured heavily over the past year, there has been no tangible impact on trade flows as of yet.

A key concern is the potential slowdown in Chinese growth, which would have a more pronounced impact for commodity reliant economies such as Saudi Arabia. China's growth factored heavily in the commodity price boom during the early 2000's, a slowdown in Chinese growth is a significant risk to commodity exporters.

Chart 1.12: Global Short-term Rates



Source: Bloomberg, Author's Calculation



2

DOMESTIC
MACRO-FINANCIAL
DEVELOPMENTS

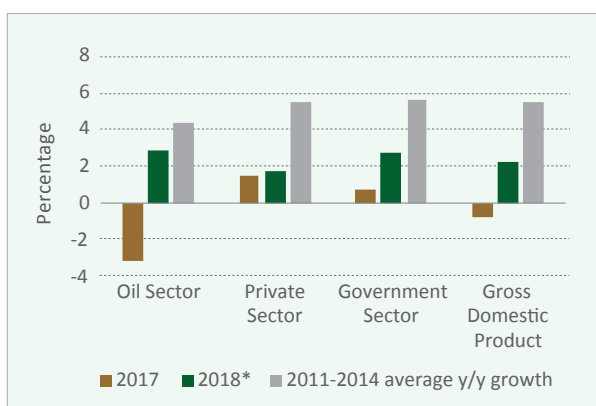
Domestic Macro-financial Developments

2.1 Growth developments

The Saudi Economy made a notable recovery in 2018, driven by the oil sector. Domestic output grew by 2.2 percent in 2018 compared to a decline of 0.7 percent in the previous year. The oil sector (Chart 2.1) grew by 2.9 percent due to both increased production and higher prices.

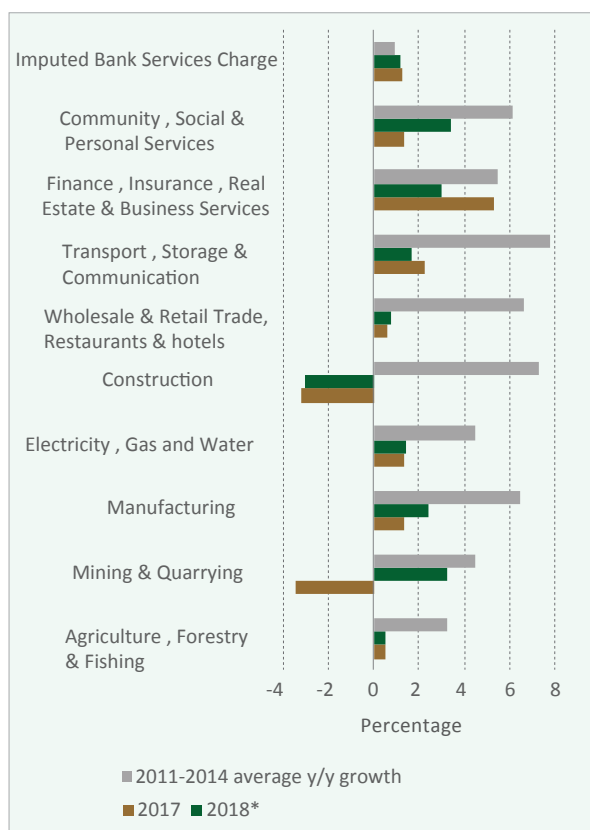
Growth in the private sector remains well below the most recent period of economic expansion. The private sector grew by a modest 1.7 percent in 2018 compared to the 2011 - 2014 average growth of 5.5 percent.

Chart 2.1: GDP Growth by Institutional Sectors



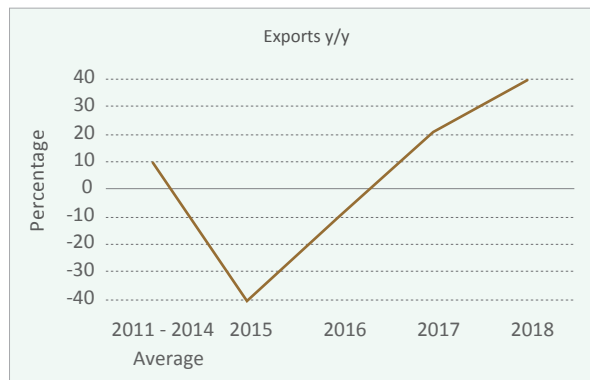
Different private sectors exhibited divergent growth rates in 2018. Finance & Insurance and Manufacturing, for example, grew at healthy rates while the construction sector continued to shrink (Chart 2.2). This was accompanied by reduced borrowing by developers, probably driven by both demand and supply factors as uncertainty prevails about the sector's growth potential.

Chart 2.2: GDP Growth by economic sector*



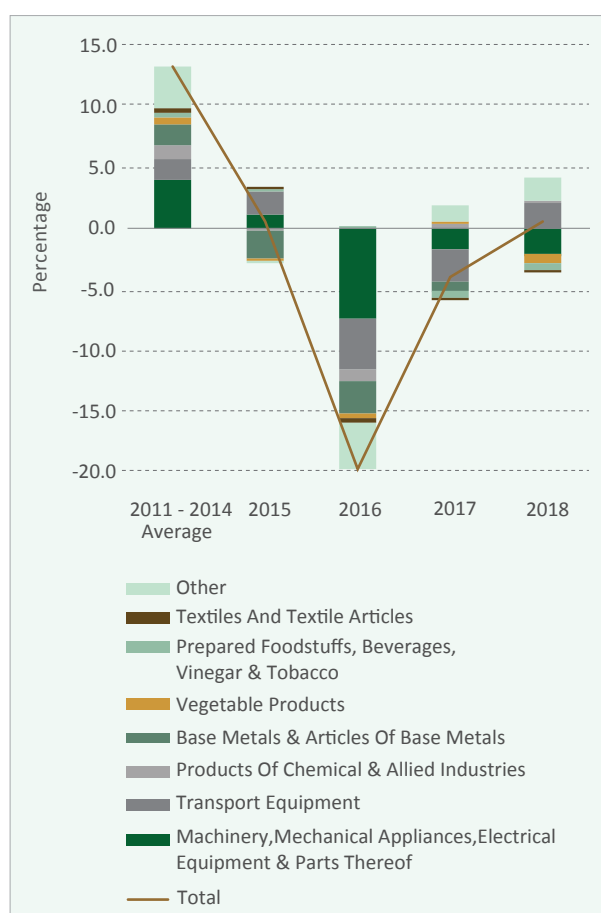
*Estimated

Chart 2.3: Export Growth



Exports recorded a significant boost on account of higher oil prices. In value terms, exports grew by some 40 percent between 2017 and 2018 (Chart 2.3). This has been boon to the Central Government, reinforcing the fiscal space and bolstering foreign capital.

Chart 2.4.: Import growth by Contribution



In line with the pickup in economic activity, imports also increased during 2018. The slight rebound in private sector growth was mirrored in imports, notably in transport equipment (Chart 2.4). When assessing historical contributions to growth, we note that during periods of sustainable economic growth, machinery and transport equipment were a key driver.

Retail consumption indicators point to a persistent increase throughout 2018. Both transactions and sales continue to grow at high rates, 46 percent and 16 percent respectively (Chart 2.5). A higher POS utilization rate (Chart 2.6), i.e. the average number of times each terminal is used, reflects a continued increase in cashless payments.

Chart 2.5.: Point of Sale performance

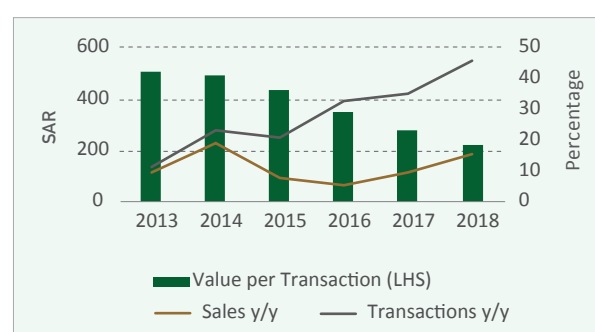
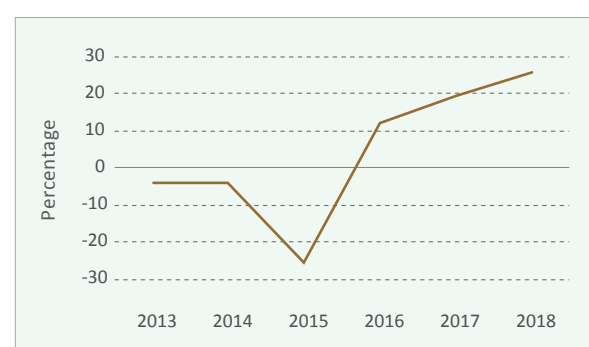


Chart 2.6: POS Utilization Rate

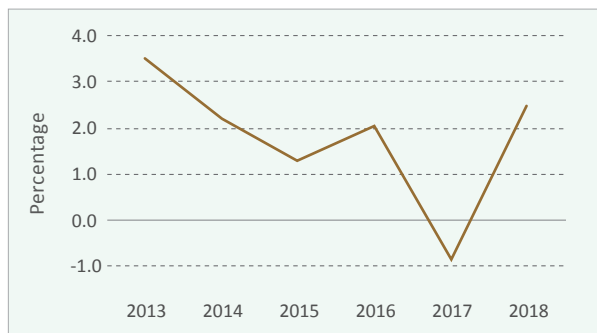


2.2 Inflation Trends

Inflation averaged 2.5 percent in 2018. One factor contributing to the jump in the inflation rate compared to the negative growth in price levels (-0.9 percent) experienced in 2017 was the introduction of several necessary fiscal measures such as energy price reform, the introduction of VAT, and the expat levy (Box 2.1).

Most components of the consumer price index showed an increase in 2018. Transportation, restaurants & hotels, and food & beverages drove some of the increases, which grew at 10.7, 8.1 and 6.5 percent respectively. As can be seen in the chart below, after the initial shock to prices in 2016, the inflation rate sharply came down during 2017. The increase in the inflation rate for 2018 is primarily driven by the VAT implementation (Chart 2.7). The rate is anticipated to remain subdued following 2018, due to low global food prices and declining domestic rental rates.

Chart 2.7: Annual inflation



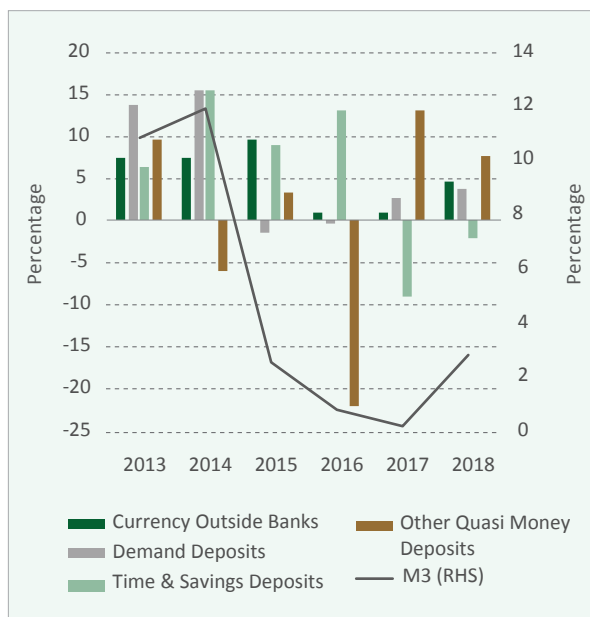
2.3 Monetary Developments

2.3.1 Monetary Aggregates

Most monetary aggregates increased slightly compared with the previous year. The monetary base recorded a growth rate of 3.2 percent compared to a decline of 0.2 percent over the last year. The broad monetary aggregate (M3) grew by 2.8 percent in 2018, reflecting the strong correlation between monetary aggregates and government expenditures.

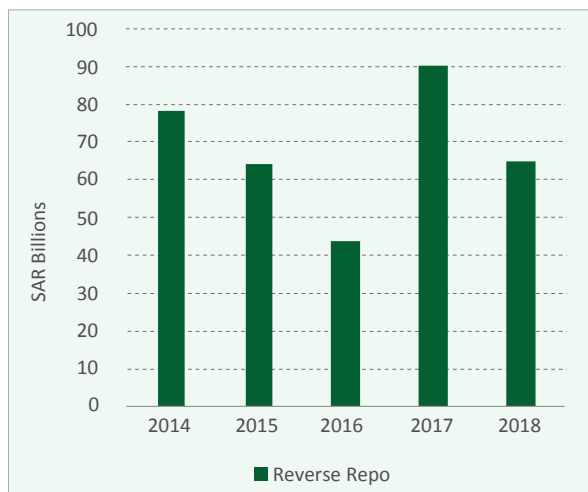
Among M3 components, demand deposits grew significantly while time and savings deposits continued to decline. Demand deposits, which represent over 50% of M3, recorded a growth rate of 3.8 percent in 2018 while other quasi-monetary deposits continued to grow at fast pace, albeit slower than in 2017. Chart 2.8 displays the evolution of M3 and its components over the past five years.

Chart 2.8: Currency Outside Banks



Reverse repo transactions dropped from the beginning of 2018. As in Chart 2.9, the monthly Average reverse repo stood at SAR 65 billion in 2018 compared to SAR 90 billion in 2017. Despite the decrease in Reverse Repo levels, they remain well-above 2016, a period that coincided with a brief tightening of liquidity.

Chart 2.9: Reverse Repo Transactions Performance



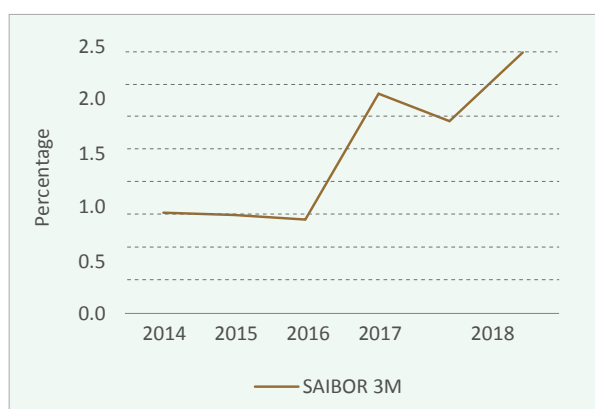
2.3.2 Monetary policy condition

The Saudi Arabian Monetary Authority (SAMA) is firmly committed in maintaining its exchange rate policy. The Saudi Riyal has been pegged to the US Dollar Since 1986 at the rate 3.75 per USD. The commitment to the currency peg underpins monetary and financial stability in Saudi Arabia and provides a predictable business

environment. During 2018, SAMA increased the rate of its reverse repo by 100 basis points in increments of 25 basis points, in line with rate increases by the US Fed, resulting in a reverse repo by end-year of 2.5 percent.

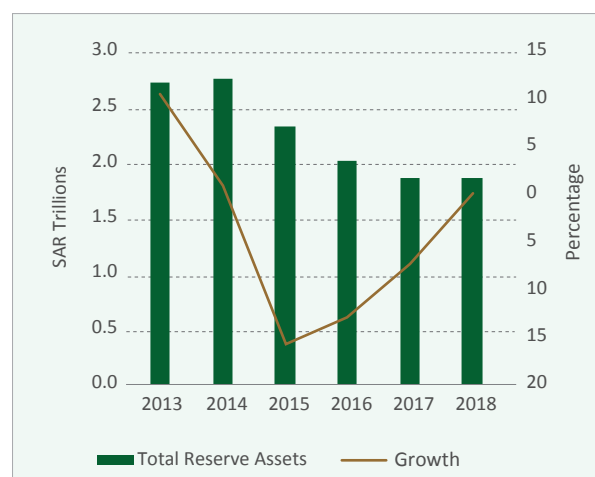
The 3-month Saudi Arabian Interbank Offer Rate (SAIBOR) increased in 2018, in response to the hike in monetary policy rate. As Chart 2.10 illustrates, the SAIBOR increased during 2018 and averaged 2.45 percent, reflecting monetary normalization in the United States. However, rates remain far below historical averages. Furthermore, as can be noted in the Real Sector (Section 2.8); even further increases during 2019 may only have a limited impact on domestic growth given the limited level of debt in most publicly listed companies.

Chart 2.10: Saudi Interbank Offer Rate (SAIBOR)



In 2018, SAMA's total foreign reserve assets slightly increased for the first time since 2014. SAMA's foreign reserve assets by end of 2018 were about SAR 1,862 billion, up from SAR 1,861 billion in 2017, compared to a decline of 7 percent in 2017 (Chart 2.11). Current reserves are sufficient for approximately 40 months of imports. Thus, it can be concluded that the current foreign reserves held by SAMA would soften any external shock.

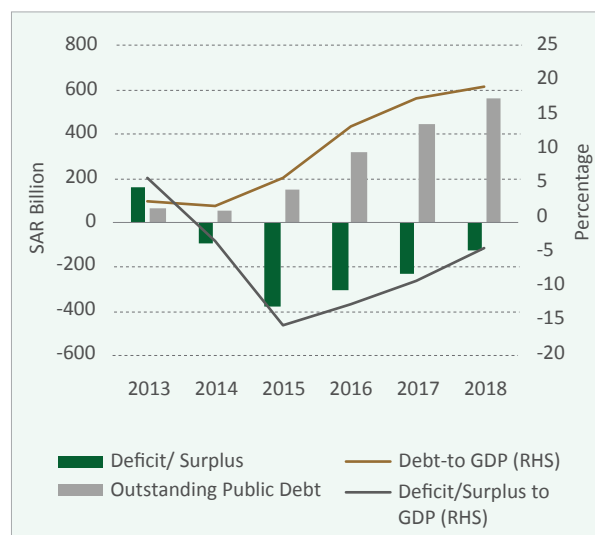
Chart 2.11: Total Reserve Assets



2.4 Fiscal Developments

The government budget improved in 2018 as a result of fiscal reforms and higher oil prices. The estimated government budget deficit reached SAR 136 billion, or 4.6 percent of GDP. This was a marked improvement on the 9.3 percent deficit in 2017 (Chart 2.12), reflecting the government's commitment to attaining fiscal balance by 2023.

Chart 2.12: Fiscal Developments

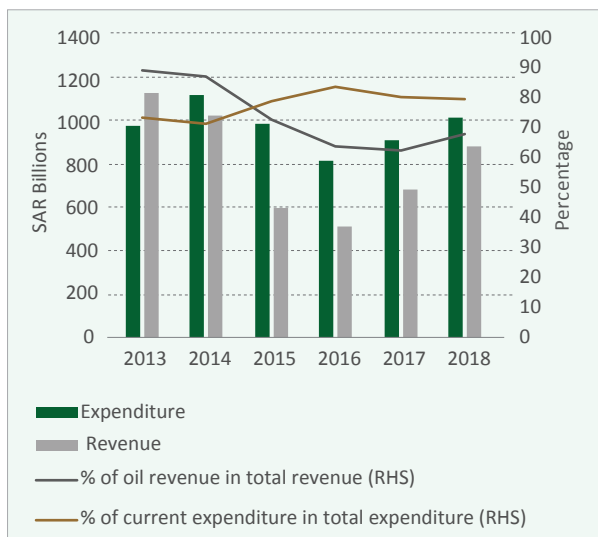


Government revenues increased significantly in 2018 from both the oil and non-oil sectors. Total revenue reached SAR 895 billion in 2018, an increase of almost 30 percent compared to the previous year. Non-oil revenue amounted to SAR 287 billion, of which tax revenue represented some SAR 166 billion, an increase of almost 90 percent on the previous year. Despite the marked success in

raising non-oil related revenues, due to initiatives such as the introduction of VAT and energy price reforms, the country remains largely reliant on oil receipts which still represent a big chunk of the total government revenue. (Chart 2.13)

Government expenditures increased by 11 percent to approximately SAR 1 trillion in 2018. Current expenditures grew by 10 percent, reaching SAR 825 billion in 2018. Salary expenses are the main component of current expenditures, constituting some 57 percent. Capital expenditures reached SAR 205 billion by the end of 2018, demonstrating growth of 14 percent compared to the previous year. Expenditures also reflect the continuance of 1,000 SR inflation allowance, along with various measures to boost private sector activity.

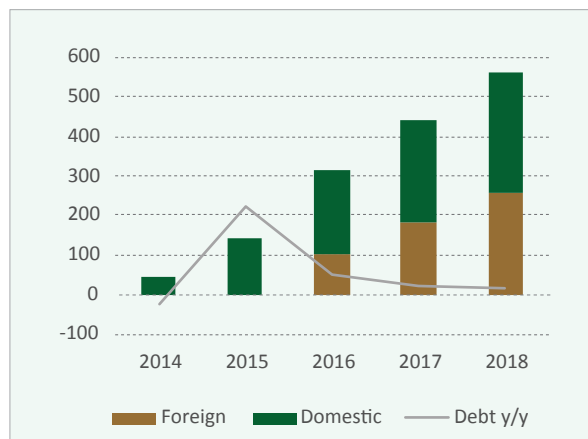
Chart 2.13: Revenues and Expenditures



The government financed its deficit through debt issues and drawdowns of foreign reserves. Public debt continued to increase and reached approximately SAR 560 billion or 19 percent of GDP by end of 2018. All debt issuances were oversubscribed and received high attention from investors; reflecting confidence in the Saudi economy. In addition, the success of international issuances allowed the government to diversify its debt across markets and categories.

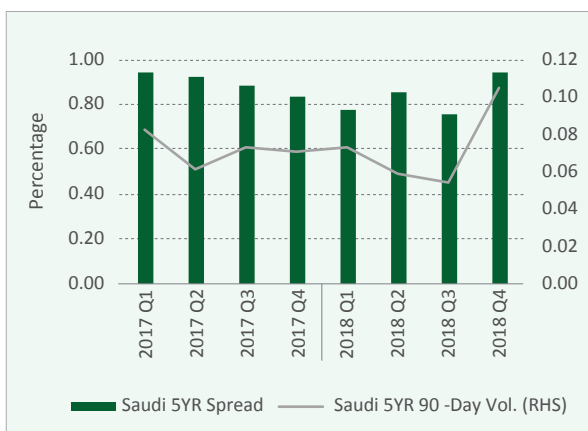
The share of foreign sovereign issuances increased in 2018, however domestic issuances still account for the majority of the government's debt exposure. Domestic issuances accounted for roughly 54 percent by the end of 2018. Foreign issuances are denominated in USD (Chart 2.14), meaning that foreign exchange risks are effectively contained by virtue of the SAR-USD peg.

Chart 2.14: Outstanding Saudi Sovereign Debt



Yield volatility on international bonds increased at the end of 2018. 30-day rolling volatility of daily yields on the 5-Year Saudi International bond increased during the last quarter of 2018 (Chart 2.15), coinciding with an uptick in the spread between Saudi paper and US paper of a similar tenor.

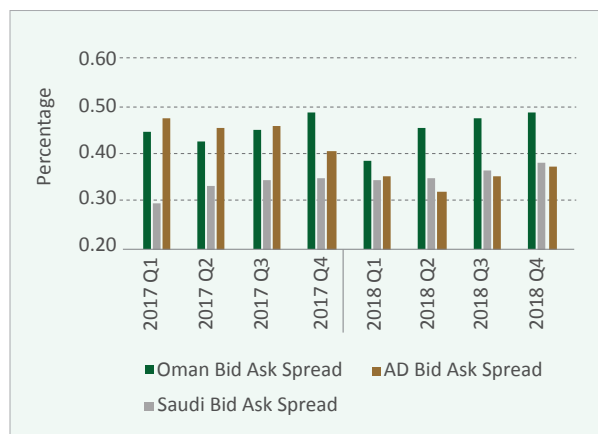
Chart 2.15: Five Year Saudi Sovereign Volatility and Spread



Spreads on sovereign issuances (the spread between similar GCC issuances and US issuances of a similar maturity) amongst GCC peers has begun to converge by the end of 2018.

Among regional sovereigns, Saudi Arabia had the tightest spread in early 2017 which increased during 2018 to be in line with its peers (Chart 2.16), with the exception of Oman.

Chart 2.16: GCC Bid-Ask Spread for 5-Y International Debt

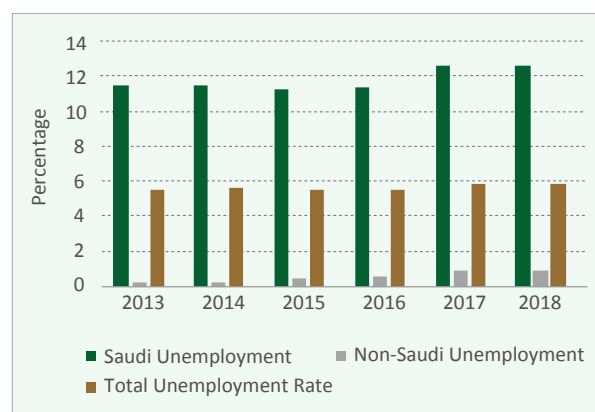


2.5 Labour Market Performance

Unemployment continues to be a challenge for the Saudi economy. The average Saudi unemployment rate for the year was maintained at 12.8 (Chart 2.17). It should be noted that when assessing 4th quarter labor developments, there was an improvement in unemployment relative to Q4 2017. The improvement was due to a notable decrease in the Saudi male unemployment rate, from 7.5 percent to 6.6 percent between Q4 2017 and Q4 2018, while the female unemployment rate increased, from 31 percent to 32.5 percent. However, unemployment has remained relatively constant over the past 5 years.

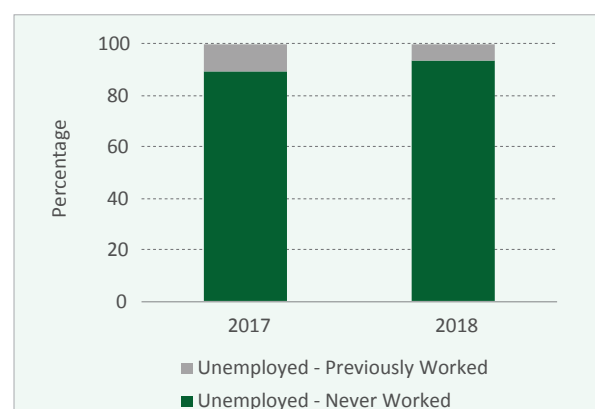
Initiatives to reduce unemployment among Saudis continue. These initiatives are a continuation of the labour market reforms that have been implemented over the past years, aimed at attracting more Saudis into the private sector by enhancing work conditions and augmenting the skill set of potential Saudi employees.

Chart 2.17: Unemployment Rate

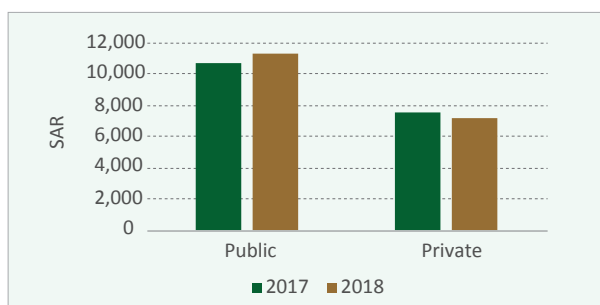


More nationals are entering the labor force but job creation in the private sector has so far been limited. As noted in Chart 2.18 most of the unemployed nationals have never held a job previously, which highlights a key challenge for the domestic labor market.

Chart 2.18: Unemployment History

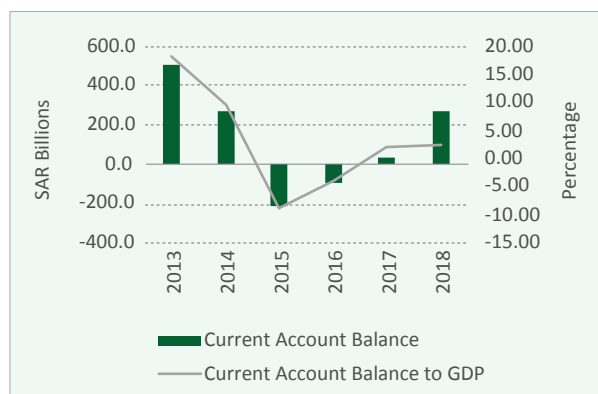


Public sector wages slightly increased relative to 2017. As of 2018, public sector wages grew at an annualized rate of 5 percent by Q4 (Chart 2.19). Public sector growth can possibly be attributed to private sector employees entering the public sector at higher wages; furthermore, this may indicate some subtle changes in the domestic labor market. On the other hand, private sector wages recorded a decrease of roughly 5 percent as of Q4 2018.

Chart 2.19: Average Wages

2.6 External sector

The current account recorded a significant improvement by the end of 2018. Estimated data suggests that there could be a surplus of SAR 271 Billion, 2.7 percent of GDP, compared with a surplus in 2017 of SAR 39 Billion (Chart 2.20). The improvements in the current account in 2018 are primarily driven by a higher oil price and increased production.

Chart 2.20: Current Account

2.7 Saudi Economy Growth Outlook and Risks

The medium-term domestic growth outlook has improved. Economic growth is expected to pick up during 2019. Oil prices dropped sharply in the last quarter of 2018 but have rebounded in the first months of 2019. For the non-oil sector, growth is expected to be stimulated by expansionary fiscal policy, as the budget for 2019 shows a significant increase in capital expenditure by SAR 245 billion.

However, there are signs of slower global growth. The main downside risk for the Saudi economy comes from the global oil market. The

oil sector accounts for around 45 percent of total GDP and for more than 63 percent of government revenue. As outlined in Chapter 1, there have been recent signs of slowing global growth, which could indirectly impact the Saudi economy.

Continued structural reforms will likely place some pressure on economic growth in the short term. The government has introduced some initiatives to mitigate the negative impacts, especially for low- and middle-income households.

Overall, the Saudi economy remains quite resilient against contagion from growing uncertainty in the global economy. High levels of foreign reserves and a low level of public debt mean that there is ample fiscal space to counter an economic downturn. This being said, in the longer term it is vital that initiatives to strengthen and diversify the Saudi economy continue in line with the economic aspirations of Vision 2030.

2.8 Real Sector Developments

2.8.1 Publicly listed companies

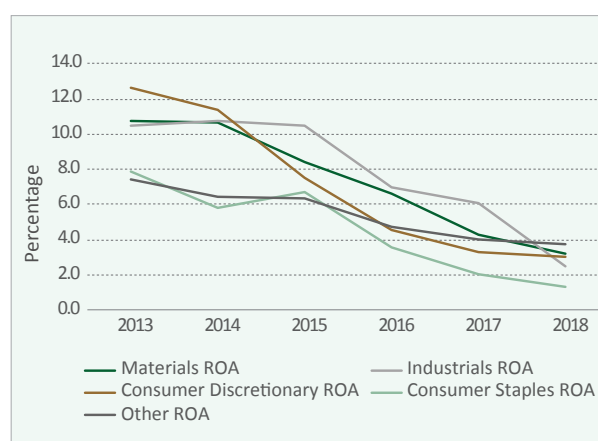
Publicly available information from companies listed on Tadawul are used as a basis for the analysis, and financial statements of these companies are used in order to track key indicators across the different sectors. A similar approach to the one followed in the 2018 Financial Stability Report is used. The approach includes taking a sample of listed companies and excluding banks and insurance companies from the analysis.³ The resulting sample had the sectoral distribution below.

Sector	Sample Size
Materials	31
Industrial	12
Consumer Discretionary	15
Consumer Staples	10
Other - Health Care	5
Other - Financials	2
Other - Telecommunication	3
Other - Energy	3
Other - Utilities	1
Other - Real Estate	2
Total	84

2.8.2 Profitability

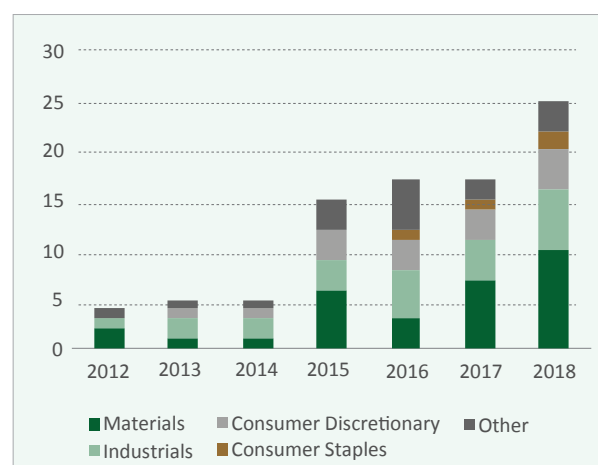
Despite the pick-up in economic activity and the rebound in oil prices, returns across all sectors have continued to decrease. There has been a marked downward trend in profitability across all sectors in our sample (Chart 2.21). The decline in return on assets was most apparent in the consumer discretionary sector, which may reflect rising input costs.

Chart 2.21: ROA by Sector



In line with declining Return-on-Assets (ROA), the number of loss-generating corporates among publicly listed companies have also continued to increase. During 2012, only 5 percent of the sample companies were loss-generating compared to 24 percent by 2018. Prior to 2015, losses appeared to be contained primarily within the Materials sector, while in recent years all sectors have been affected (Chart 2.22). Despite the increase in losses, interlinkages to the financial system are relatively minimal, given the low levels of debt in domestic companies' capital structure.

Chart 2.22: Number of Company Losses by Sector

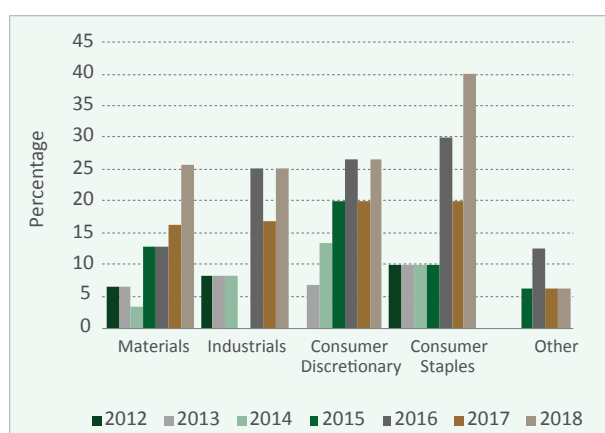


When accounting for the sample composition, consumer related sectors had the highest proportion of loss-making firms. Chart 2.23 plots the portion of loss generating firms within each sector, and each color denotes a specific year. It can be noted that most sectors reported a higher proportion of companies recording losses. Within the industrial sector, losses appear to be compa

³ In addition, companies with missing reporting during the period 2012–2018 and/or that missed key data points have also been excluded.

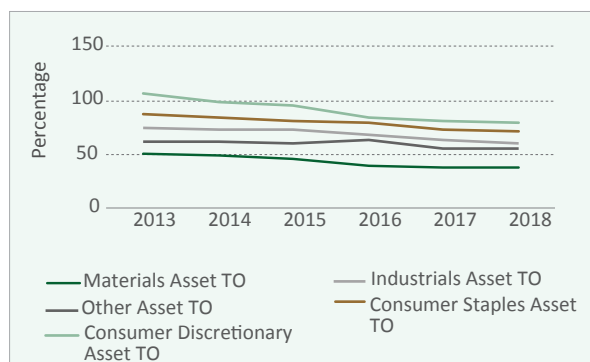
nies most heavily associated with domestic capital investment. Given the anticipated expansionary fiscal policy during 2019, we may note an improvement in their financial position and growth in lending to companies associated with the industrials sectors. The decline in both the consumer discretionary and staples sectors may be partially explained by departure of expatriates, which effectively raised operating costs for firms and reduced demand.

Chart 2.23: Proportion of companies that were loss-making by sector and year



Efficiency across sectors has stayed relatively stable during 2018. Efficiency is measured by the asset turn-over ratio and captures a firm's ability to generate revenue from its assets. Revenue generation per asset has stabilized and increased in some sectors relative to 2017 (Chart 2.24). The stabilization reflects the slowdown in total asset growth relative to previous periods, possibly in response to a decrease in capital investment in some sectors, and pullback in consumption.

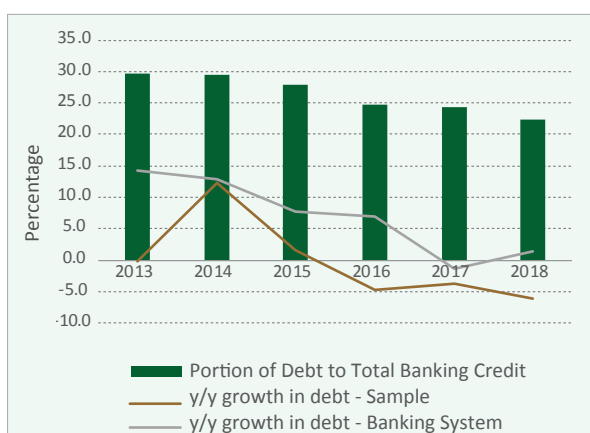
Chart 2.24: Asset turnover by Sector



2.8.3 Debt

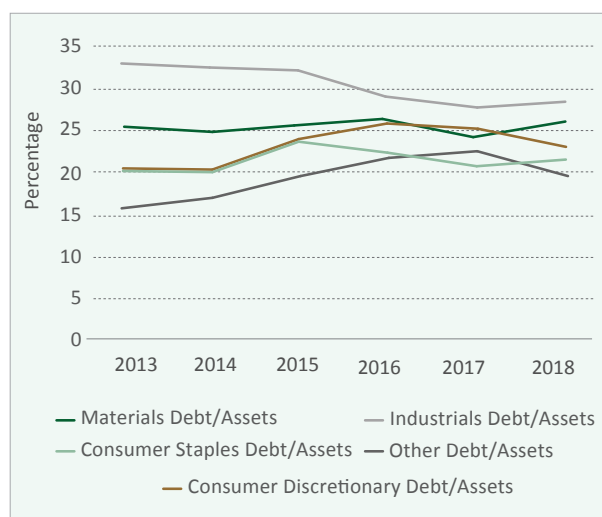
Despite the return to positive credit growth in the economy as a whole, the companies in our sample noted a continued contraction in their debt during 2018. The trend in debt growth diverged during 2018 (Chart 2.25), which is largely due to the fact that retail mortgages have been a strong driver of credit within the banking system during 2018.

Chart 2.25: Debt in sample relative to System



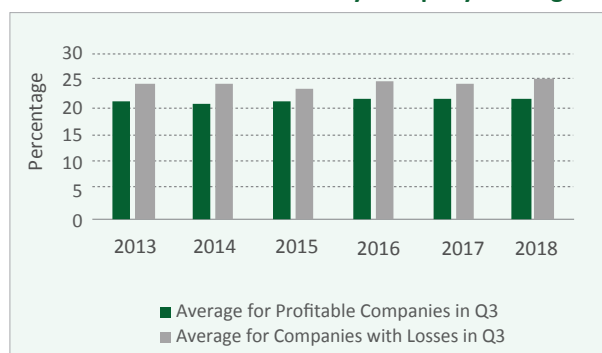
Debt as a portion of assets remains comfortably low across all sectors. The ratio ranges from roughly 18 percent to 24 percent across sectors (Chart 2.26). Given the subdued growth in assets, the stability in the ratio may indicate firms deleveraging.

Chart 2.26: Debt-to-asset ratio by Sector



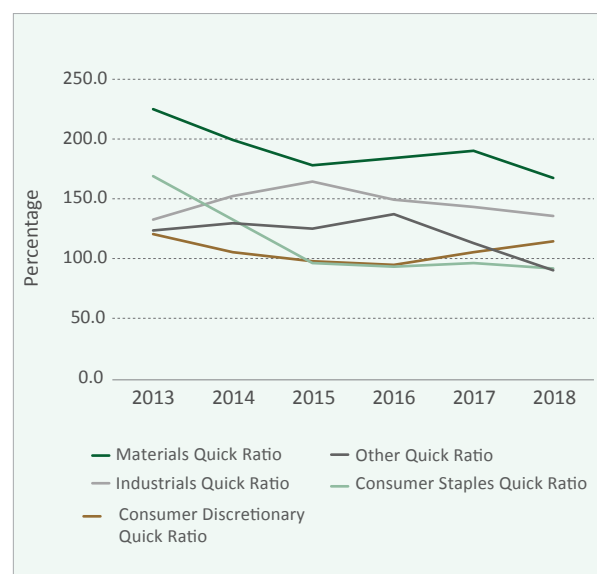
Companies that recorded losses by the end of 2018 tend to have a higher portion of debt. This is true in particular for some companies within the materials sector. The relatively high levels of debt (Chart 2.27) in these companies may indicate some of the slowdown in corporate credit may be due to risk aversion, given the high levels of debt.

Chart 2.27: Debt to Assets by Company Earnings



Measures of liquidity appear to have stabilized during 2018. Most sectors find themselves in a comfortable position even when using a strict definition of liquidity that excludes inventory (Chart 2.28). The vast majority of companies have a Quick ratio over 100%, i.e., enough liquid assets to meet their current liabilities.

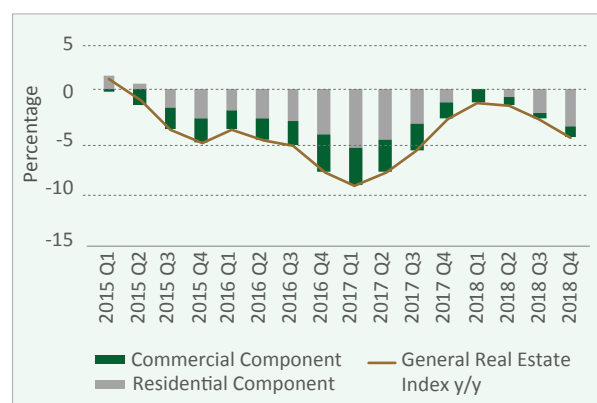
Chart 2.28: Quick Ratio by Sector



2.8.4 Real Estate Developments

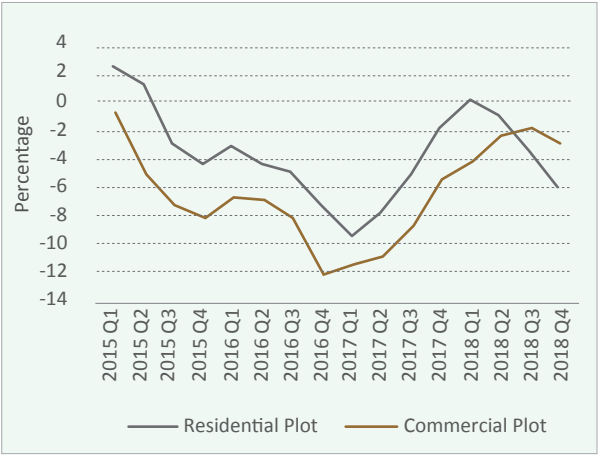
The decline in real estate prices continued throughout 2018. Following a near-stabilization by late 2017, real estate prices resumed their negative growth throughout 2018, driven by residential home prices. The real estate index as captured by General Authority for Statistics (GASTAT) is displayed in Chart 2.29.

Chart 2.29: Real Estate Index



Mirroring the development in real estate prices, prices for plots of land also decreased in 2018. The continued trend of price declines (Chart 2.30) may be attributed to excess supply in the residential market. The decline in prices has partially contributed to the recent rebound in mortgage lending.

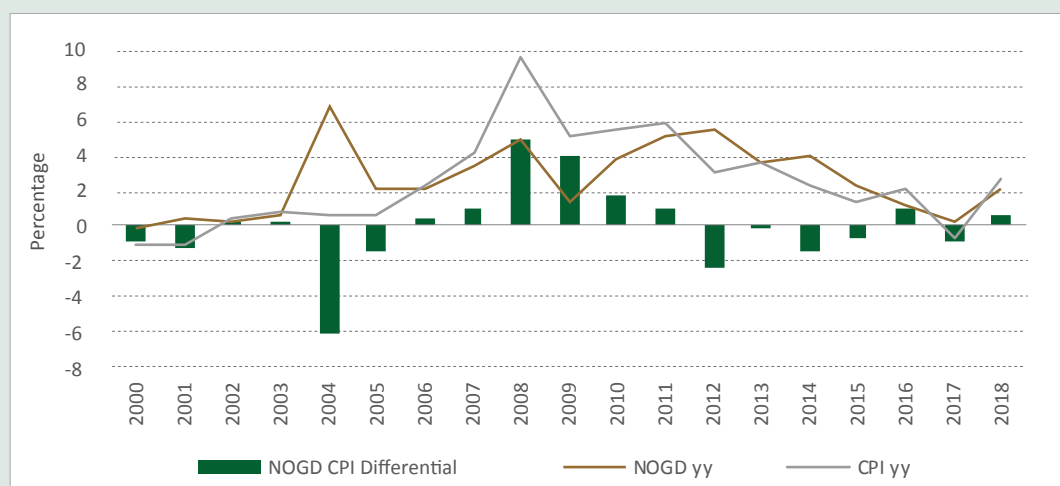
Chart 2.30: Commercial and Residential Plots y/y



Box 2.1 An Overview of Different Price Measures in Saudi Arabia

This box aims to explore the interrelations between different measures of price levels in Saudi Arabia; namely, non-oil GDP deflator (NOGD), Consumer Price Index (CPI), Wholesale Price Index (WPI) and average prices as given by Point of Sale (POS) data. We opt to focus on the Non-oil GDP Deflator as opposed to Total GDP due to the significant proportion of oil-sector related to production, which obfuscates domestic price levels.

Chart 2.31: Non-Oil GDP Deflation and CPI y/y



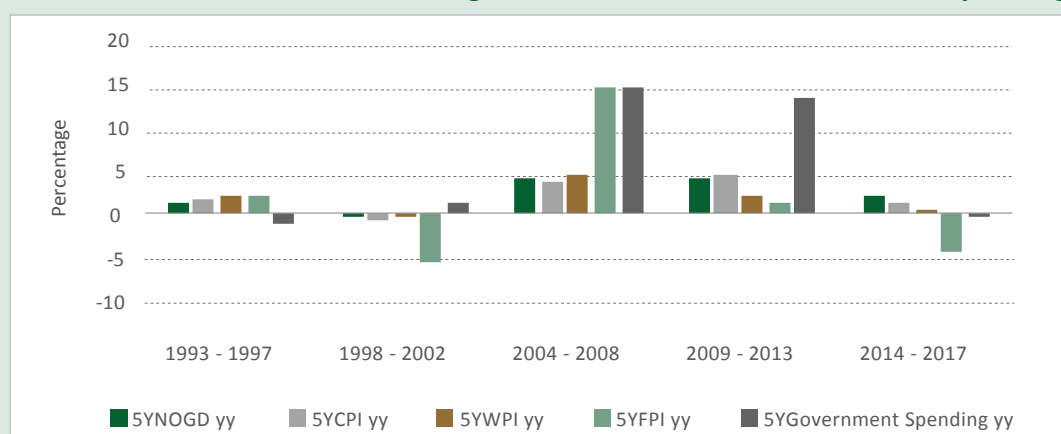
Source: SAMA, GASTAT

NOGD and CPI

NOGD and domestic price levels tend to move mostly hand in hand. However, when we consider strong differentials in price movements as noted in 2004, 2008, and 2009, they may shed insight on different factors. The earlier part of the series coincided with the beginning of Saudi Arabia's economic boom during the 2000's, the sharp uptick in NOGD in itself during 2004 reflects an increase in domestic economic activity, which contain non-oil exports. The sharp difference may reflect the prices of non-oil goods Saudi Arabia exported as opposed to domestic price levels. It also sheds insight on the persistence of subdued price levels in the domestic economy.

While 2008-2009 culminated with the Global Financial Crisis, which resulted in a sharp downturn in commodity prices by 2009; the sharp slowdown in economic activity did not materialize in domestic price levels. The differential can be explained by domestic factors that may have resulted in inflationary pressures, but with the ultimate benefit of warding off a non-oil GDP recession in Saudi Arabia; government spending remained strong during 2008 and 2009; where current expenditure averaged around 15 percent y/y.

The following years, 2011-2018, NOGD and CPI moved in tandem despite the volatility in oil prices, and a series of fiscal reforms; there was no apparent disconnect between the two measures. In closing, the NOGD measure of inflation is a closer approximation of price levels as opposed to Total GDP due to the large impact of oil prices on Total GDP.

Chart 2.32: 5-Year Averages of Price Levels and Government Spending

Source: SAMA, GASTAT, WB, FAO

Determinants of Inflationary Trends

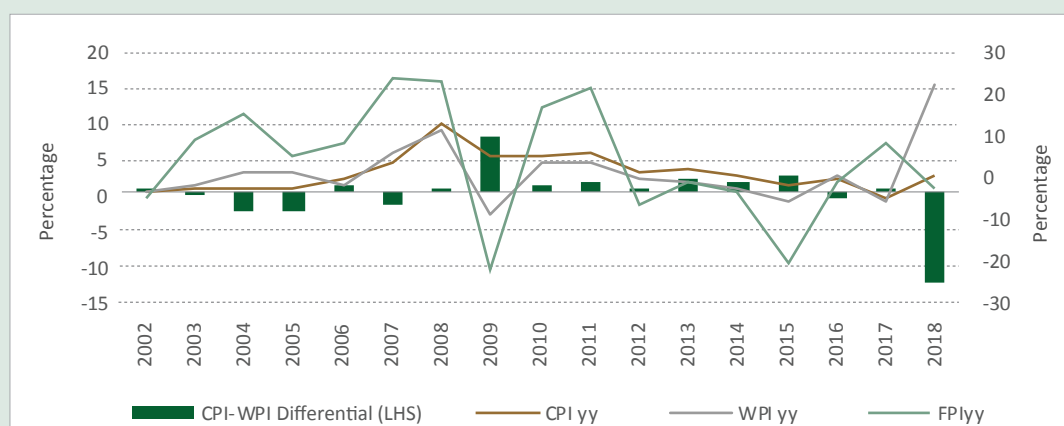
Chart 2.32 further explores the CPI alongside a set of relevant indicators, namely:

- 5Y NOGD YY: 5-year average of Non-Oil GDP Def. annual changes.
- 5Y WPI YY: 5-year average of Wholesale Index annual changes.
- 5Y CPI YY: 5-year average of Consumer Price Index annual changes.
- 5Y FPI YY: 5-Year average of Global Food Price Index annual changes.
- 5Y Government Spending: 5-year average of annual changes.

CPI tends to move with fiscal developments as a domestic factor, and food price changes as an international factor. It can be noted the years between 1993 and 2002 coincided with a period of relatively muted economic activity, which in turn implied generally subdued government spending. Indeed, the fiscal cuts following the '98 oil market downturn resulted in a persistent deflationary environment, which lasted until 2001, where it was positive but below 1 percent y/y growth. This period also coincided with sharp contractions in food prices, which may have weighed on the domestic price level. This is further captured in the WPI, which was also growing at sluggish rates.

In the following years, 2004 – 2008, marked a period of consistent economic growth in Saudi Arabia; government spending was ample, which materialized in an increase in system liquidity. The commodity price boom also meant sharp increases in global food prices, where we can note that WPI was relatively elevated during that period, and that materialized in an increase in consumer price levels.

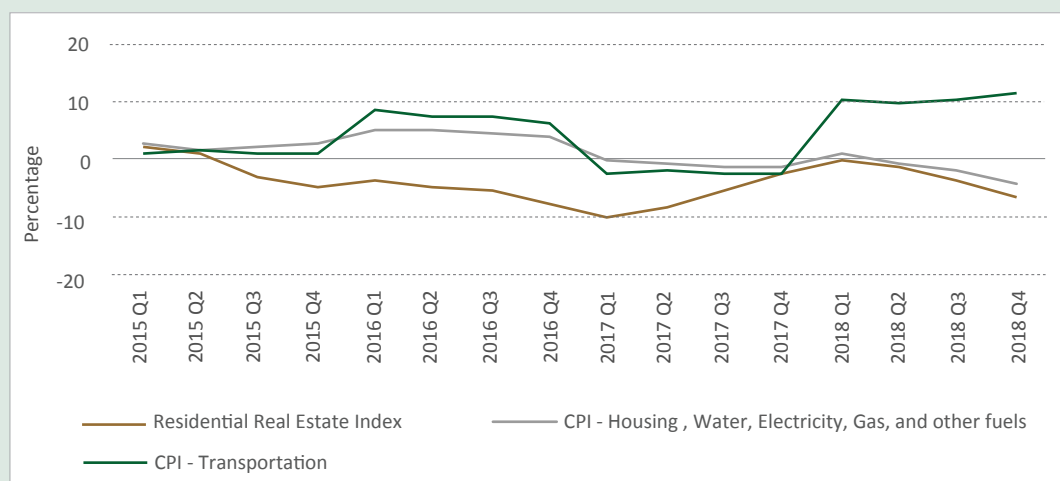
Chart 2.33: CPI and WPI y/y



Source: GASTAT, FAO

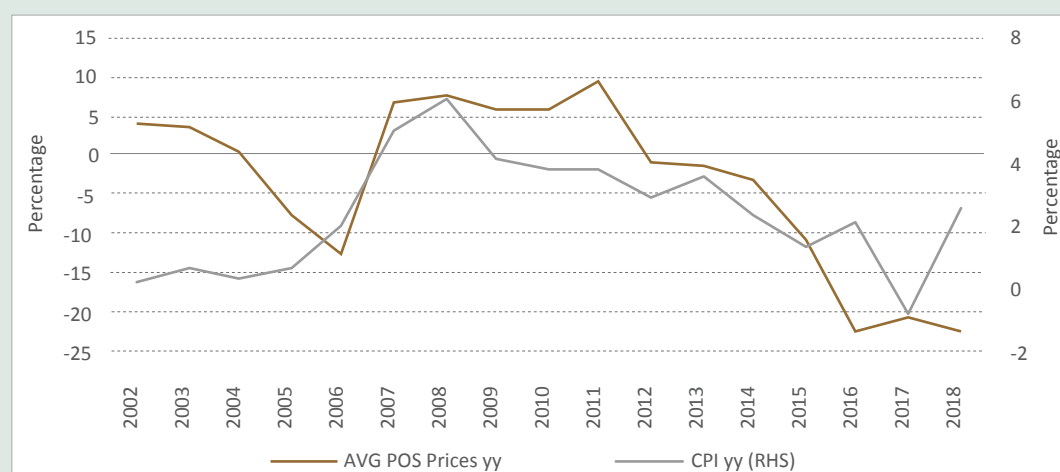
Chart 2.33 displays both consumer and wholesale price movements, along with the differential between both measures. The notable increase in domestic consumer price levels moved in line with wholesale prices. However, by 2009 it was evident there was a steep contraction in global food prices, which materialized itself in a sharp reduction in the WPI. While CPI did ease somewhat by 2009, the cost savings in wholesale prices were not immediately transferred over to consumers. The differential between the CPI and WPI continued to be positive up to 2016, i.e. consumer prices growing at greater rates than wholesale prices. Factors that may explain the persistence in domestic inflation could be related to the continued government spending as captured in the 5-year averages, where government spending held steady through-out the period. In contrast, inflationary pressures witnessed during 2016 and 2018 are not attributed to factors that contribute to domestic growth, but largely due to fiscal reforms such as adjustment of energy prices in 2016 and 2018, in addition to the introduction of the VAT by 2018.

A significant component of the CPI are Housing and Utilities accounting for roughly 25 percent of the basket, where it is influenced by both energy prices and residential rentals. It can be noted that during the past 4-years residential real estate prices have notably declined; however, it only materialized in the CPI by 2018. This category as previously mentioned is influenced by energy prices, where energy also influences the transport sub-component of the CPI.

Chart 2.34: CPI Sub-component and Residential Retail y/y

Source: GASTAT, FAO

Both the Transport, and Housing & Utilities categories increased in 2016; however, only the former responded to the increase in energy prices in 2018. This can partially be explained by the lagged response to rental prices to real estate market developments, by December 2016 rental prices as per the CPI were growing at a rate of roughly 2.4 percent, while by December 2018, rentals contracted by approximately 8 percent. We can then deduce the developments in real estate market in terms of the value of land and houses do not immediately materialize in an adjustment of rental prices.

Chart 2.35: Average POS Prices y/y and CPI y/y

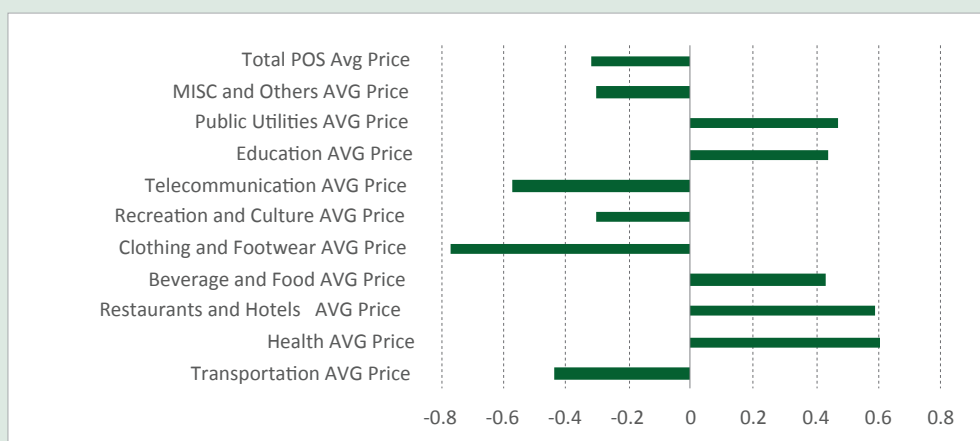
Source: SAMA, GASTAT

Average prices as given by POS transactions (Value over Volume) appear to move in line with domestic prices up to 2015. AVG POS prices have been on a consistent decline since 2012 and sharply contracted during the 2012-2018 period, decreasing from -1 percent to -22 percent by 2018. The sharp decline in average prices by POS can partially be explained by the growing prevalence of POS terminals, where the basket of goods that underpin POS activity may have changed over the past few years to include cheaper items. Despite the contractions, the trend moves in line with domestic consumer Prices. However, by 2016 we note some volatility in

consumer prices that was not apparent in POS prices.

To further capture how POS activity maps to the CPI, we compare the correlations between sectoral POS transactions to their respective CPI component from 2016 – 2018 on a monthly basis. It should be noted that Public Utilities was mapped to Housing and Utilities, therefore it fails to capture rental prices. The strongest negative correlation is in the clothing and footwear, registering -0.77; however, this occurred during a period of disconnect between POS and CPI activity as shown in Chart 2.36. Going forward, POS data may be a useful indicator to gauge domestic price trends on a more frequent basis.

Chart 2.36: Sectoral Correlations between POS and CPI



Source: SAMA, GASTAT

In summary, beyond the temporary price distortions caused by fiscal reforms; domestic price levels are motivated by a set of global and domestic factors. On the global front, food prices weigh heavily on domestic price levels along with oil prices, which influence the level of domestic government spending. Rental prices, given their weight in the index, have a clear impact on the domestic price level, which is expected to weigh down on inflationary trends over the next year.

3

BANKING

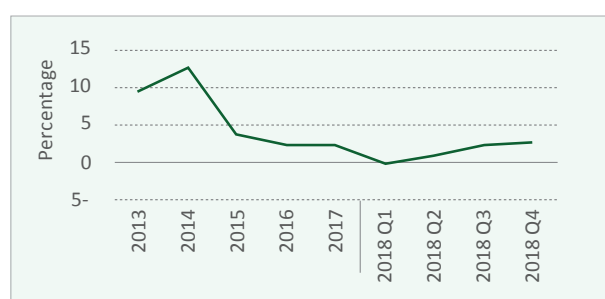
SECTOR
DEVELOPMENTS

Banking Sector Developments

3.1 Assets

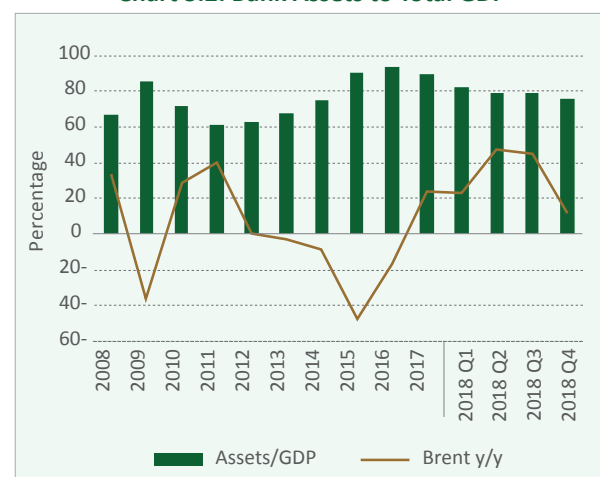
Banking sector assets grew consistently throughout 2018. A slight contraction during the first quarter was mainly driven by a reduction in bank reserves given the sluggish growth in deposits. By year-end, asset growth reached 2.5 percent year-on-year (Chart 3.1), the highest level of growth since 2015. The pick-up in assets can be attributed to the return to positive credit growth during 2018. On foot of continued planned government spending, asset growth is expected to continue throughout 2019.

Chart 3.1: Asset Growth (Y/Y)



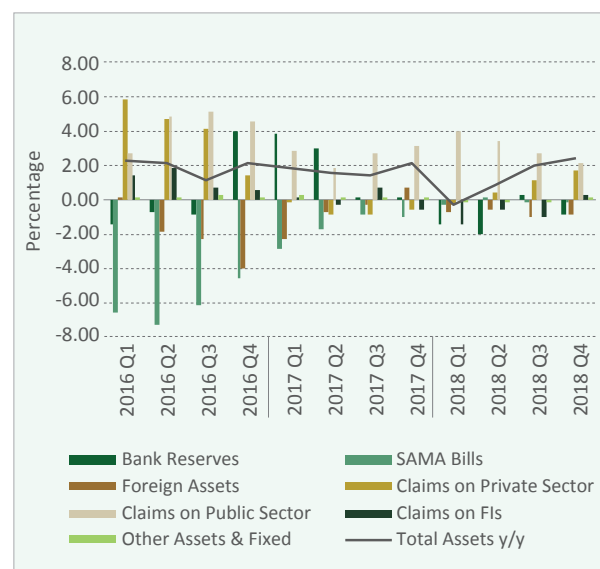
Asset growth is expected to benefit from the pick-up in oil prices (Chart 3.2). Brent oil prices reached a high of 84 USD in 2018, the highest since late 2014. High oil prices positively impact overall economic growth, while the effect on banking assets is indirect through government spending. The relationship between oil prices and the bank assets-to-GDP ratio is usually negative, as GDP reacts more strongly to oil prices.

Chart 3.2: Bank Assets to Total GDP



The year 2018 noted favorable developments in the asset composition of the banking sector. Claims remains the main source of asset growth (Chart 3.3), but there was also a positive contribution of private claims after sequential contractions since the fourth quarter of 2016. The increase in private sector claims is in line with the market expectations as government stimulus packages start to unfold and are expected to further increase in 2019.

Chart 3.3: (Y/Y) sectoral contribution to asset growth

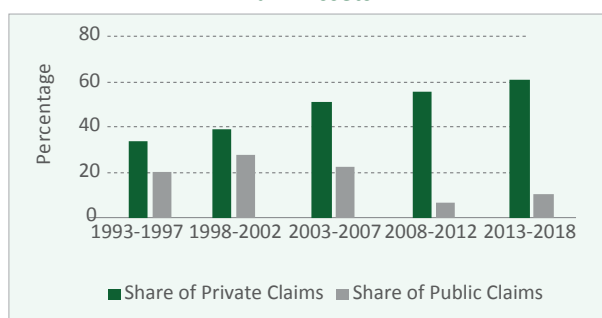


3.2 Credit

Bank credit recorded an uptick in 2018, after a period of contraction. Credit growth has largely been driven by retail lending while corporate credit remains sluggish. The share of private claims of banks' asset portfolio has been growing consistently and now constitute some 60

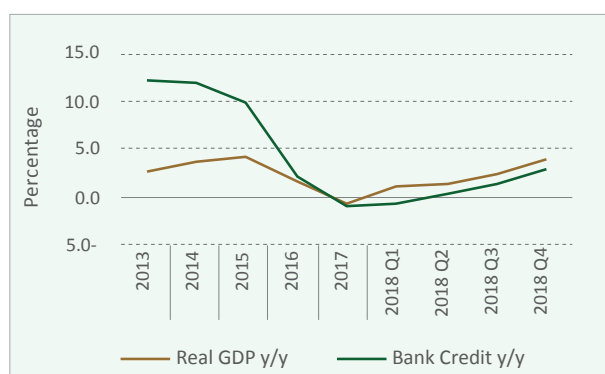
percent, compared to less than 40 percent 20 years ago.

Chart 3.4: Shares of Private and Public Claims to total Bank Assets



Historically, credit growth has outpaced growth in economic output, adding to concerns of excess leverage in the banking system. However, in the recent economic pick-up credit has so far been growing at a slightly lower rate than GDP (Chart 3.5).

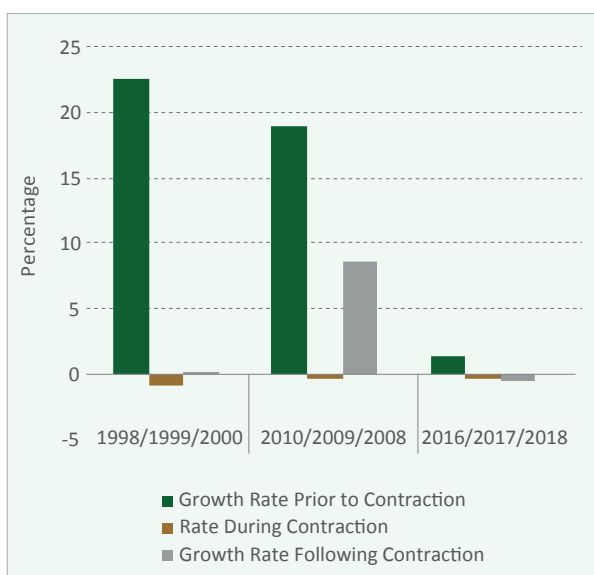
Chart 3.5: GDP and Total Banking Credit Growth Rates



3.2.1 Corporate Credit

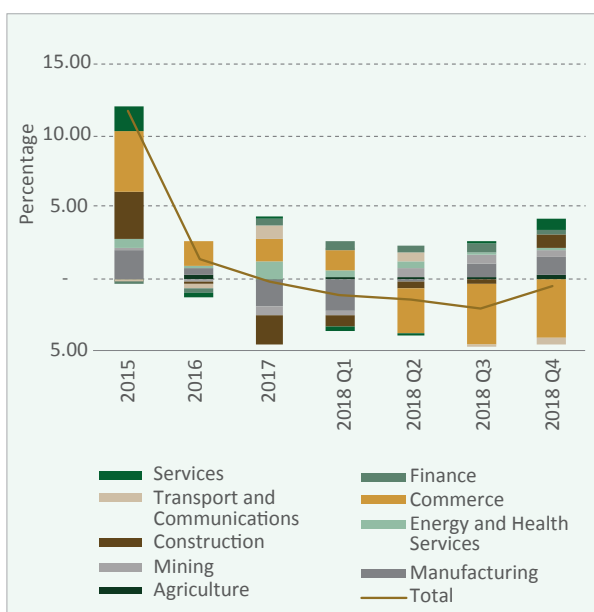
Corporate credit contracted slightly in both 2017 and 2018, with an annual growth rate of -0.5 percent. Although corporate credit contractions have been rare and short-lived over the last two decades (Chart 3.6), private sector growth during the period has tended to move more closely with economic growth and a persistent slowdown may, therefore, result in slower credit growth.

Chart 3.6: Episodes of Corporate Credit Contraction



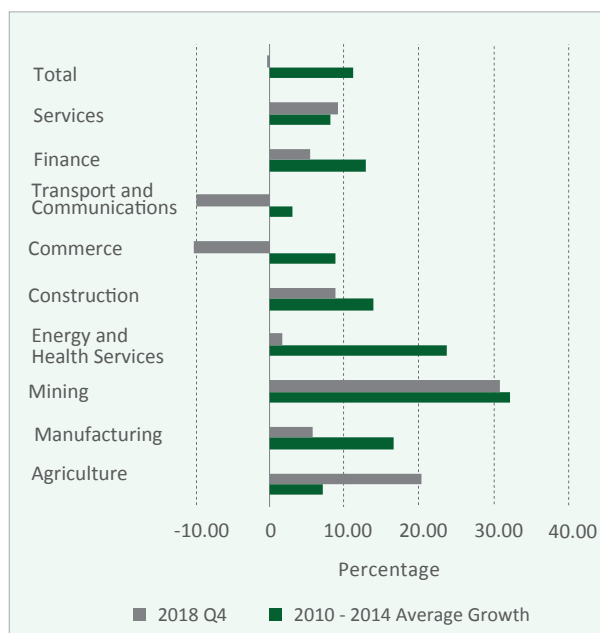
As in 2017, commerce weighed heavily on corporate credit growth. Construction continued to contract throughout 2018 (Chart 3.7), however by the end of the year it noted a pick-up, possibly as a lagged response to the uptick in government spending. As highlighted in Section 2.2, other sectors within publicly listed companies have also experienced a slowdown in asset growth, possibly driven by consolidation in the private sector as companies streamlined their operations.

Chart 3.7: Contribution to Corporate Credit Growth



Commerce noted a significant contraction relative to historical trends. The slowdown in credit for the Commerce sector may be related to the apparent decline in profitability for consumer related sectors (Chart 3.8).

Chart 3.8: Loan Book Changes



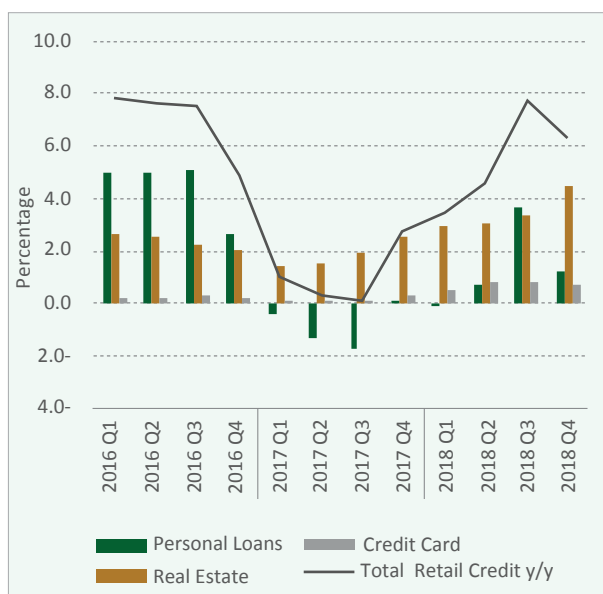
Corporate sector NPLs continue to increase but remain comfortably low. The NPL ratio for the corporate sector reached 2.4 percent by Q4 2018 (Banking system NPL is 1.8). The upward trend in NPLs during the past three years appear to have stabilized during 2018 (Chart 3.9), with construction, manufacturing and commerce stabilizing at slightly elevated rates. Given the banking system's practice of timely writing off bad loans, in addition to the recovery in credit growth, we anticipate NPL rates to continue to ease.

Chart 3.9: Largest Sectoral Shares of Corporate Credit and NPL Rates

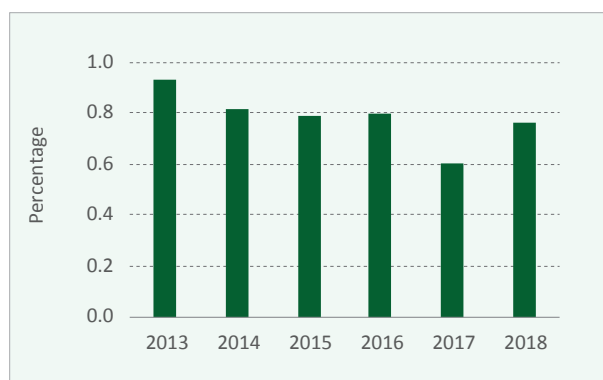


3.2.2 Retail Credit

Unlike corporate credit, retail credit has been growing since the fourth quarter of 2017, reaching an annualized growth rate of 6.3 percent by year-end 2018. The main drivers were real estate and personal loans with around 4.4 and 1.2 percent contributions to total retail credit growth respectively (Chart 3.10). SAMA's recent easing of the LTV limit and initiatives by the Ministry of Housing to increase home ownership might have contributed to the increase in retail real estate loans. This argument is supported by real estate credit growing consistently relative to personal loans. Personal credit fluctuates more than real estate loans. As personal loans have much shorter duration, economic conditions and interest rates translate much faster to them.

Chart 3.10: Quarterly Contribution to Retail Credit Growth

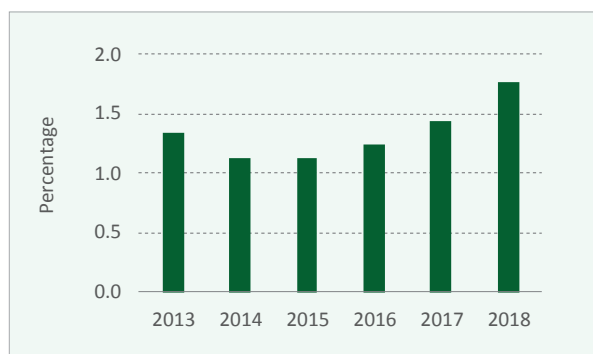
Retail NPL ratios remain extremely low. The banking system's retail portfolio is primarily secured by salary assignment, therefore default risk is quite limited (Chart 3.11). Prior to the recent increase of the LTV limit, SAMA studied the risk characteristics of the banking system's retail portfolio and concluded that an increase in the LTV would pose minimal risks to retail customers.

Chart 3.11: Retail Loans NPL Ratio

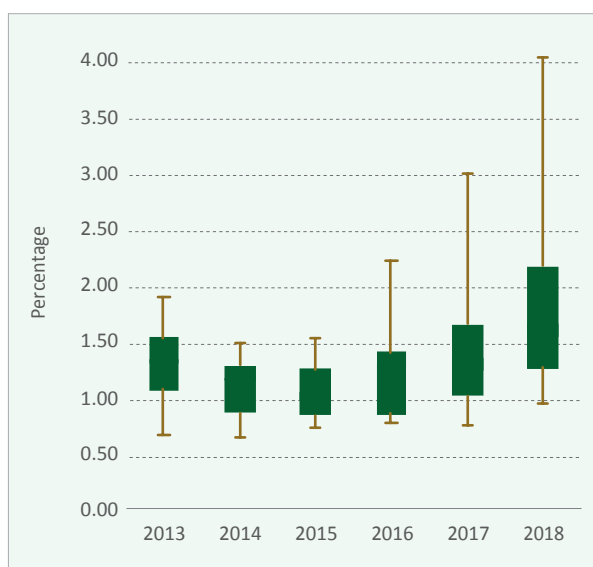
3.3 Asset Quality

NPLs in the banking system continued to increase in 2018. Banks' NPL ratio reached its trough in 2014 and has continued to increase afterwards (Chart 3.12). However, the level of NPL remains remarkably low relative to other economies. Moreover, the banking system has made adequate provisions; the provision coverage ratio for the banking system is well above 100 percent. The NPL

portfolio is mainly concentrated in Building and Construction, Commerce, and Manufacturing.

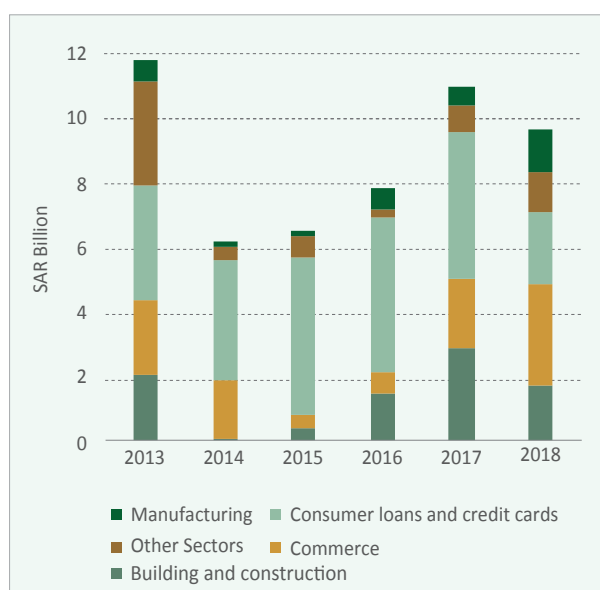
Chart 3.12: Banking System NPL Ratio

NPL ratio variation across banks has increased during 2018. Banks with higher concentration of lending in poor-performing sectors have continued to experience higher NPL growth (Chart 3.13).

Chart 3.13: Distribution of NPL Ratio

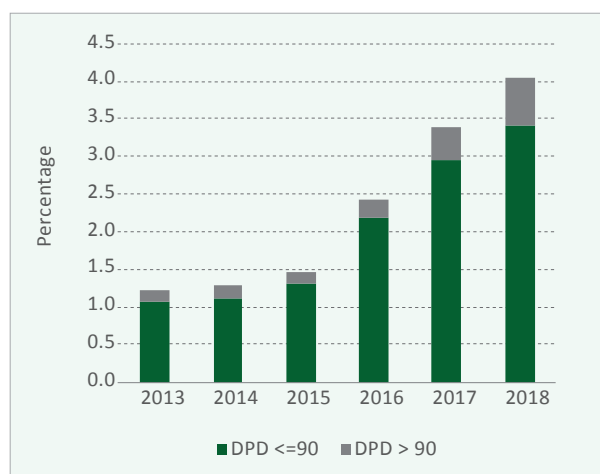
System write-offs have decreased during the period. By the end of 2018, write-offs decreased by roughly 12 percent. The major shift in write-off activity has been in the consumer portfolio, where write-offs for 2018 reached their lowest level in 5 years (Chart 3.14). On the other hand, write-offs related to manufacturing have increased, in addition to commerce, and the latter accounted for the greatest proportion of write-offs for 2018.

Chart 3.14: Banking System Write-Offs



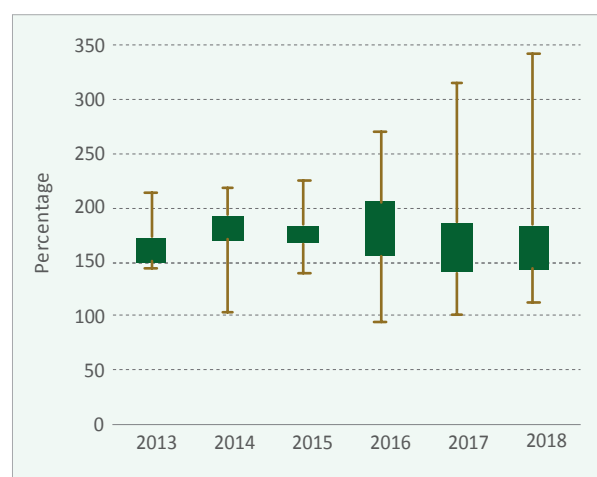
Delinquencies across the system have continued to increase. Analysis of exposures that exhibited delinquent behavior but are still classified as performing loans, reveals a notable increase in both buckets of delinquent exposures (Chart 3.15) (below and greater than 90 days).

Chart 3.15: Days Past Due as % of Gross Loans



Provisions in the domestic banking system remains ample. There has been no substantial shift in the provision coverage ratio across the banking system (Chart 3.16). The provision coverage ratio during 2018 held steady despite the increase in the NPL ratio, meaning that the banking system continues to adequately put funds aside to cover for any future deterioration in asset quality.

Chart 3.16: Distribution of Coverage Ratio



3.4 Funding and Liquidity

Banks' liability structure remained stable with minor variation. Total liabilities increased by 3.4 percent in 2018 (Chart 3.17 and Chart 3.18). Deposits remain the dominant source of funding. The relatively stable share of capital as a source of funding reflects the overall profitability of the banking system (Chart 3.19), as banks replenish their capital base through retained earnings.

Chart 3.17 & 3.18: Component of Banking Liabilities

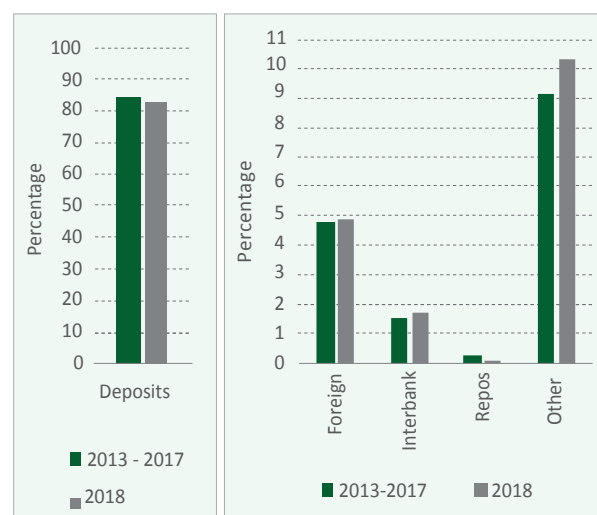
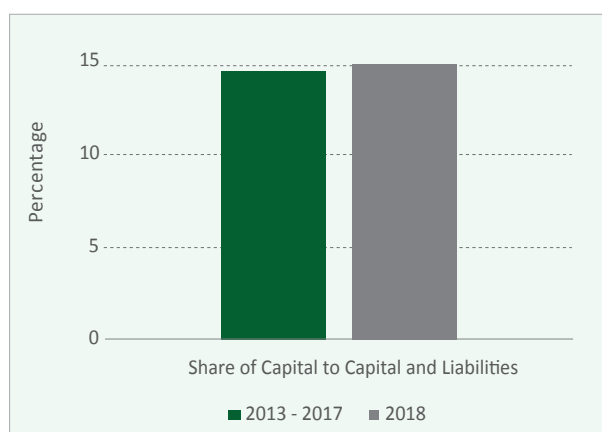
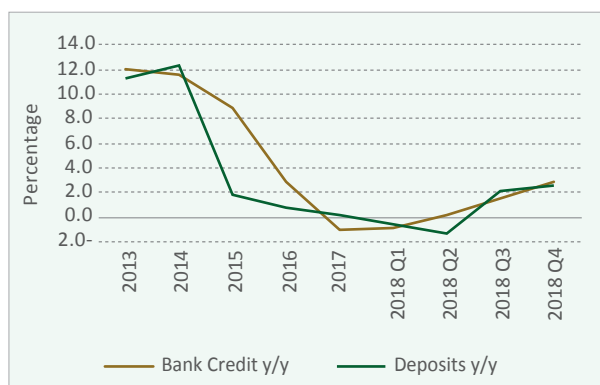
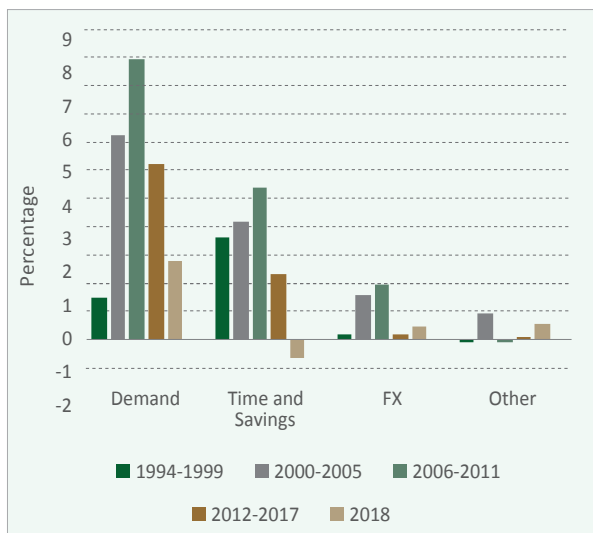


Chart 3.19: Share of Capital (of banks' consolidated balance sheet)

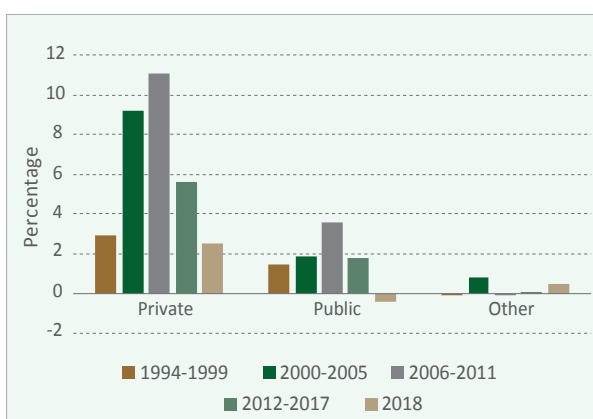
The pick-up in banking credit was reflected in the growth of deposits from the private sector, which grew at roughly 3.3 percent by Q4 2018. While this is a welcome development, it should be noted that total deposit growth was weighed down by a decrease in public sector deposits (Chart 3.20).

Chart 3.20: Deposits and Credit y/y

Deposits composition is heavily influenced by economic conditions, therefore it is not surprising to witness new deposit portfolio formation as the business cycle develops. While all types of deposits exhibited slow or negative growth in 2018, the shift towards demand deposits continued (Chart 3.21), and is expected to do so as government spending continues throughout 2019. The relationship between deposit composition and economic conditions consist of significant growth in private sector demand deposits during periods of economic expansion, and growth in public sector placements during periods of sluggish economic growth.

Chart 3.21: Six Year Ave. of Contribution to Deposit Growth by Type of Deposits

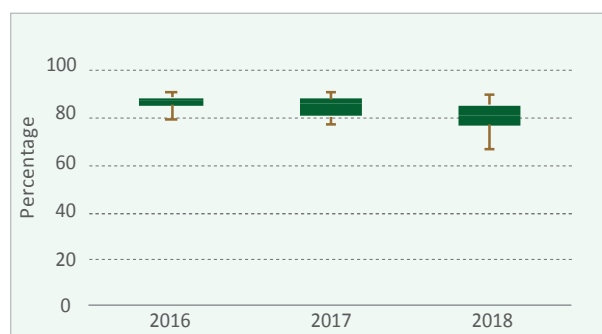
As mentioned above, public sector withdrawal of time and saving deposits weighed down on deposit growth in 2018. Total public sector deposits decreased by the end of year (Chart 3.22), largely due to drawdowns on time and savings. While public sector demand deposits increased by the end of 2018, it was not enough to compensate for decline in time and savings.

Chart 3.22: Six Year Average of Contribution to Deposit Growth by Sector

The loan-to-deposit ratio (LDR) for the banking system as a whole has continued to decrease. As highlighted earlier there was an uptick in credit during 2018, however this was outweighed by growth in deposits (Chart 3.23). Another contributing factor was the implementation of SAMAs weighted LDR scheme to incentivize the banking system to source funding from long-term

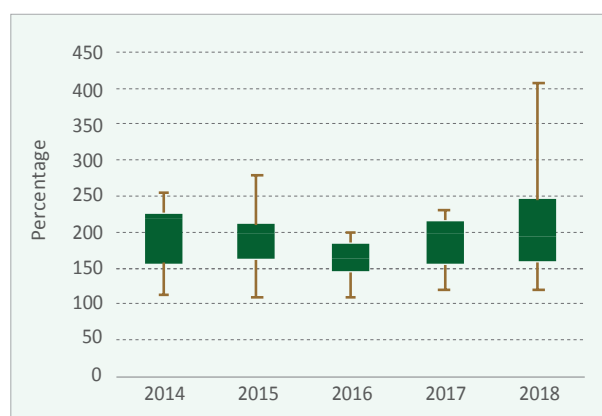
sources, which may increase and promote a saving culture in Saudi Arabia.

Chart 3.23: Distribution of LDR



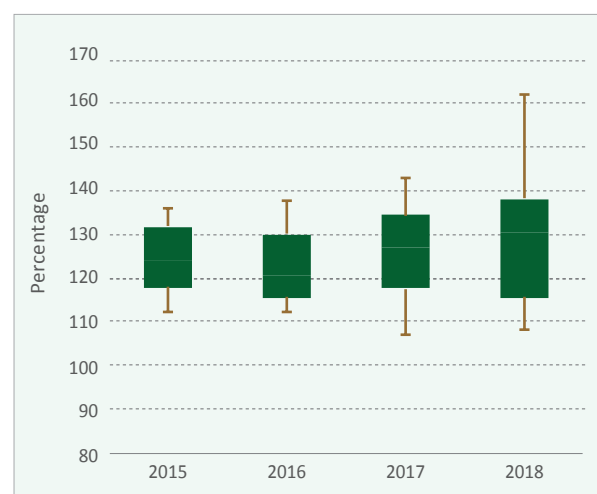
The Liquidity Coverage Ratio (LCR) continued to remain stable for the banking sector. It reflects the resilience of the banking sector to withstand short-term liquidity stress. In brief, the LCR relates banks' holdings of High Quality Liquid Assets (HQLA) to one month's net outflows in a stressed scenario. Overall Saudi banks are well above the required levels (90 percent for 2018), mainly thanks to significant holdings of sovereign bonds (Chart 3.24).

Chart 3.24: : Distribution of LCR



Banks' long-term liquidity position, as given by the Net Stable Funding Ratio (NSFR) showed little change during 2018 (Chart 3.25). The ratio indicate that the banking system has ample sources of stable funding to meet their obligations.

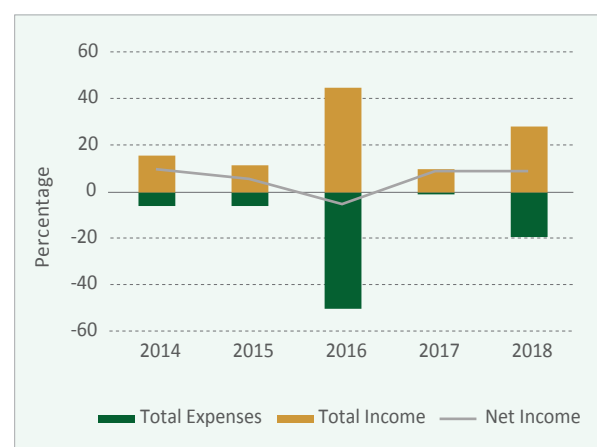
Chart 3.25: Distribution of NSFR



3.5 Profit and Loss Developments

The banking system's profits held steady in 2018. Income grew by 8.7 percent y/y, slightly lower than in 2017, (Chart 3.26) but there was also a notable pickup in expenses, which weighed on profits. The increase in expenses largely stemmed from higher interest payments, reflecting the gradually increasing rate environment. Revenues also witnessed strong growth, and as credit growth continues to pick up and loans are re-priced, this should translate into higher profitability over the next years.

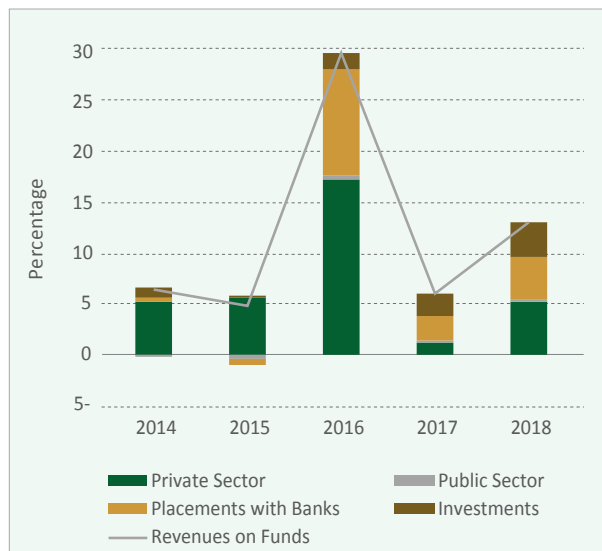
Chart 3.26: Contribution to Net Income Growth



Revenue from the private sector picked up, but remains low relative to historical trends. Similar to 2017, a large driver of revenues has been from investments or placements with other banks (Chart 3.27). Given the increase in policy rates, revenue from inter-bank loans have also increased.

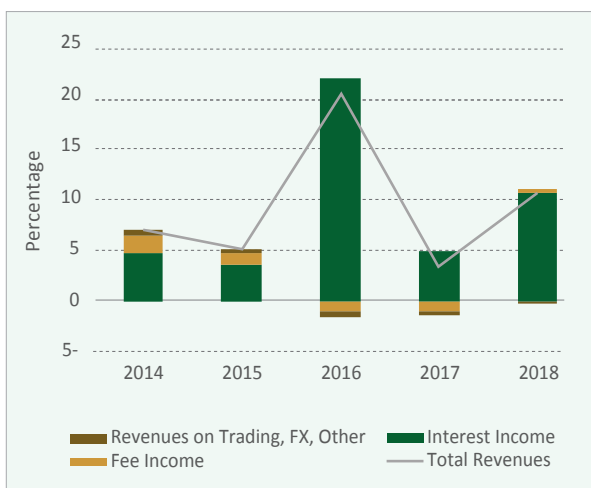
Investments have also grown, and this may be due to the reduced credit opportunities, where the banking system has been investing excess funds in high quality investments to earn some returns.

Chart 3.27: Contribution to Revenue on Funds



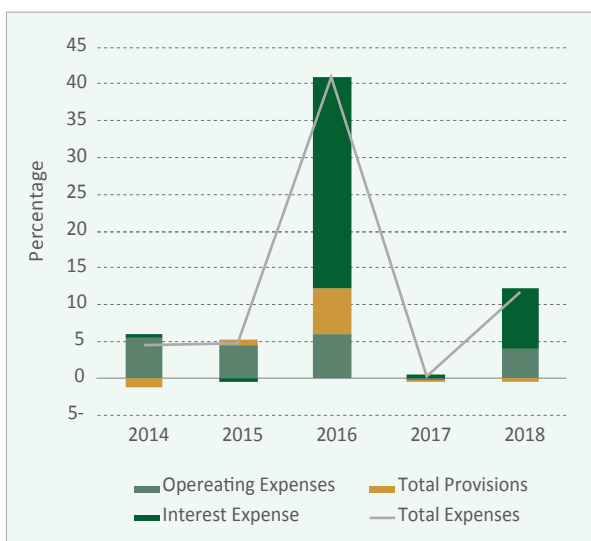
The slight pickup in credit is further reflected in the different types of revenues generated by the banking system. Chart 3.28 highlights the contributors to growth in total revenues, which is a component in total revenues. When assessing total revenues, we note a pick-up in fee revenue, which is primarily attributed to administrative fees from loan origination. In contrast, the previous two years noted a persistent decline in fee revenue, given the contraction in credit and the overall slowdown in economic growth.

Chart 3.28: Contribution to Total Revenues growth



Similar to total revenues, drivers of total expenses are depicting a return to normality. After the sharp uptick in costs during 2016, specifically in provisioning and interest-related expenses, the costs drastically came down in 2017 (Chart 3.29). During the previous year, cost drivers have stemmed from operating expenses, and interest related expenses remain elevated, likely due to the rising interest rate environment and the slight increase in bank placements.

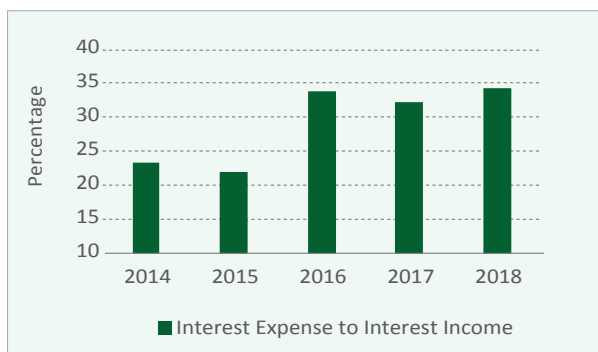
Chart 3.29: Contribution to Total Expense Growth



Interest-related expenses as a portion of interest income remain elevated. The slight recovery in credit has still not reached its historical averages, therefore implying that the asset composition in the banking system remains tilted towards lower yielding assets. Chart 3.30 reflects a stabilization of the ratio at around 35 percent during the past three

years, however this is likely to decrease if credit growth continues to pick up.

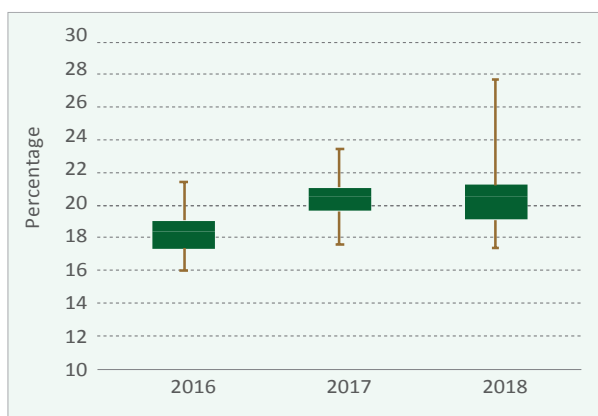
Chart 3.30: Cost of Funds to Revenues on Funds Ratio



3.6. Capitalization

Banks' capital position improved in 2018. The Capital Adequacy Ratio (CAR) averaged 20.5 percent by year-end compared to 20.2 in 2017. The strong levels of capitalization (Chart 3.31) underlines the banking system's ability to withstand shocks. Moreover, the ample levels of capital means that banks stand ready to capitalize on the potential increase in credit demand over the coming years.

Chart 3.31: Distribution of Capital Adequacy Ratio (CAR)



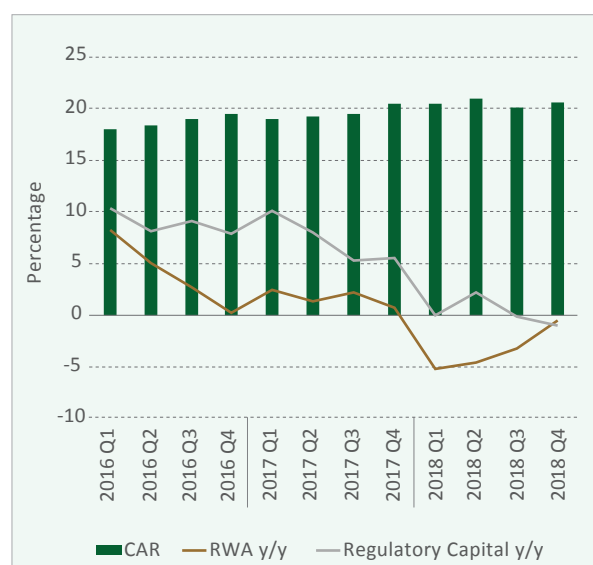
Risk - Weighted Assets (RWA) to total assets decreased in 2018 to 81.8 percent. The decrease largely stems from the pick-up in retail mortgage loans (Chart 3.32), which are associated with lower risk weights.

Chart 3.32: Risk-Weighted Assets to Total Assets



The improvement in CAR has primarily been driven by capital outpacing the growth in RWA. The slight deceleration in regulatory capital (Chart 3.33) may have been driven by the implementation of International Financial Reporting Standards IFRS 9 (Box 3.1). Furthermore, as corporate credit recovers, we expect RWA to grow in line with capital and the CAR ratio to hold steady, since the banking system replenishes its capital through income generated from lending activities.

Chart 3.33: Drivers of Total CAR



Box 3.1: IFRS 9 standard and implementation in Saudi Arabia

The International Accounting Standards Board (IASB) issued the standard IFRS 9 in 2014. As part of SAMA's role as supervisor of the banking sector and in order to keep up with global accounting standards, SAMA enforced the implementation of IFRS 9 as of 1 January 2018. IFRS 9 fundamentally amends the accounting principles for financial instruments. It introduces a new methodology for financial instruments classification. The previous incurred-loss impairment model is replaced with a more forward-looking expected-loss model, and new requirements on hedge accounting are introduced. This box describes the main differences between IFRS 9 and the previous standard (IAS 39), as well as the implications of implementation.

The changes can be put into three groups. Firstly, classification and measurement. Under IAS 39, financial assets were divided into four categories, namely: held to maturity, loans and receivables, fair value through profit or loss, and available for sale. As per IFRS 9, there are now only three categories: amortized cost, fair value through profit, and fair value through other comprehensive income.

Secondly, IFRS 9 provides a 3-stage impairment model, addressing weaknesses of the previous model such as the delays in recognition of credit losses and requires impairment testing for all financial instruments. Stage 1 of the model is concerned with financial instruments with no significant deterioration in credit quality; stage 2 covers instruments with high deterioration in credit quality (without objective evidence); and stage 3 includes financial assets where there is objective evidence of impairment.

Finally, there are additional changes related to hedge accounting. Financial instruments may cause large fluctuations in profit and loss due to fair value accounting. The main objective of the amendments on hedge accounting is to reflect the effect of banks' risk management activities on their financial statements and manage the impact arising from exposures. Hedge accounting is performed according to one of three methods:

- Fair Value Hedge: A hedge of the exposure to changes in fair value of a recognized asset or liability or unrecognized firm commitment that is attributable to a particular risk and could affect profit or loss.
- Cash Flow Hedge: A hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with all or a component of a recognized asset or liability and could affect profit or loss
- Hedge of Net Investment in a Foreign Operation: A hedge of the amount of the reporting entity's interest in the net assets of foreign operations.

Several possible implications emerge due to the adoption of the new framework, in particular higher income statement volatility. IFRS 9 raises the likelihood that more assets will have to be measured at fair value with changes in fair value recognized in profit and loss as they arise. Also, it requires earlier recognition of impairment losses on receivables and loans, including trade receivables. Hence, firms will have to provide for possible future credit losses in the very first reporting period a loan goes on the books – even if it is highly likely that the asset will be fully collectible. Lastly, the new standard introduces significant new disclosure

requirements.

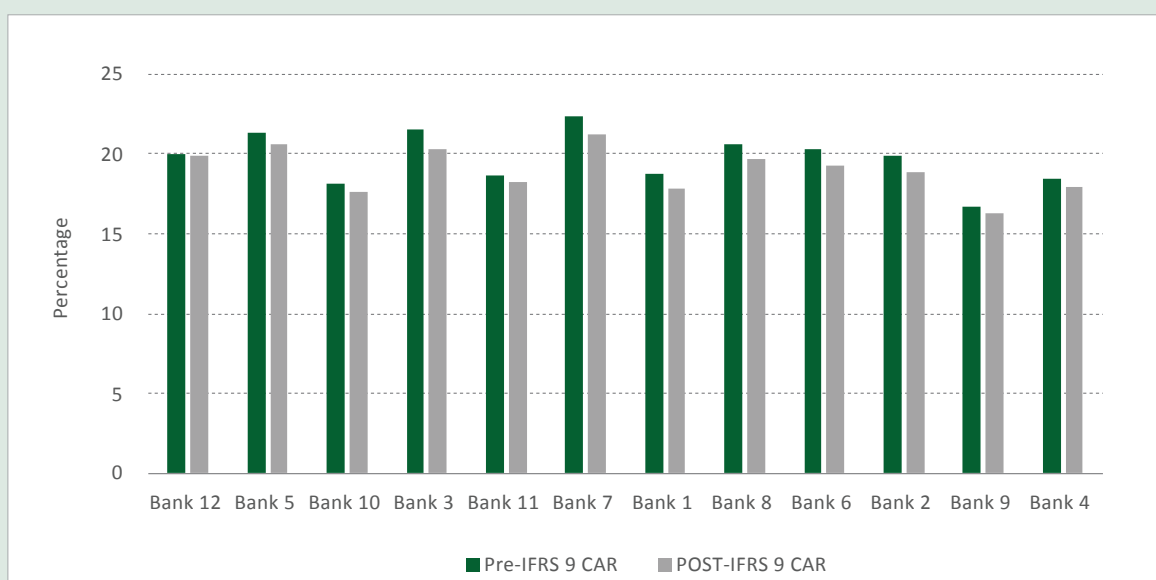
Ever since the issuance of IFRS 9 in 2014, SAMA has taken steps to facilitate seamless implementation of the new methodology and avoid reporting disruption and inaccuracies. In 2015, SAMA established a working group under the Saudi Banking System's CFO committee. The members of this working group included CFOs, CROs, economists and technical experts. IFRS 9 guidelines were issued in 2016 to ensure consistent implementation of IFRS 9 across the Banking Sector. During 2015-2017 banks submitted four rounds of quantitative impact studies along with detailed sections in their ICAAP documents. These initiatives helped the successful implementation of the standard in Saudi Arabia.

Impact on the Saudi Banking System's Capital Adequacy Ratio

The clearest impact to the Saudi Arabian Banking System following the implementation of IFRS 9 was a reduction in retained earnings for some banks, however this varied among banks. A possible explanation behind the variability in retained earnings impact is the heterogeneity in the domestic banking system's capitalization structure. Certain banks may rely heavily on retained earnings as a source of capital than other banks in the system.

The impact on each bank's capital adequacy ratio was muted. The average reduction in CAR was roughly 74 Basis Points, with an impact ranging from 14 Basis Points to 118 Basis Points for individual banks. Due to the banking system's high provisioning coverage, as required by SAMA's 2004 loan classification and provisioning rules, the transition to IFRS 9 was a smooth process for the Saudi Arabian Banking System.

Chart 3.34: Post-IFRS 9 CAR Impact



Box 3.2: Stress Testing of the Banking Sector in Saudi Arabia

As part of its risk assessment toolkit, SAMA conducts macro stress testing of the Saudi banking sector on an annual basis. This Box provides an overview of SAMA's credit risk stress testing model, its assumptions, and its main results. SAMA's top-down stress tests complement the semi-annual exercise submitted by each of the domestic banks.

1. Objectives of the Exercise:

The main objective of the stress testing exercise is to assess the ability of the Saudi Banking Sector to absorb macroeconomic shocks. It also aims to identify weaknesses in the banking system as a whole or in individual banks to enable SAMA to design appropriate supervisory responses to proactively address any potential weaknesses.

2. Scope and Coverage:

The focus of the exercise is to stress test the banking sector against credit risks. The test has been carried out using bank-level data of NPLs, provisions, income components and Risk-Weighted Assets (RWA) covering the period 2000 to 2018. Total credit and NPLs are decomposed into subsector levels. There are 11 subsectors used in this exercise: Banks and Other Financial Institutions, Agriculture and Fishing, Manufacturing, Mining and Quarrying, Electricity, Water and Gas, Health Services, Building and Construction, Commerce, Transportation and Communication, Services, Consumer loans and Credit Cards, and Other Loans.

3. Stress Testing Methodology:

The following methodology has been used to conduct the stress testing exercise:

- i. Step 1 - three scenarios are defined based on SAMA's macro-economic forecasting model and expert judgments. The scenarios assume shocks in several macroeconomic variables including 1) oil prices; 2) government spending growth; 3) implicit lending rates; 4) SAIBOR; and 5) Tadawal All Share Index (TASI).
- ii. Step 2- various "satellite" models are constructed to estimate the underlying relationship between macroeconomic and banking sector variables.
- iii. Step 3- based on the underlying scenario, changes in major banking variables (such as NPLs, provisions, and profitability) are obtained.
- iv. Step 4- based on the impacts estimated in step 3, stressed levels of bank capital are projected.

4. Data Collection:

In order to complete the stress testing exercise for December 2018, the following data have been collected:

- i. Bank level data: A time series of a quarterly data from January 2000 to December 2018 on Non-Performing loans, Total Credit, Provisions, Net Interest Income, Net Other Income, Net interest Expense, Dividend payments, Total Regulatory Capital and Tier 1 Capital and Risk Weighted Assets;
- ii. Macroeconomic data: A time series of a quarterly data from January 2000 to December 2018 on Oil Prices, Government Spending, SAIBOR, TASI, and Total Credit.

5. Stress test Results:

The stress test results show that Saudi banks can easily withstand various economic shock scenarios. In the baseline scenario, the NPL ratio initially decreases to 1.6% by the end of 2019, and then increases gradually to reach 1.7% by the end of the stress period (by the end of 2021). Consequently, the NPL coverage ratio would increase from 168% to 195% in the second quarter of 2019 and then decrease gradually until it reaches 175% in Q4 2021. Individual banks NPL ratios range from 2.55% (the upper percentile) to 0.69% (the lower percentile) as of Q4 2021. The average CAR exhibits a gradual decline and reaches 20% by the end of 2021.

Under the mild macroeconomic shock scenario, the projected coverage ratio is expected to increase in the first two quarters to reach a level of 191% and then decrease gradually until it reaches 175% at the end of Q4 2021. The projected non-performing loan ratio would reach a low by Q2 2019 of 1.7% and slightly increases to 1.8% by the end of the stress period. Individual banks NPL ratios would range from 2.5% (the upper percentile) to 0.62% (the lower percentile). The projected CAR would deteriorate gradually to 15.6% by the end of the stress period.

Under the severe macroeconomic shock scenario, non-performing loans (NPL) decreases to 1.7% during the first two quarters, and then it increases gradually until it reaches 2% by the end of the three-years projection period; i.e., by Q4 2021. Individual bank NPL ratios range from 2.9% (the upper percentile) to 0.69% (the lower percentile). The coverage ratio is expected to reach its highest level of 188% in Q2 2019, then it gradually declines and reaches its lowest level of 165% by Q4 2021. The CAR is projected to deteriorate to 14.71% in Q4 2021.

The stress test results using all three stress scenarios suggest that the banking sector will remain well capitalized under large shocks. Banks capital adequacy ratios are still comfortably above the Basel requirement of 8% and above SAMA's threshold of a 12% of a minimum CAR requirement.

4

INSURANCE SECTOR DEVELOPMENTS

Insurance Sector Developments

4.1 Overview of Developments in the Insurance Market

A number of regulatory reforms were introduced in the insurance market during 2018. The Risk-based Supervision Framework went live for all insurance companies and insurance intermediaries; it is expected to assist the regulator tremendously in effective and timely monitoring of insurance companies and intermediaries, as well as assist the insurance companies and intermediaries in strengthening their internal controls and management reporting.

In respect of motor insurance, No Claims Discount (NCD) framework was introduced for the first time for motor comprehensive policies and the existing framework for motor third party liabilities was improved significantly, with the objective to encourage higher uptake of insurance and to reward safe driving behavior. A one-time discount was offered to female drivers, permitted to drive since mid-2018, and for new male drivers as part of the new NCD framework.

To facilitate entry of large foreign insurance companies and attract foreign investment, regulations were issued to simplify setting-up of business via branch operations.

Significant enhancements were made to the supervisory framework for assessment of and monitoring the adequacy of technical provisions held by the insurance companies through implementation of standard reserve reporting templates for annual and quarterly submissions and use of benchmarking techniques. Submissions by the appointed actuaries were subject to strong regulatory challenge and there was emphasis on adherence to the actuarial best practice, e.g., actual - vs - expected analysis to support change in ultimate claims, reserve uncertainty analysis, etc.

In terms of the business underwritten, the insurance market contracted by 4.6 percent during 2018 (chart 4.1). This was driven mainly by the motor line of business, which contracted by 15.4 percent. The sharp decline was mainly attributable to the reduction in the average cost of motor insurance policies, which was consistent with the goals of the regulatory reforms introduced in 2018. It is expected that the reduced motor insurance cost and regulatory emphasis on fair pricing will encourage higher insurance uptake and promote safer driving conditions, hence benefitting the insurance market in particular and the society in general. Other lines of business, except for health, also recorded a negative Gross Written Premiums (GWP) growth; this outweighed the noticeable growth in the health business (chart 4.2).

Chart 4.1: Segments Contribution to GWP

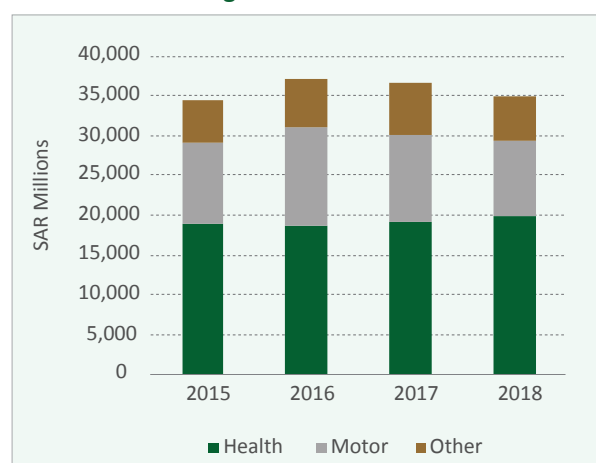
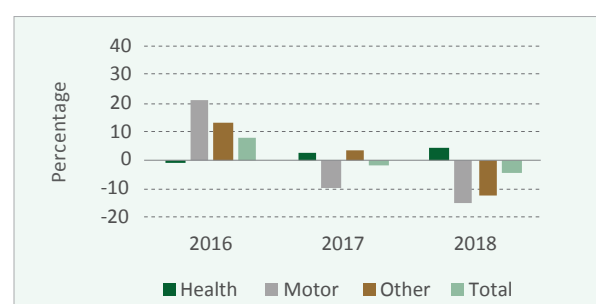


Chart 4.2: GWP Annual Growth



The 4.5 percent growth in health insurance premium was driven by a number of factors; providers of medical services continued to push prices higher; more Saudis joining the health insurance pool; enhanced minimum benefits under the unified health insurance policy;

technical prices were more closely adhered to than last year for the policies sold during 2018, indicating improvements in underwriting discipline adopted by the insurance companies on the back of strong regulatory monitoring. The increase in health insurance premium could have been even higher had it not for the reduction in the expatriate workforce.

In view of the strengthened regulatory framework, likely entry of foreign branches of large multinational insurance companies, expected revival of economic activities attributable to improved oil prices, and impetus provided by Vision 2030, it is expected that the performance of the insurance sector will improve going forward.

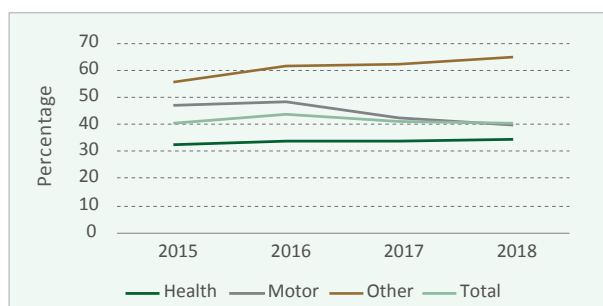
4.1.1 Sectors and concentration

The insurance market remains dominated by the health and motor lines of business, as they collectively account for 84 percent of the market. The motor line's share of GWP continued to shrink for the second consecutive year, from 33 percent in 2016 to 27 percent in 2018. This decline was mitigated by the growth of health insurance, whose share reached 58 percent in 2018. All other insurance lines have maintained their market shares over the last three years.

4.1.2 Intermediation

Around 40.6 percent of the 2018 premiums were written through insurance brokers and insurance agents, which is slightly below the three-year average of 41.7 percent. The health and motor lines were somewhat less reliant on intermediaries (chart 4.3).

Chart 4.3: Insurance Premiums Written Through Intermediaries



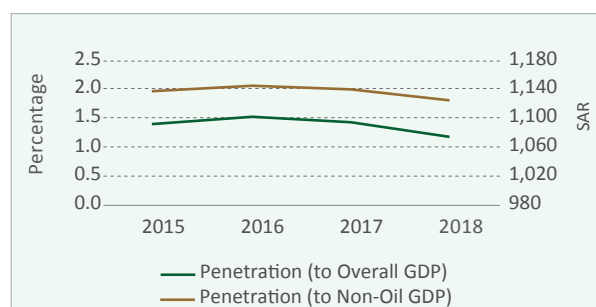
4.1.3 Insurance Penetration

In 2018, the penetration of the insurance sector to total GDP declined, from 1.42 percent in 2017 to 1.19 percent (chart 4.4). However, the decrease is mainly attributed to the sharp increase of 13.6 percent in nominal GDP in 2018 due to the improvement in oil prices as well as due to the reduction in the volume of insurance premium.

The health insurance contributed to 0.68% of total GDP while the motor insurance sector contributed to 0.32%. As the economic recovery continues into 2019, insurance revenues are expected to grow, in particular for property, engineering and marine lines of business.

The insurance penetration rate to non-oil GDP declined as well, from 2.0 percent in 2017 to 1.8% in 2018.

Chart 4.4: Insurance Penetration



4.2 Insurance Market Performance

4.2.1 Underwriting Performance & Profitability

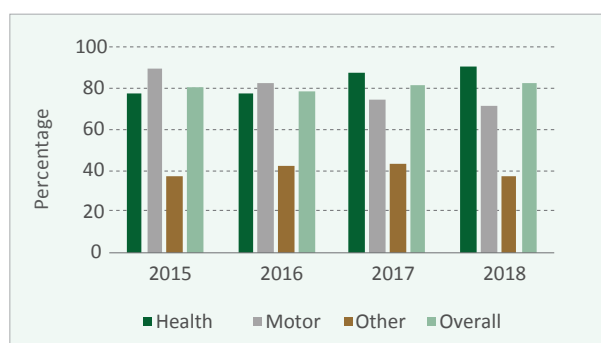
The overall loss ratio slightly increased from 81.2% in 2017 to 82.2% in 2018 (chart 4.5). The result is above the three-year average of 79.8 percent.

In terms of the underwriting performance, despite reduction in the average cost of a motor insurance policy, motor insurance business improved its loss ratio for the fifth consecutive year, reaching 70.9 percent in 2018 from 74.3 percent in 2017.

On the other hand, the loss ratio for health insurance, the biggest segment by volume of premium, continued to increase during 2018, thus

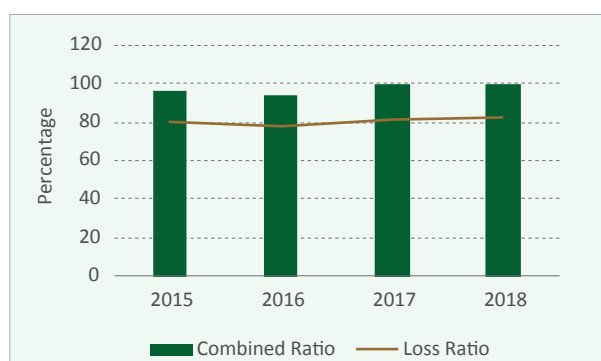
putting pressure on the overall profitability of the insurance companies during 2018. The loss ratio in health insurance increased to 90.6 percent in 2018 from 87.7 percent in the previous year, with the increase attributable mainly to health cost inflation and enhanced benefits.

Chart 4.5: Loss Ratio Per Segment



The insurance market had an expense ratio of 18.0 percent in 2018. Generally, the market has a relatively stable expense ratio, with an average of 17.0% for the last five years (chart 4.6).

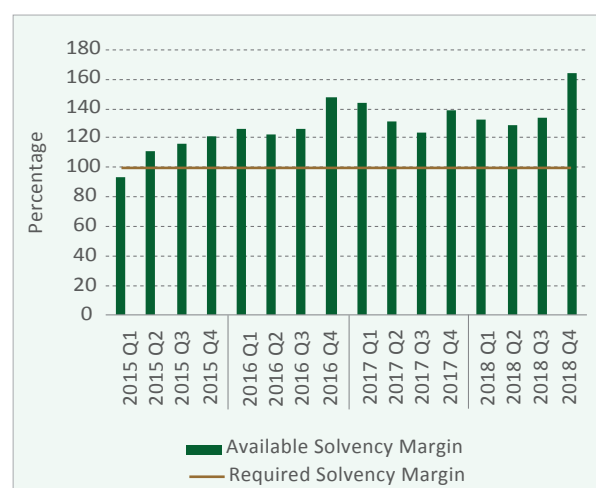
Chart 4.6: Combined Ratio



4.2.2 Adequacy of Capital & Provisions

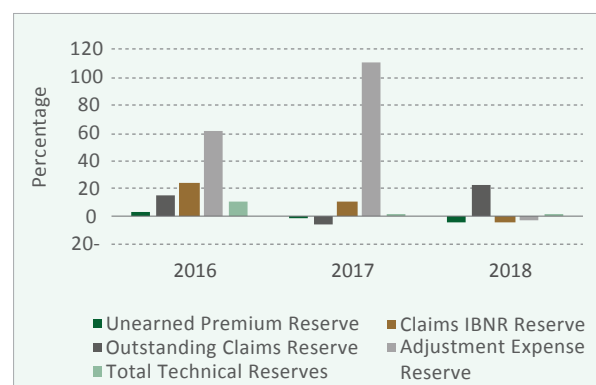
On an aggregate level, the insurance sector continued to show a strong solvency position (chart 4.7) in 2018. Most insurance companies had solvency margins well above the required solvency margin of 100%.

Chart 4.7: Quarterly Developments in The Solvency Margin



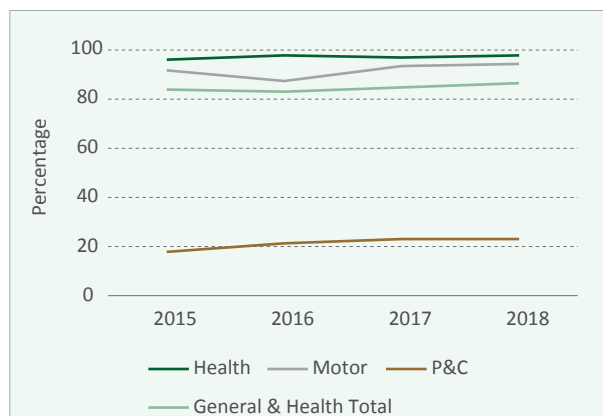
Increased technical reserves fosters the market resilience to insurance risk. In 2018, the total technical reserves recorded an increase by 2.5 percent on annual basis (chart 4.8).

Chart 4.8: Technical Reserves Annual Growth



4.2.3 Reinsurance Performance

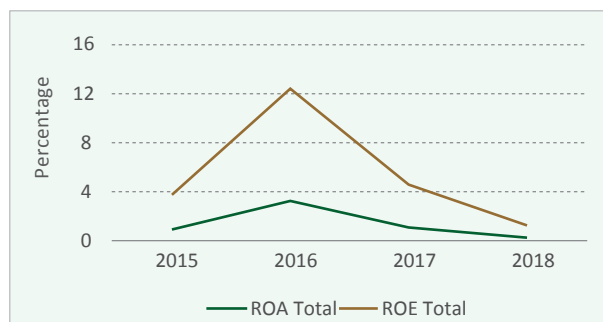
Insurance companies were less reliant on reinsurance agreements in 2018. The retention of total premiums of general and health insurance products increased from 84.8 percent in 2017 to 86.2 percent. Health and motor insurance had the highest retention ratios of 97.2 percent and 94.0 percent respectively. The property and casualty lines of insurance maintained an overall retention rate of 23 percent in 2018 (chart 4.9).

Chart 4.9: Insurance Premiums Retention Rates


4.2.4 Investment Performance & Profitability

Return-on-Assets (ROA) and Return-on-Equity (ROE) for the insurance market in aggregate decreased to 0.54% and 2.12% respectively in 2018, driven mainly by the profitability challenges faced by the health insurance segment (chart 4.10).

The insurance market generated a net profit of SAR 0.6 billion in 2018.

Chart 4.10: Profitability of The Insurance Sector


Box 4.1: Unified Health Insurance

In 2018, The Cooperative Council for Health Insurance (CCHI) introduced a unified health insurance policy that replaced the unified policy issued in 2014. The new policy applied to all employment-based health insurance policies issued or renewed by health insurers operating in the kingdom, from July 1st, 2018. The new policy, and the tighter measures taken by CCHI to monitor compliance, is expected to make the private sector more attractive to Saudi nationals and to reduce the burden on the public healthcare system. However, given the current economic conditions, the number of beneficiaries covered under the unified policy might decrease as employers might opt to downsize their businesses.

The maximum coverage per insured remains capped at SR. 500,000; however, many new benefits have been added in the new mandated policy. These benefits include coverage of the following:

- Sleeve gastrectomy surgeries for beneficiaries with a body mass index (BMI) of 45 kg/m² up to a maximum of SR. 20,000;
- treatment of psychological disorders up to a maximum of SR. 15,000 for severe psychological issues and SR. 5,000 for non-severe disorders;
- treatment of pathological conditions requiring hospital isolation determined by the Ministry of Health;
- treatment of psoriasis;
- program for critical congenital heart defects (critical CHDs) for all births;
- respiratory syncytial virus (RSV) vaccines for children;
- coverage of early hearing impairment program in early childhood;
- costs of infant formula for infants in need of formula for medical reasons up to the age of 24 months pursuant to the regulations;
- increasing the limits on autism care from SR. 15,000 to SR. 50,000;
- treatment of dental and periodontal diseases including costs of one-time dental cleaning during the policy period; and
- increasing the limit of acquired heart valve benefit from SR 75,000 to SR. 150,000.

The extended benefits led to re-pricing of premiums in the third and fourth quarters of 2018. This contributed to the growth of 4.5 percent in health premiums achieved in 2018 despite the downward pressure resulting from the steady decrease of expatriates in the Kingdom.

The effect of the new unified policy on GWP, as well as on net claims, is expected to continue throughout Q1 and, to a lesser extent, Q2 of 2019.

5

FINANCE
COMPANIES
DEVELOPMENTS

Finance Companies Developments

5.1 Overview

The finance companies sector did not witness any significant changes in 2018 compared to 2017. Both number of licensed companies and their capital position remained stable (Table 5.1). However, a notable development was the commencement of activities of the Saudi Real Estate Refinance Company's (SRC), which has a paid-up capital of SAR 1.5 billion. The purpose of SRC is to provide liquidity to mortgage lenders through either portfolio acquisitions, direct short-term financing, or securitizations (box 5.1).

Finance companies are expected to become an important player to unlock SMEs financing. The sector has been incorporated in the nation's credit guarantee Kafalah program, which has recently increased its capital by SAR 800 million through the Ministry of Finance's private sector stimulus package. Moreover, one of the Monshaat programs aims to support SME financing by providing low-cost government financing solutions to SAMA licensed finance companies. As of 2018, Monshaat had extended loans to 14 finance companies that are active in SMEs lending.

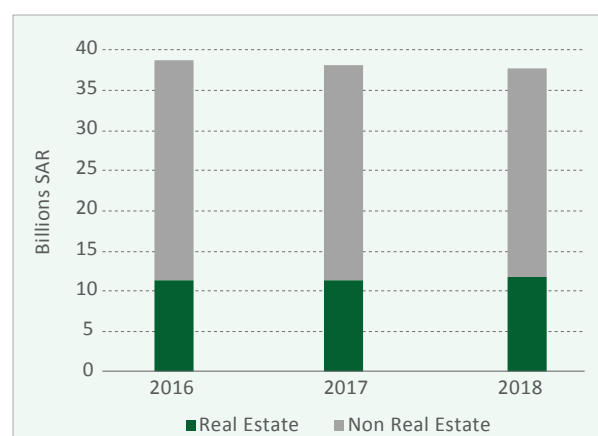
Table (5.1): Development of Finance Companies Sector

	2013	2014	2015	2016	2017	2018
Total number of licensed companies	3	18	30	34	37	37
Real estate companies	2	5	6	6	6	6
Non-real estate companies	1	13	24	28	29	29
Refinance company	0	0	0	0	1	1
Micro finance	0	0	0	0	1	1
Total capital (Million SAR)	1,650	7,401	11,250	12,470	14,158	14,427

5.2 Finance Companies Assets

Finance companies maintained a stable risk profile, while the sector continues to constitute a small share of the financial system. Finance companies represented approximately 1.6 percent of total financial system assets in 2018, equivalent to 1.4 percent of GDP. Out of this, real estate assets accounted for about 32 percent (Chart 5.1).

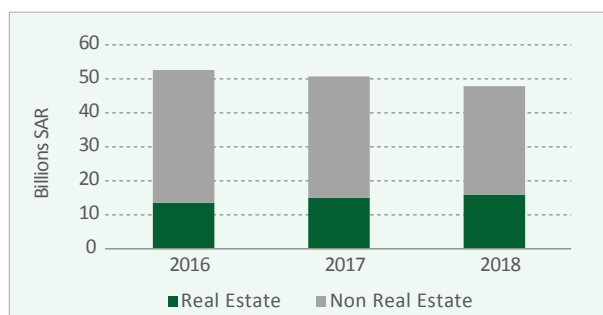
Chart 5.1: Total Assets of Finance Companies



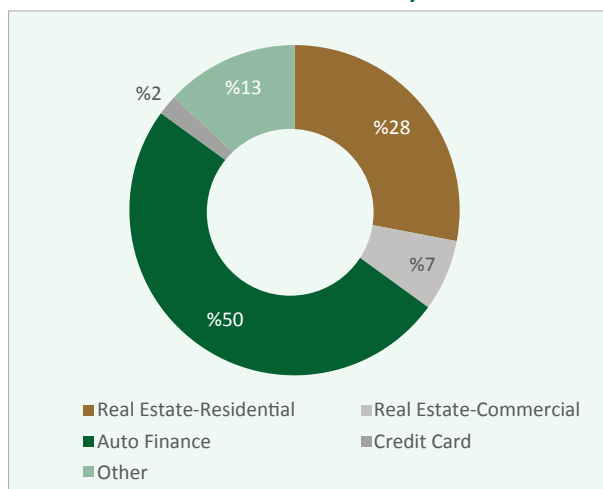
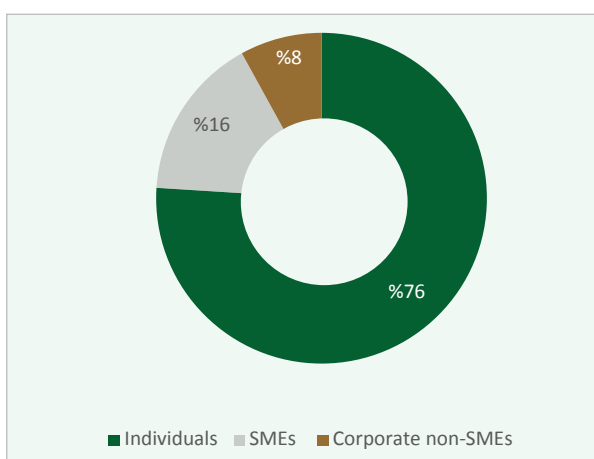
5.3 Finance Companies Portfolio

Lending by finance companies continued to moderate with total credit contracting by 6 percent in 2018 reaching SAR 48 billion. Total credit (on and off-balance sheet) accounted for approximately 3.23 percent of the total banking sector and finance companies credit.

In contrast to trends in total credit, real estate credit indicated some positive developments. Real estate financing grew by 10 percent in 2018 to reach SAR 16.1 billion. Real estate and non-real estate accounted for 34 percent and 66 percent, respectively of total finance companies credit (Chart 5.2).

Chart 5.2: Total Credit of Finance Companies

Auto finance continues to claim the largest share of finance companies portfolios. There has been no significant change in the distribution of finance portfolio since last year. As of 2018, auto finance accounted for 50 percent of the sector's portfolio, whereas residential and commercial real estate accounted for 28 and 7 percent, respectively. As for others, personal finance constituted 5 percent and miscellaneous 8 percent (Chart 5.3). Loans to individuals represented 76 percent of the portfolio, the SME sector 16 percent and non-SMEs corporates 8 percent (Chart 5.4).

Chart 5.3: Finance Portfolio by Activities**Chart 5.4: Finance Portfolio by Sector**

5.4 Sources of Funds

Given that finance companies are non-depository institutions, funding may be more sensitive to expected increases in interest rates. At the end of 2018, the sector's equity and liabilities totaled some SAR 35 billion. Of this, debt funding accounted for 38 percent, while capital represented 36 percent and reserves and provisions amounted to 26 percent (Chart 5.5).

Looking forward, the sector's sources of funds are expected to diversify. There have been several recent initiatives that are expected to create additional channels of funding for finance companies, including: the SRC financing activities, portfolio acquisitions, the Kafalah program, and the indirect lending initiative for SMEs and the securities issuance standards of finance companies (bonds / sukuk) which were approved in April 2018. In addition, the issuance of the circular «The indirect contribution of investment funds in the finance sector» in February 2018 will enable finance companies to sell their portfolios to investment funds and conclude agreements with investment funds to provide co-financing.

Chart 5.5: Funding Structure

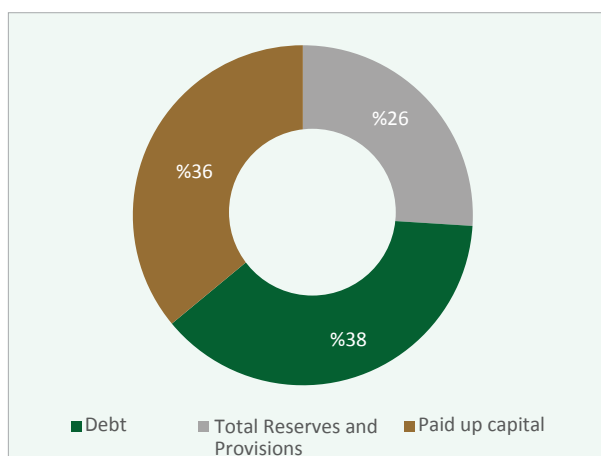
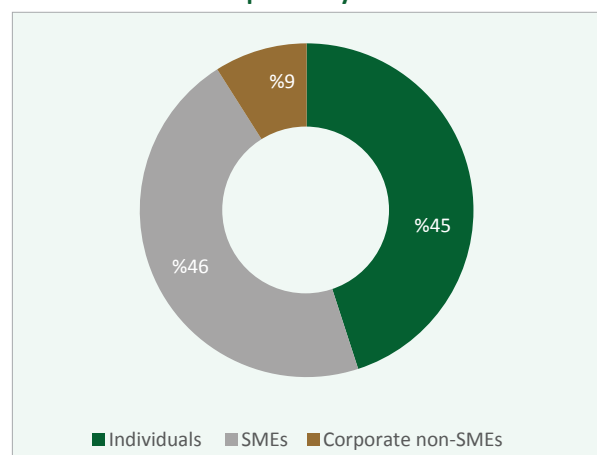


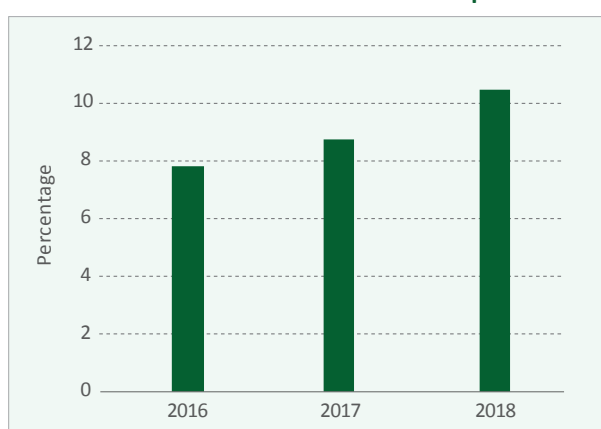
Chart 5.7: Non-performing Loan Amount for Finance Companies by Sector



5.5 Risk Outlook of Finance Companies

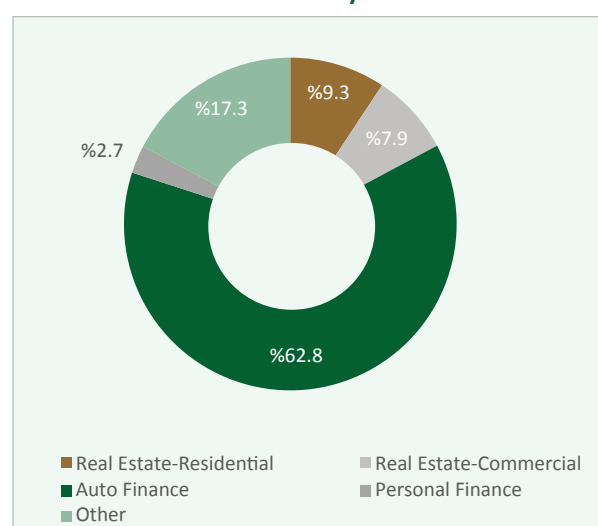
The major challenge facing finance companies is to contain the increase in non-performing loans. Asset quality continued to deteriorate in 2018, with the aggregate NPL ratio increasing from 8.7 percent to 10.61 percent. The increase stemmed both from loans to SMEs and individuals (Chart 5.6). NPL ratios may have been affected by the introduction of the new accounting standard IFRS 9. By 2018, the non-performing loans amount was SAR 4.44 billion, of which 45 percent and 46 percent were for individuals and SME's sectors (Chart 5.7). Although NPL rates are high in finance companies, high capital buffers and reserves provide a considerable buffer in most companies.

Chart 5.6: NPL Ratio of Finance Companies



Auto finance represented more than half of total NPLs in 2018, at 63 percent. This was primarily due to difficulties in reclaiming vehicles as it requires notification from the Ministry of Justice. In that regard, there has been continued coordination between SAMA and the Ministry of Justice, and a resolution is expected during the coming year. Finally, it can be noted that residential real estate financing constitutes one of the smallest portions of the total NPL portfolio, highlighting the relatively minimal levels of risk (Chart 5.8).

Chart 5.8: NPLs by Activities



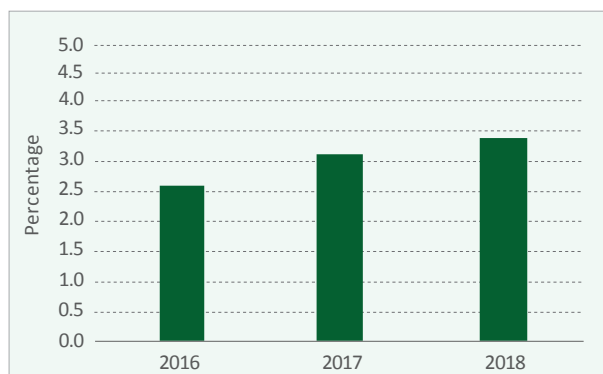
5.6 Finance Companies Resilience

5.6.1 Profitability

Despite prevailing uncertainty, profitability posted healthy growth in 2018. Finance companies have been exposed to changing market conditions

and fiscal reforms since they started operating in Saudi Arabia in 2013. However, in 2018 the sector posted growth in profits of 8 percent, reaching SAR 1.27 billion. ROE and ROA reached 6.94 percent and 3.36 percent, respectively (Chart 5.9).

Chart 5.9: Return on Assets of Finance Companies

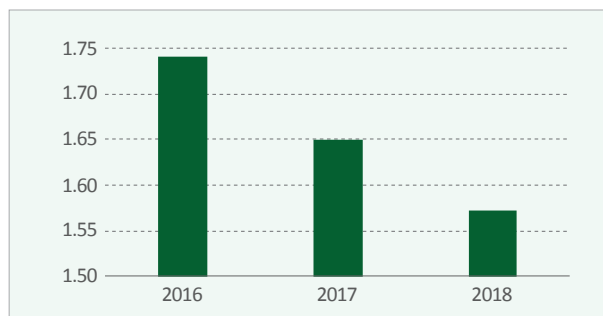


5.6.2 Leverage

Finance companies' leverage remained well below the maximum limits allowed by SAMA⁴. The sector's leverage ratio has continued to decline since 2015 reaching a level of 1.57 in 2018.

Real estate finance companies' leverage has been stable at a level of 2.15, while the non-real estate companies' leverage has reached a level of 1.36, a minor decrease from 2017's level of 1.46. The leverage ratio limit set by SAMA can be seen as a macro-prudential measure to increase finance companies' resilience and help ensure stability within the financial sector (Chart 5.10).

Chart 5.10: Leverage Ratio of Finance Companies



⁴ SAMA's regulations in regard to leverage state that the amount of real estate credit extended by companies shall not exceed five times the company's capital and reserves. This policy can be raised to a maximum of seven times, given SAMA's approval. As far as non-real estate companies are concerned, leverage shall not surpass three times the amount of capital and reserves, with an upper limit of five times, after obtaining a no objection letter from SAMA.

Box 5.1 Saudi Real Estate Refinance Company: Operational Framework

Saudi Real Estate Refinance Company (SRC), a wholly owned subsidiary of the Public Investment Fund (PIF), which was founded in 2017, aims to create a secondary mortgage market, injecting liquidity by providing warehousing facilities and acquiring mortgage loans. It will help broaden the activities of mortgage financing companies and banks. SRC will issue bonds (sukuks, and later on RMBS) supported by the mortgage contracts, tapping capital market over various tenors, currency and profile. Indeed, SRC will be a bridge between foreign and local investors and the housing market, in addition to raising the standards according to investors' expectations.

As a newly established company in the kingdom, SRC faces risks related to the launching of its activities and beyond, to a range of risks emanating from its mortgage refinancing activities. Since receiving its operating license on September 25, 2017, SRC's overall risk exposure has remained within expectations. SRC discussions to obtain a government guarantee for its funding sources have progressed and are now entering into the detailed implementation phase. This guarantee from MoF will be critical to SRC's ability to fully meet its strategic objectives of launching competitive mortgage rates and especially long-term fixed rate mortgages while keeping rates to borrowers as low as possible.

SRC deploys its funding towards interested Real Estate Finance Companies and Banks through facilities allowing originators to ramp up portfolios of loans and through loans acquisition. Acquired portfolios of loans are typically in the form of Ijara leases. SRC acquires legal title on the underlying residential properties and all of the relevant originating lenders' rights. SRC carries the loans on its books and bears the full credit risk of each portfolio purchased without recourse to the relevant originating lender for default risk. Post-acquisition of each Portfolio, for now, the relevant originator/lender, acting as the appointed servicer, will continue to administer the contracts on SRC's behalf. The servicing lender will collect and remit payments and instalments due by the underlying customers/borrowers to SRC in return for a servicer fee as agreed with SRC.

In originating the contracts, the originator lender must satisfy certain criteria prescribed by SRC (SRC's Loan Eligibility Criteria). These criteria cover the following categories:

- The underlying property (e.g., type -villas and apartments-, age, purpose (owner occupied)).
- The commercial terms of the contracts (e.g., tenor, principal amount, payment terms, and events of default); Contracts originated since August 2018 must be based on SAMA's standardized contract.
- Delinquencies; Contracts must be current at the date of acquisition and no payments worse than 60-days late in the last 24 months.
- The characteristics of the customer who is receiving home financing (e.g., nationality -Saudi National-, age-min 20-years at origination, and max 70-years at contract maturity-, employment-public or private sector subject to verification-, creditworthiness, income, debt income ratio).

The SRC Eligibility Criteria is proprietary and subject to revision from time to time based on

market conditions.

SRC's quality control process involves due diligence performed on 1- the lender and 2- the loans SRC intends to purchase (on a statistical basis).

- Lender Due Diligence: SRC will assess lender eligibility from SRC's point of view from corporate capabilities, origination capabilities and servicing capabilities.
- Loan Level Due diligence: SRC will assess data integrity and undertake validation of the accuracy of the data based on sampling or full portfolio review
- Following the file review, SRC confirms its assessment and confirms which loans satisfy SRC's criteria and are eligible for acquisition.

After the loans are acquired, the servicing lender will report on a monthly basis loan performance, payments collected and updated principle balance. For delinquent loans, servicing lenders are required to report on actions taken to resolve the delinquencies which should be aligned with the policies and procedures reviewed and agreed upon with SRC.

SRC has launched its Sukuk program in December 2018 allowing the company to raise up to 11 billion SAR that would be directed to the Residential Real Estate financing market in the Kingdom, a step that would further enhance the growth in the sector. SRC has already successfully issued 750 million SAR over four tranches and three different tenors without the guarantee of the Ministry of Finance (MoF). The proceeds of the Sukuk will be deployed in refinancing existing Mortgage portfolios as well as new contracts with long-term fixed rates. SRC also provides short/medium term finance products that support the originators with warehousing facilities for the mortgages during the minimum seasoning period required by SAMA before the acquisition of the portfolio.

SRC's Upcoming 5-Year Milestones

Assets

- Broaden the scope of originators through active engagement and covering the market as broadly as possible.
- Offering innovative products and solutions, to meet the needs of originators.
- Developing a digital eco-system, which will include database and market intelligence in addition to a more standardized underwriting and reporting process.

Liabilities

- Developing a long-term fixed rate benchmark curve, through continued issuance which would support the market in price discovery.
- Diversifying the company's access to Funding
 - Tapping a broad array of investors domestically and internationally.
 - Considering different currencies.
 - Diversifying the issuances, through different types of paper and currency (sukuk, securitization, etc).
- Developing tenor structure and issuance profile, in coordination with relevant government entities.
- Achieving a corporate rating, which will grant SRC's issuance more appeal among investors.



6

**CAPITAL
MARKET
DEVELOPMENTS**

Capital Market Developments

The Capital Market Authority (CMA) undertook several reforms in 2018 to increase capital inflows into the Saudi Economy. Most notably, the CMA revised the Qualified Foreign Investor (QFI) rules, including:

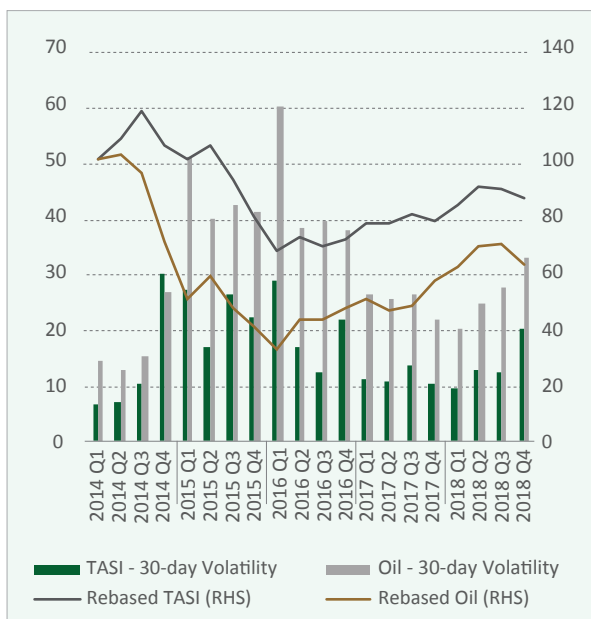
- Eliminating the requirement for CMA to review and approve QFI qualifications.
- Lowering the minimum required assets under management/custody for QFIs to USD 500 million.
- Qualifying affiliates and foreign portfolio managers of QFIs without the need to submit separate applications.

The easing of the QFI rules was a key step to enable Saudi Arabia's inclusion in major global indices, which should result in a greater pick-up of capital inflows to the kingdom.

In 2018, CMA also approved the Financial Technology Experimental Permit. The purpose of the permit is to increase innovation in the domestic economy in line with ambitions of Vision 2030, specifically the Financial Sector Development Program. The CMA's approach follows a similar methodology to SAMA's sandbox approach, which allows new products and technologies to be tested under the auspices of the regulator to limit risks.

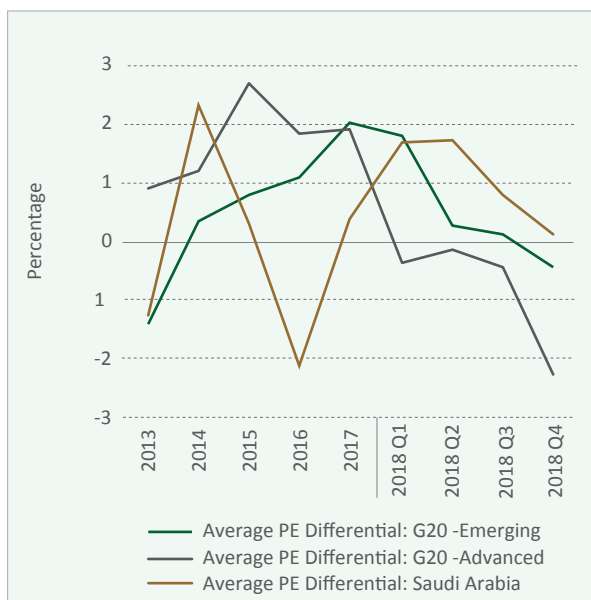
Stock market volatility picked up by the end of 2018. As highlighted in Chapter 1, advanced economies noted a steep sell-off in equities, which spilled over to emerging economies. The uptick in volatility of Tadawul All Share Index (TASI) also coincided with an increase in oil price volatility. Chart 6.1 shows the development in the TASI and oil prices, where both are rebased to Q1 2014, along with their 30-day volatility. Unsurprisingly, prices and volatility for oil tend to move hand in hand with TASI developments.

Chart 6.1: TASI and Oil Price



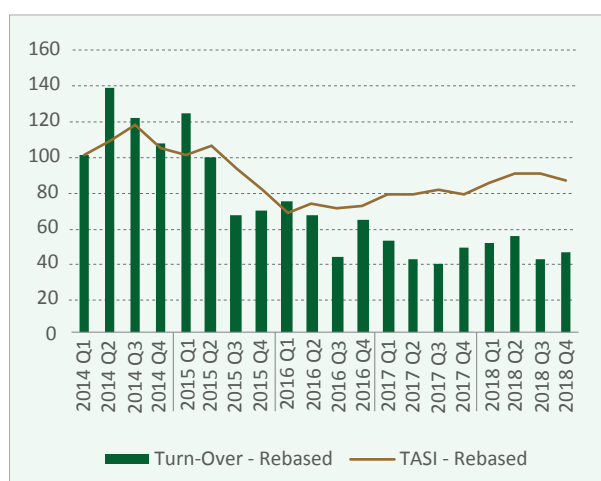
Despite the increase in volatility, sell-offs were not as steep in Saudi Arabia relative to other economies. Following a similar approach to the one adopted in Chapter 1, we compare the long-term price-to-earnings (PE) ratio of each country's main equity index to its most recent PE ratio. Saudi equities still trade relatively near their long-term valuation (Chart 6.2).

Chart 6.2: PE Differential



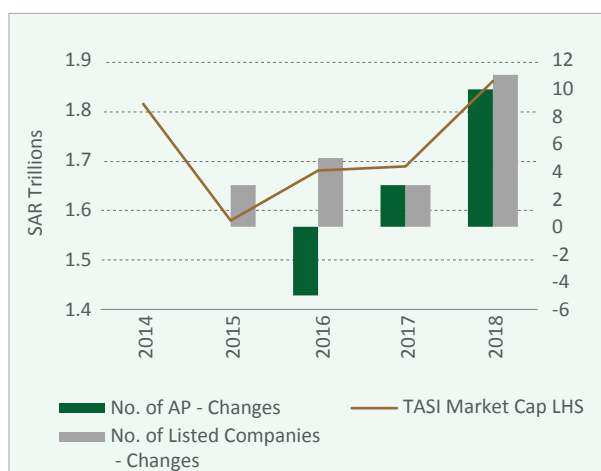
Equity market activity remains well below 2014 levels. Even with the relative improvement in TASI during 2017, market activity as measured by turnover remains at notable lows during 2018 (Chart 6.3).

Chart 6.3: TASI and Turnover



TASI's market capitalization continued to increase in 2018. By the end of 2018, market capitalization reached SAR 1.9 trillion; this in part captures the increase in listed companies over the year. The number of Authorized Persons (AP) and listed companies both increased, by 10 and 11 to reach 96 and 190, respectively (Chart 6.4).

Chart 6.4: Market Size



Capital market activity increased during 2018. There was an increase in the number of total capital market activities; this is especially evident in private placements for both equity and debt (excludes government-related placements). Private placements went up from 106 during 2017 to reach 117 in 2018 (Chart 6.5 and Chart 6.6).

Chart 6.5: Number of Capital Market Activities

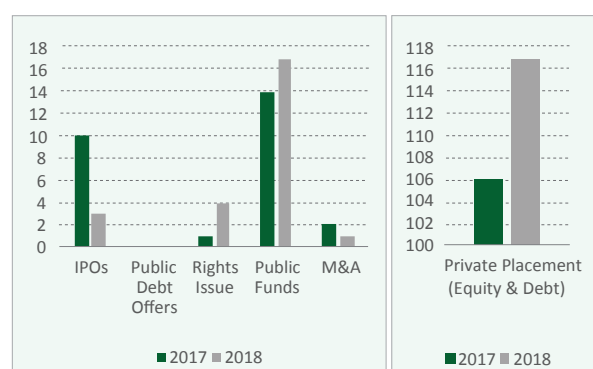
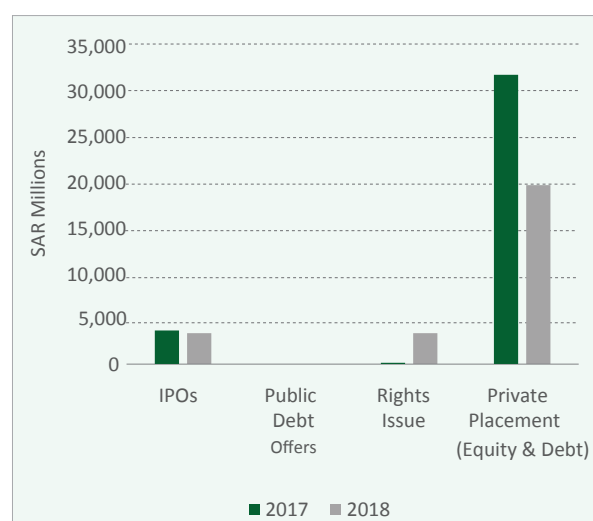
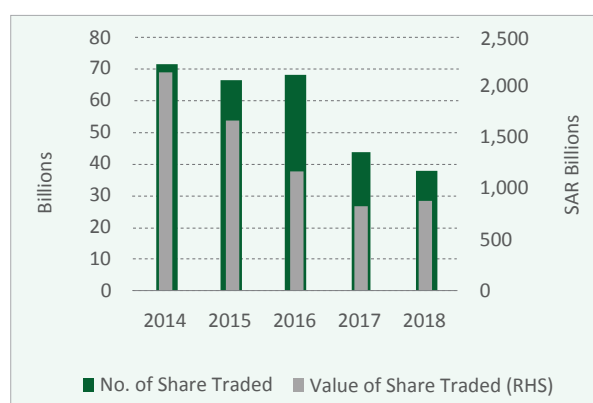


Chart 6.6: Total Issuance Value



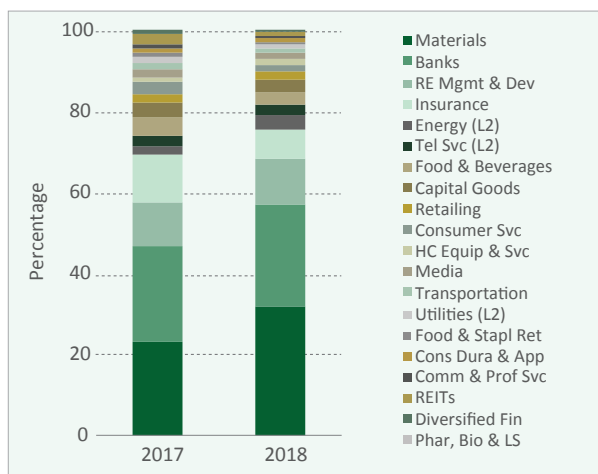
The subdued turnover highlighted earlier was captured in shares traded. Both the number and value of shares traded remain well below the average over the past years. The value of shares traded by 2018 reached roughly SAR 870 Billion, which is far below the SAR 2.1 Trillion recorded during 2014 (Chart 6.7).

Chart 6.7: Number and Value of Shares Traded



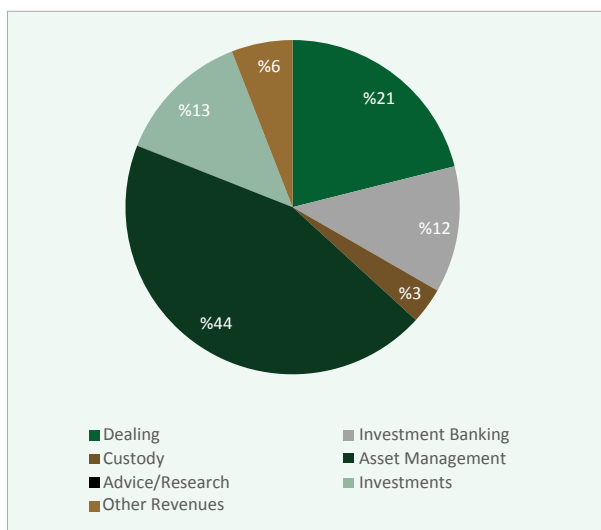
There has been a slight shift in the distribution of shares traded between sectors. The Materials sector claimed a higher portion of the value traded during 2018, accounting for 31 percent by the end of the year, which was an increase of roughly 800 basis points. In contrast, the insurance sector noted a slight decrease from 12 percent to 7 percent by the end of 2018 (Chart 6.8).

Chart 6.8: Value Traded by Sector



There has been little change in the revenue mix for Authorized Persons (AP's). Similar to 2017, the bulk of AP's revenue stem from asset management. Despite capital market deals trending down during 2018, the share of revenues from dealing activities was unchanged (Chart 6.9).

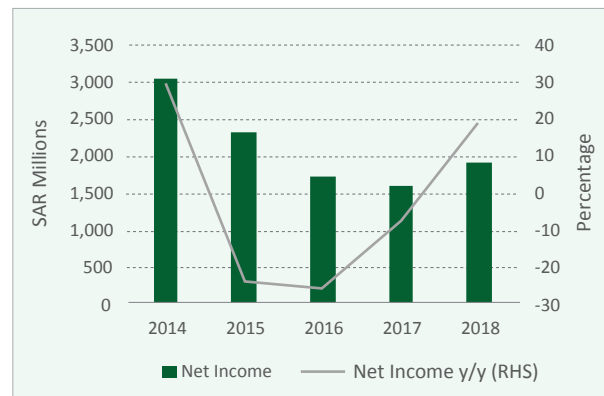
Chart 6.9: APs Revenue Distribution



There was a significant improvement in APs net income during 2018. Despite the relatively

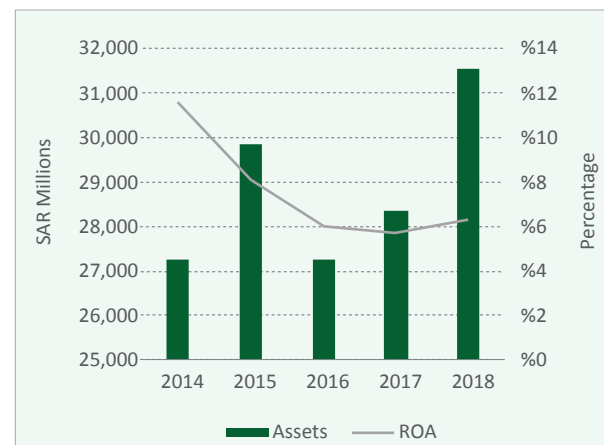
-muted capital market environment, APs posted significantly higher profits in 2018; jumping by 19 percent by the end of the year. The increase in profitability may have helped strengthen AP's capital adequacy ratio, which increased from 26.9 percent to 27.6 percent (Chart 6.10).

Chart 6.10: APs Net Income



AP's asset also noted a healthy increase during 2018. Total assets reached SAR 32 Billion, from SAR 28 billion in 2017. Despite the notable increase in assets, return on assets also improved during 2018 (Chart 6.11).

Chart 6.11: APs Assets and Return



Most asset classes that AP's invest in recorded a decline during 2018, despite the total value of investments increasing. The total was largely driven by an increase in the value of listed shares, while asset classes such as real estate, debt instruments and funds witnessed a decline relative to 2017 (Chart 6.12).

Chart 6.12: APs Investments in Asset classes

