FINANCIAL STABILITY REPORT

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البنك المركزي السعودي
SAMA
Saudi Central Bank

Financial Stability Report 2021

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Glossary

AEs	Advanced Economies
BoJ	Bank of Japan
BoP	Balance of Payments
CAR	Capital Adequacy Ratio
CCPs	Central Counterparties Clearing
CMA	Capital Market Authority
CPI	Consumer Price Index
DLT	Distributed Ledgers Technologies
DTFCs	Deposit Taking Finance Companies
ECB	European Central Bank
Edaa	Saudi Securities Depository Center Company
EMEs	Emerging Market Economies
EONIA	Euro Overnight Index Average
ESTR	Euro Short-term Rate
ETFs	Exchange Traded Funds
FBBs	Foreign Banks Branches
FCA	Financial Conduct Authority
FinTech	Financial Technology
FMIs	Financial Market Infrastructure
FRBNY	Federal Reserve Bank of New York
FSB	Financial Stability Board
FSDP	Financial Sector Development Program
FSR	Financial Stability Report
GASTAT	General Authority for Statistics
GAZT	General Authority of Zakat and Tax
GDP	Gross Domestic Product
GFSR	Global Financial Stability Report
GHOS	Group of Central Bank Governors and Heads of Supervision
GTR	Global Transition Roadmap
GWP	Gross Written Premium
HQLA	High Quality Liquid Assets
IBNR	Claims Incurred but not Reported
IBOR	Interbank Offered Rate
IFRS 9	International Financial Reporting Standard 9
IFRS 17	International Financial Reporting Standard 17
IMF	International Monetary Fund
ILAAP	Internal Liquidity Adequacy Assessment Process
IPO	Initial Public Offering
ISDA	International Swaps and Derivatives Association
LCR	Liquidity Coverage Ratio
LDR	Loan-to-Deposit Ratio
LIBOR	London Interbank Offered Rate
M3	Broad Monetary Aggregate
MMF	Money Market Funds
MoF	Ministry of Finance

Monshaat	General Authority for Small and Medium Enterprises
MSMEs	Micro, Small, and Medium-sized Enterprises
Muqassa	Securities Clearing Center Company
NBFIs	Non-bank Financial Institutions
NCI	Net Claims Incurred
NII	Net Interest Income
NMEG	Non-bank Financial Institutions Monitoring Experts Group
NPLs	Non-Performing Loans
NSFR	Net Stable Funding Ratio
OCR	Outstanding Claims Reserve
OMO	Open Market Operations
OPEC+	Organization of the Petroleum Exporting Countries and Allies
OSSG	Official Sector Steering Group
OTC	Over the Counter
P&C	Property and Casualty
P&S	Protection and Savings
PIF	Public Investment Fund
PMI	Purchasing Managers Index
POS	Point of Sales
REITs	Real Estate Investment Trusts
RETT	Real Estate Transaction Tax
RFRs	Near-Risk-Free Rates
ROA	Return on Assets
ROE	Return on Equity
RWAs	Risk-Weighted Assets
SAIBOR	Saudi Arabian Interbank Offered Rate
SAMA	Saudi Central Bank
SARIE	Instant Payment System
SARON	Swiss Average Overnight Rate
SCAV	Standing Committee for Vulnerability Assessment
SIFIS	Systemically Important Financial Institutions
SIX	Swiss Exchange
SMEs	Small and Medium-sized Enterprises
SOFR	Secured Overnight Financing Rate
SRC	Saudi Real Estate Refinance Company
Tadawul	Saudi Stock Exchange
TASI	Tadawul All Share Index
UPR	Unearned Premium Reserve
VAT	Value Added Tax
WEO	World Economic Outlook
Y/Y	Year-on-Year

Executive Summary

The Saudi Arabian economy and financial sector have remained resilient to unprecedented uncertainty as a result of the COVID-19 pandemic during 2020. The banking sector has continued to provide financial support via new lending to businesses and households throughout the pandemic. As COVID-19 continues to have a global impact, the macroeconomic outlook and global recovery remain uncertain; however, the Saudi Arabian economy, financial sector and assets market remain well-positioned to respond to further developments and to facilitate the path to recovery.

Countries around the world have taken varying sets of measures to contain the fallout of the COVID-19 pandemic. In most cases, some combination of monetary, fiscal, regulatory flexibility and prudential policy actions were deployed to support the economy and maintain financial stability, which reinforced the resilience of the financial sector and allowed it to maintain the flow of credit and support economic recovery. Nevertheless, some sectors may be exposed to some vulnerabilities amid an uncertain recovery pathway. Limited capacity in the health care system, capital outflows and more constrained fiscal space were the main drivers of differentiated output growth outcomes between emerging market and developing economies on the one hand, and advanced economies on the other.

Turning to the Saudi economy, it witnessed a considerable contraction in 2020, in line with the necessary precaution health measures put in place in response to the COVID-19 pandemic, which temporarily impacted both demand and supply. The oil sector of the economy was negatively affected as global oil demand declined significantly. The decline in non-oil sector was mainly attributed to the precautionary measures imposed to limit the spread of the virus. Notwithstanding the economic downturn, the inflation rate remained in the positive territory as a result of the value added tax increase in the second half of 2020. Domestic fiscal indicators were impacted as government revenues declined and expenditures held steady to support the economy in response to the pandemic. Higher expenditure was attributable to both the economic downturn and the government response to the pandemic.

Despite uncertainties that could affect the economic recovery, the economy has remained resilient to the impact of COVID-19, with a wide range of mitigation measures implemented via fiscal and monetary policy initiatives in 2020. In particular, the non-oil private sector saw its situation starting to improve towards the second half of 2020 as a result of the effective policy measures. Although oil prices stabilized in the second half of 2020, the risk associated with further waves in the COVID-19 pandemic and a slower than anticipated vaccination pace globally could create some volatility in oil prices. In general, the Saudi macroeconomic outlook remains relatively stable supported by the government response to mitigate the adversity of the COVID-19 impact on the economy.

The domestic banking sector has so far proven both operationally and financially resilient to the impact of the COVID-19 pandemic. Credit extended by the banking sector has grown at a solid pace, primarily because of the high growth in retail real estate. Credit to micro, small and medium-sized enterprises increased, which was reinforced by the government’s packages to support the private sector. Non-performing loans have risen on aggregate, however, they remained low. Given the banking sector's strong solvency position as measured by the domestic banks’ capital adequacy ratio, the banking sector is well-positioned to sustain any further potential deterioration in its asset quality.

Liquidity conditions in the banking sector remained ample, underpinned by the growth in private sector deposits as well as the Saudi Central Bank's liquidity support. Banks' profitability on the contrary decreased in 2020 with declining interest income and increased provisioning weighing on net profitability. However, the sector is expected to perform more strongly in 2021 against a backdrop of the expected recovery in economic activity, the further rollout of vaccines and its impact on confidence, as well as the ongoing structural reforms in the kingdom.

The insurance sector has fared well despite the impact from COVID-19. In the health insurance segment, growth has remained positive during the pandemic. However, motor insurance premium continued its decline for the fourth consecutive year. Still, the insurance sector's solvency has continued to display a strong standing, even though technical reserves witnessed a lower growth rate. The loss ratio of the sector improved in 2020, as the lockdown lowered the number of claims. In sum, despite the impact from the pandemic, the insurance sector remains resilient.

As for the finance companies sector, their total assets recorded increases, along with growth in total real estate and non-real estate credit. Overall, finance companies performed positively, as evidenced by the lower non-perfoming loans, which reflects effective supervisory efforts and a robust regulatory framework.

Saudi Central Bank's liquidity support to the domestic financial market mitigated the impact of fluctuations in external capital flows and the build-up of systemic risk vulnerabilities. In turn, this backdrop helped improve investor sentiment, as reflected by the Tadawul All Share Index recovery to its pre-pandemic level by the end of the year 2020.

The year 2020 was also marked by the approval of the Saudi Central Bank Law. The Saudi Central Bank's regulatory activities during the past year remained focused on updating prudential rules, FinTech, payment systems, and the cybersecurity response to the economic and financial disruptions.

GLOBAL ECONOMIC DEVELOPMENTS

1

1. Global Economic Developments

1.1 Overview

The COVID-19 pandemic severely impacted all parts of the world with dire consequences for world economic growth and employment specially in the services sector. In 2020, the world experienced the worst economic recession since the Great Depression of the 1930s. The pandemic also triggered a massive fiscal and monetary policy response to save lives and livelihoods and prevent an even deeper economic downfall. Global fiscal stimulus packages in 2020 far exceeded those in 2008/09 (Table1). Notably, 2020 stimulus packages are larger in total and as a share of GDP compared to 2008/09. Gross public debt rose on account of both the recession and the stimulus packages by more than 13 percentage points worldwide, according to the April 2021 IMF Fiscal Monitor.

Table 1.1: Global Fiscal Stimulus Packages

	Average of 2008-2009 Stimulus Package	Average of 2020 Stimulus Package	
	in % of GDP	in % of GDP	Change (%)
Developed	**2.6**	**9.7**	**270**
Developing	**4.6**	**5.5**	**18**
HIC	7.6	8.4	10
UMIC	6.0	6.4	6
LMIC	2.5	3.7	50
LIC	2.0	3.3	65
Transition Economies	**13.2**	**3.4**	**-74**

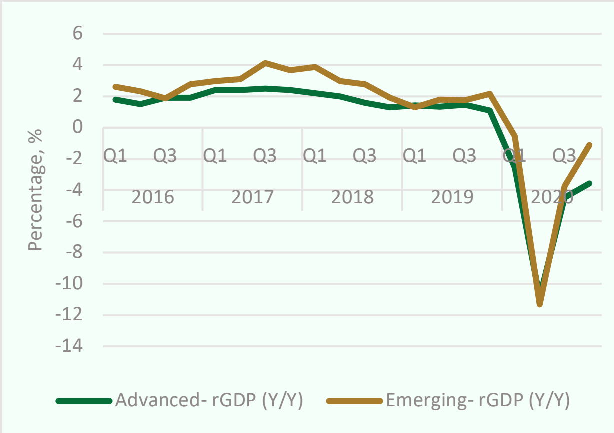
Source: UNCTAD, December 2020

The response of monetary policy to the COVID-19 crisis has consisted of several measures (near zero or even sub-zero policy rates, asset purchase programs, macroprudential measures, yield curve control) with the aim of ensuring sufficiently supportive financial conditions to maintain the flow of credit to the real economy Small and Medium-sized Enterprises (SMEs). The historic monetary policy enacted by many countries has served to contain greater vulnerabilities stemming from the economic fallout, which contributed to mitigating some of the major economic consequences of the global pandemic.

1.2 Growth and Economic Output

The global pandemic has sparked an unprecedented economic crisis, with a more negative impact on economic activities in the first half of 2020 than originally anticipated. Some economies exhibited signs of recovery by the second half of 2020 (Chart 1.1). More limited capacity in healthcare systems and less fiscal space impacted Emerging Market Economies (EMEs) more severely than Advanced Economies (AEs). Saudi Arabia was not an exception to global developments, with oil prices falling due to the demand shock. According to the April 2021 IMF World Economic Outlook (WEO), world output shrunk by 3.3 percent in 2020, but it is projected to rise by 6.0 percent in 2021, backed by continued policy support and vaccine rollout. However, the recovery is likely to be uneven depending on the effectiveness of vaccination programs, the extent of policy support and the structural characteristics of economies.

Chart 1.1: Global GDP Growth

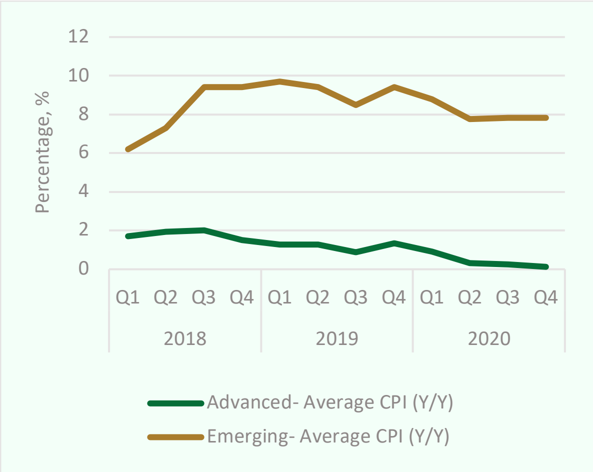


Source: Bloomberg

1.3 Inflationary Trends

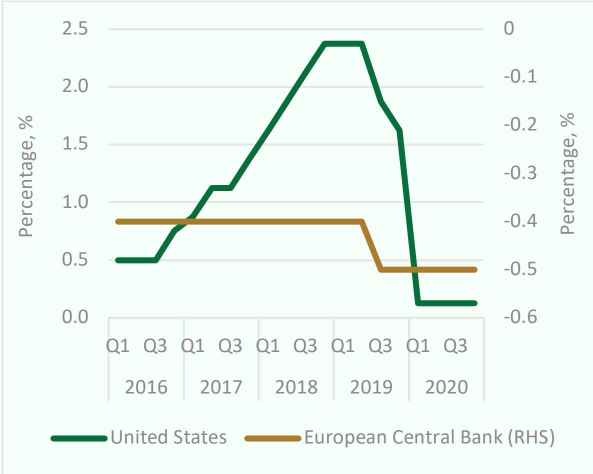
The pandemic's impact on economic activity resulted in lower consumer demand for goods and services. Protective measures such as social distancing and travel restrictions slowed in particular the demand for services in the economy. The average Consumer Price Index (CPI) for AEs stood at 0.1 percent in December 2020 compared to 1.4 percent in 2019. The CPI for EMEs softened to 7.8 percent compared to 9.4 percent. Notably, inflation rates for EMEs remained elevated relative to AEs (Chart 1.2). A pickup in inflation is now a key theme for the markets due to the size of the continued fiscal stimulus across the globe, especially in the US, and the anticipated pent-up demand driving the possible pickup in inflation across different jurisdictions.

Chart 1.2: Global CPI



Source: Bloomberg

Chart 1.3: Interest Rates



Source: Reuters

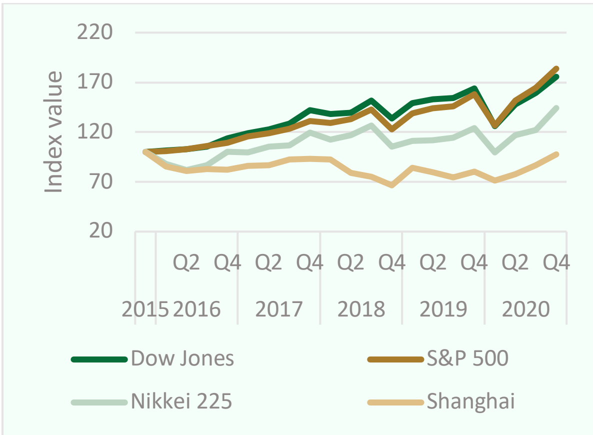
1.4 Interest Rates

Nearly all central banks cut policy rates in 2020 besides applying additional measures such as asset purchase programs, liquidity provision through special facilities, relaxation of macroprudential requirements, and expansion of US dollar swap lines. The Fed, which has recently adopted a new monetary policy strategy called FAIT (Flexible Average Inflation Targeting), is all but certain to keep its benchmark overnight rate in a target range of 0 percent to 0.25 percent for the foreseeable future. The Federal Reserve's new inflation strategy and the pickup in economic activity have helped the US Treasury yield curve to steepen. Large-scale asset purchase programs are intended to keep term premia and risk premia that are embedded in long-term yields contained. While the European Central Bank (ECB) recalibrated its stimulus measures, it kept its policy rates unchanged, with the refinancing rate (repo rate), marginal lending rate and deposit rate staying at zero, 0.25 percent and minus 0.5 percent respectively (Chart 1.3). In Japan, the short-term policy rate is minus 0.10 percent for current accounts held by financial institutions with the Bank of Japan (BoJ). The BoJ is focused on effective and sustainable effects of its prolonged monetary easing in achieving its target inflation rate while keeping an eye on its side effects (i.e. bank profitability and market functioning). In EMEs, policy rates vary, reflecting the extent of their reliance on foreign capital, exchange rate volatility and inflationary risks.

1.5 Global Financial Markets

2020 was a remarkable year for financial markets, exhibiting unexpected patterns following the steep fall in March 2020. The disconnect between the economy and the stock market, was pronounced in the second quarter of 2020. Stocks staged a rally since bottoming in late March (Chart 1.4). Sovereign bonds have given up their lofty gains of early 2020 on potential inflationary concerns (Chart 1.5).

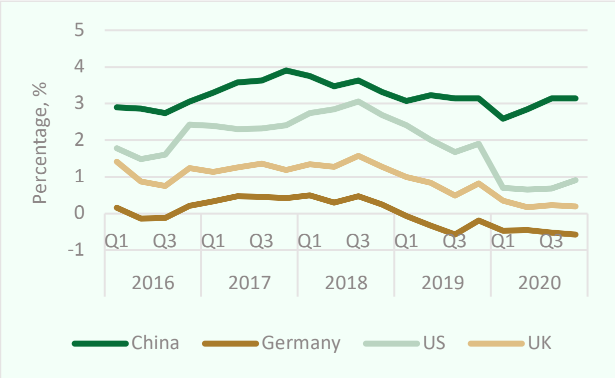
Chart 1.4: Normalized Global Market Indices



Source: Bloomberg.
Base Year: 2015

For EMEs, the pandemic led to an unprecedented and sharp reversal of portfolio flows, highlighting the challenges of managing capital flows in emerging and frontier markets. Financial conditions in AEs tend to influence portfolio flows to and from EMEs. Banks, have entered this crisis from a position of strength, given the post-global financial crisis reforms, which resulted in a global banking system that is well capitalized and liquid.

Chart 1.5: 10-Years Bonds Yields



Source: Bloomberg

1.6 Oil Market

The pandemic has also severely affected oil markets. The global demand shock resulted in an oversupply of oil, causing oil prices to fall precipitously on the back of the containment measures. Unlike 2019, oil prices were significantly volatile in 2020. However, as economies emerged from lockdowns and the Organization of Petroleum Exporting Countries and its allies (OPEC+) maintained its oil output restraint, market prices recovered to the semblance of delicate stability. Brent oil prices at the end of 2020 stood at $ 51.8/barrel vs its lowest level of $ 19.2/barrel in April 2020 (Chart 1.6).

Chart 1.6: Crude Brent Oil Price

Source: Bloomberg

1.7 Global Growth Outlook and Risks

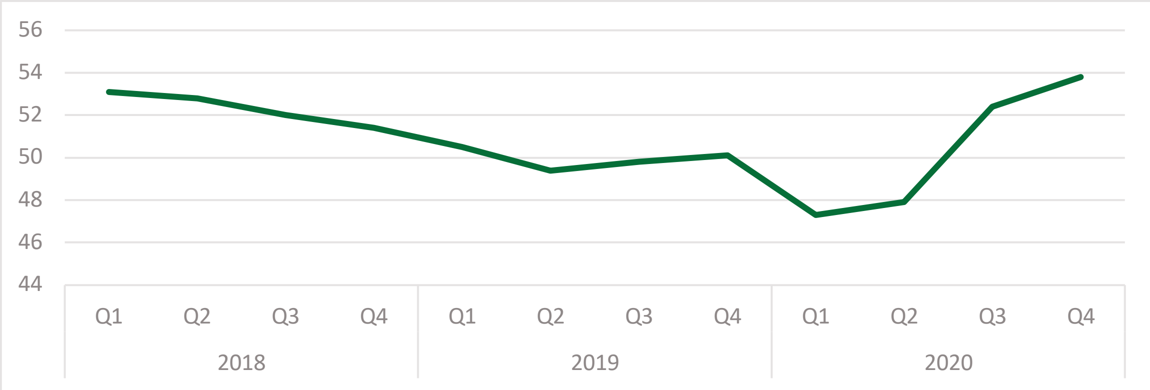
An unprecedented fiscal and monetary response to contain the pandemic impact has been instrumental in dampening the global recession in 2020. Recent upward revisions of growth projections have brightened global growth prospects. Major central banks remain focused on supporting growth, and in this context, their message is one of patience in reversing their accommodative policy course, despite markets' concern about inflation, in a bid to minimize potential risks to the nascent recovery. Consumers in the world's largest economies have reportedly amassed $2.9 trillion in extra savings (half of that, or $ 1.5 trillion, is in the US alone)[1]. Out of the three motives for saving (i.e. for consumption, debt repayment and savings), consumption could be an add-on to global demand growth.

The other side of the massive policy stimulus has essentially taken the form of swift accumulation of sovereign and corporate debt, facilitated in particular by large central bank balance sheet expansion. If interest rates rose noticeably from the current levels, the potential risk would be one of debt servicing problems with implications for economic activity. Central banks therefore face a challenging situation in balancing growth and inflation risks.

[1]Source: Bloomberg

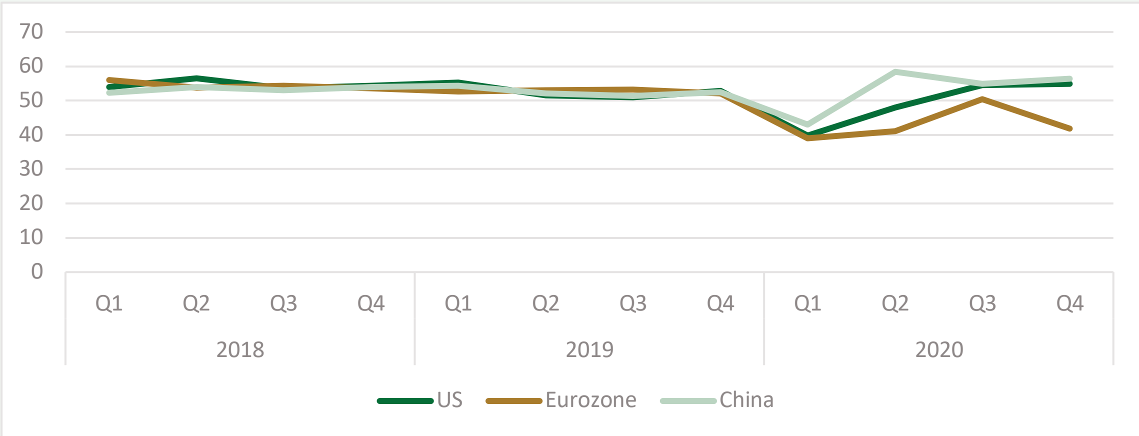
Box 1.1: Effects of COVID-19 on Manufacturing and Services Industries

Chart 1.7: Global Manufacturing PMI



Source: Reuters

Chart 1.8: Global Services PMI



Source: Reuters

A broad-based slowdown in manufacturing activities occurred in 2019 amid the macroeconomic consequences of global trade policy and tariffs imposed by the US, which negatively affected global business sentiment and consumer confidence. The slowdown turned into a deep downturn as the COVID-19 pandemic exerted pressure on main industries including manufacturing and services during Q1 2020 on the back of a strongly reduced demand. An unusually sharp contraction in manufacturing and slower capacity utilization due to short-term shutdowns to sanitize factories, in addition to containment measures, have caused deeply negative growth rates in Q2 2020.

However, a recovery took hold by the second half of 2020 as the manufacturing sector recovered, supported by a shift in demand for goods and services. With regional variations across countries, the recovery of the services sector is lagging in those countries such as the Eurozone area due to the lockdown measures, which had to be extended or reintroduced during the second half of 2020. Notably, the recovery path on the services industry is mainly conditional on the pace of COVID-19 vaccine rollouts.

DOMESTIC MACRO-FINANCIAL DEVELOPMENTS

2

2. Domestic Macro-Financial Developments

2.1 Overview

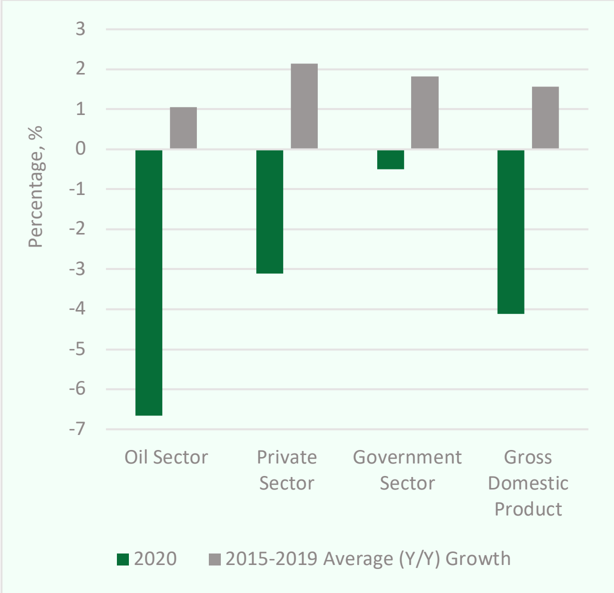
In 2020, the COVID-19 pandemic has negatively impacted most economies around the world and the Saudi economy was no exception. The domestic economy faced a significant decline in GDP due to a decline in most sectors of the economy, as well as a significant decrease in oil demand during 2020.

2.2 Growth Developments

Saudi Arabia's real GDP contracted by 4.1 percent in 2020 compared to a growth of 0.3 percent in 2019, as production in both oil and non-oil sectors declined throughout 2020. The oil sector shrunk by 6.7 percent compared to a decline of 3.6 percent in the previous year and a positive average annual growth of 1.1 percent between 2015 and 2019 (Chart 2.1). This drop in oil sector activity was clearly attributable to the COVID-19 pandemic, which negatively affected global oil demand. Additionally, OPEC+ producers agreed on production cuts until the end of December 2020 to stabilize oil prices.

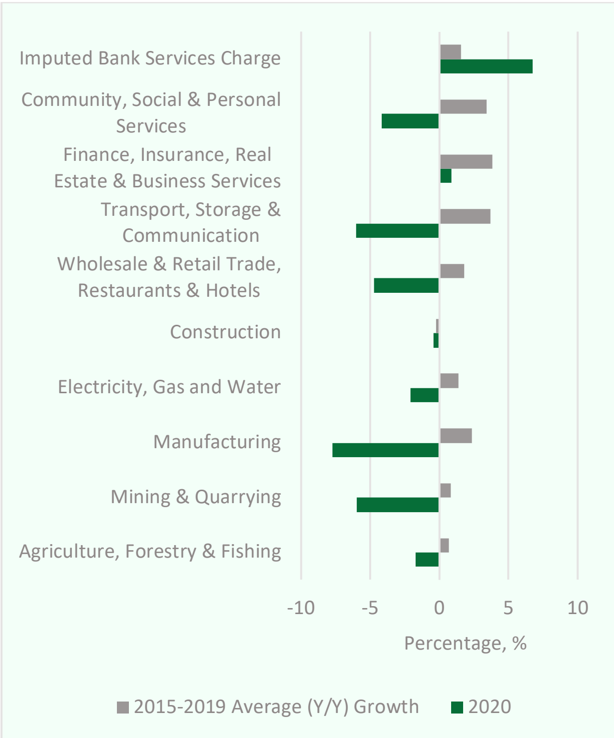
The non-oil sector also recorded negative growth of 2.3 percent in 2020 compared to a positive growth rate of 3.3 percent in the previous year. The decline in non-oil output was mainly attributable to the COVID-19 precautionary measures taken by the Saudi government to limit the spread of the virus. The lockdown and restrictions on mobility mainly in Q2 2020 significantly affected a number of sectors, most notably Manufacturing, Wholesale & Retail Trade, Restaurants & Hotels, and Transport, Storage & Communication. These three sectors experienced production declines of 7.7 percent, 4.8 percent, and 6.0 percent respectively (Chart 2.2).

Chart 2.1: Real GDP Growth by Institutional Sectors



Source: General Authority for Statistics

Chart 2.2: Real GDP Growth by Economic Sector



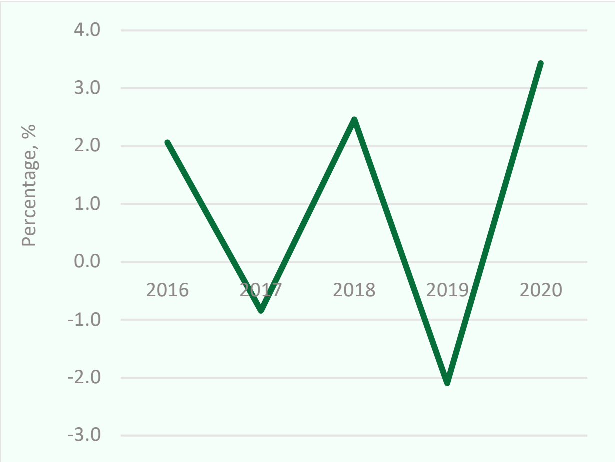
Source: General Authority for Statistics

2.3 Inflationary Trends

Saudi Arabia's inflation rate distinctly increased in the second half of 2020, with the annual average of 1.0 percent in the first half of the year rising to 5.8 percent in the second half. The main factor to this sharp increase was the increase of the Value Added Tax (VAT) from 5 percent to 15 percent in July 2020.

Another contributing factor was the increase in custom duties in June 2020, with rate increases ranging from 0.5 percent to 15 percent for various products. Still, in the course of the second half of 2020 the inflation rate gradually decreased again from an annual average rate of 6.2 percent in August to 5.3 percent in December. When looking at the two half-yearly periods combined, the CPI averaged 3.4 percent in 2020 compared to -2.1 percent in 2019 (Chart 2.3).

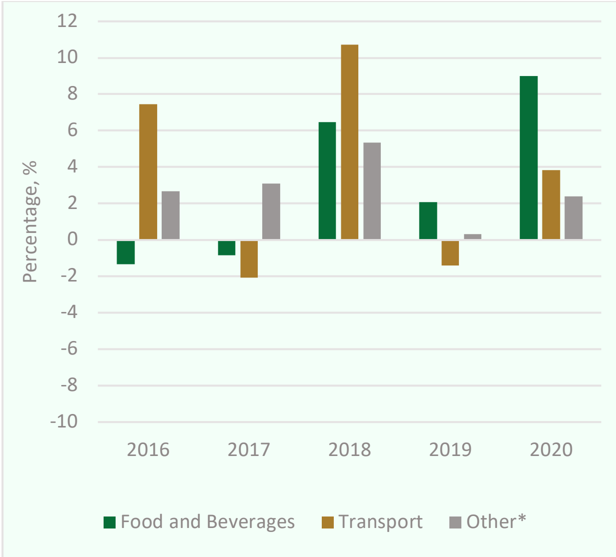
Chart 2.3: Annual Inflation (2018=100)



Source: General Authority for Statistics

Prices of seven main consumer product groups in the CPI basket increased in 2020. The category that saw the most notable increase was food and beverages with an average rise of 9.0 percent in 2020. The other six categories that saw distinct increases over the year were tobacco (7.1 percent); communication (4.8 percent); furnishing, household equipment and maintenance (4.6 percent); restaurants and hotels (4.3 percent); goods and services (4.0 percent); and transport (3.8 percent). On the other hand, the housing, water, electricity, gas, and other fuels category showed a slight contraction (-0.6 percent), which can be attributed to the decline in oil prices, in addition to the decline in rental property prices during 2020 (Chart 2.4).

Chart 2.4: Inflation Rate of CPI by Main Categories

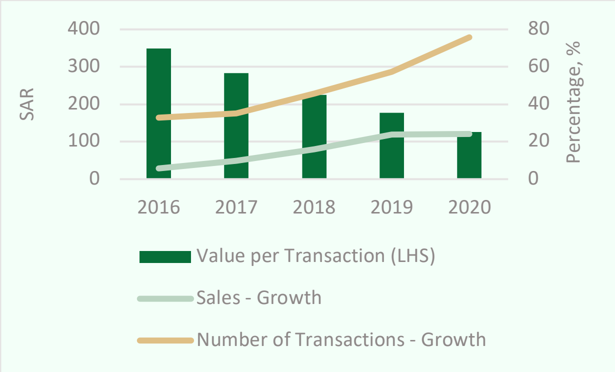


Source: General Authority for Statistics
**Other includes Clothing and Footwear, Housing, Water, Electricity, Gas, and other fuels, Furnishings, Household equipment, Communication, and Restaurants and Hotels.*

2.4 Consumer Spending

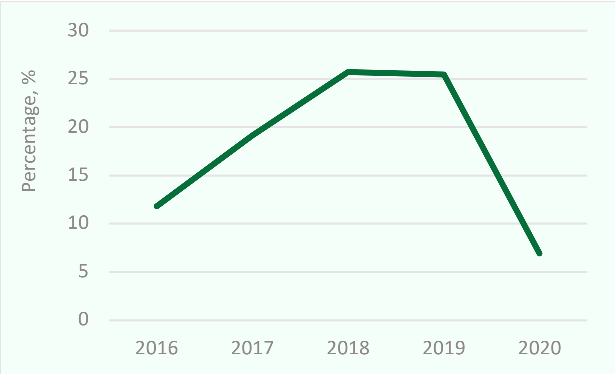
Point of sales transactions increased by 75.8 percent and sales grew by 24.2 percent, respectively, in 2020 (Chart 2.5). The main explanatory factor for the strong rise in Point of Sale (POS) transactions relates to the precautionary measures taken to limit the spread of the COVID-19 virus by reducing the use of cash payment and by enhancing the recourse to cashless payment instruments, as well as an increase in the number of sales terminals by 64.4 percent to reach 721,000 units. When considering the utilization rate, i.e. the average number of times each terminal is used, a 6.9 percent increase in the utilization rate occurred compared to a growth of 25.5 percent in the previous year (Chart 2.6). This higher use of electronic payments also explains the decline in ATM cash withdrawals by 15.1 percent during 2020. Additionally, private final consumption expenditures as measured in GDP at current prices showed a decline by 4.1 percent in 2020 compared to the previous year, due to the lockdown and the precautionary measures taken in the context of the containment of the pandemic. As a result, private consumption declined during the past year.

Chart 2.5: POS Activity



Source: Saudi Central Bank

Chart 2.6: POS Utilization Growth Rate



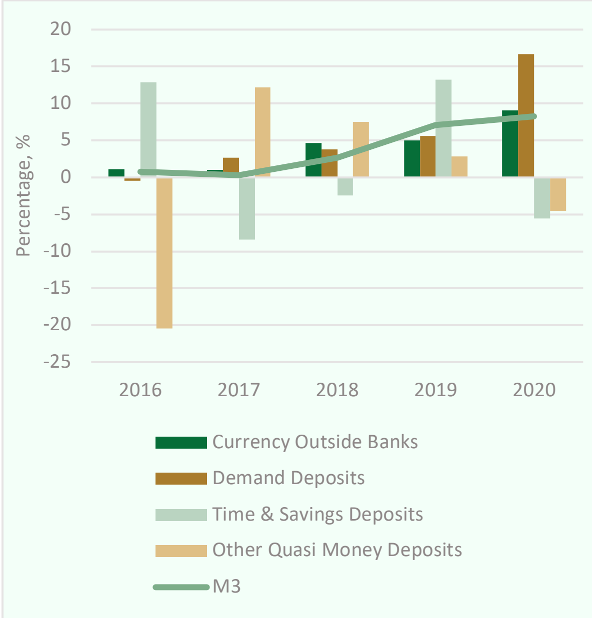
Source: Saudi Central Bank

2.5 Monetary Developments

2.5.1 Monetary Aggregates

Monetary aggregates grew compared with the previous year. The monetary base recorded a growth rate of 8.6 percent in 2020 compared to an increase of 4.2 percent in 2019. As a result of increased government spending and ample liquidity provision by the Saudi Central Bank, the broad monetary aggregate (M3) grew by 8.3 percent year on year by the end of 2020. This represented the highest annual growth rate since 2015 and was driven mainly by an increase in demand deposits. Demand deposits, which represent 59.7 percent of M3, recorded a growth rate of 16.7 percent in 2020 mainly supported by an increase in business and individuals' deposits. Currency outside banks grew at a solid rate of 9.1 percent, compared to a rate of 5.0 percent in 2019. This led to a rise in M1 of 15.6 percent in 2020, almost three times as much as in the previous year. Other components of M3, such as time and saving deposits and other quasi-money deposits displayed negative year on year growth rates in 2020 of -5.5 percent and -4.5 percent, respectively (Chart 2.7).

Chart 2.7: Growth Rates of M3 and its Components



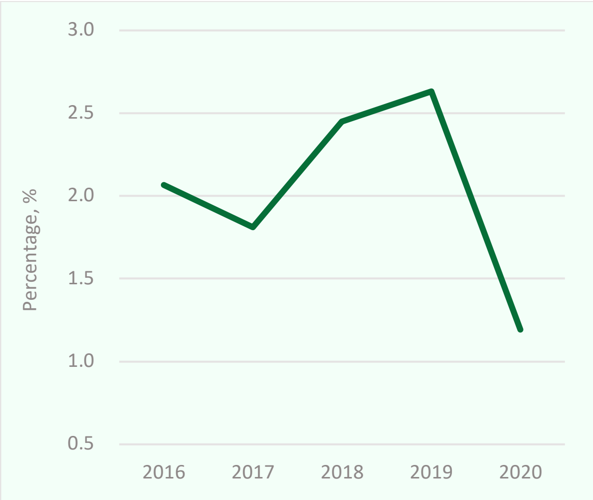
Source: Saudi Central Bank

2.5.2 Monetary Policy and Financial Conditions

Early in the pandemic, the Saudi Central Bank affirmed its commitment to its exchange rate policy of pegging the Saudi riyal to the US dollar as a strategic choice that had supported economic growth in Saudi Arabia. Furthermore, Saudi Central Bank declared that it remained committed to maintaining the exchange rate at the official rate of 3.75 riyals to the dollar to safeguard monetary and financial stability. In the wake of the negative macroeconomic developments, Saudi Central Bank decided to cut its repo and reverse repo rates twice in March of 2020. First, the repo rate was cut by 50 basis points (from 2.25 percent to 1.75 percent) and the reverse repo rate by the same amount (from 1.75 percent to 1.25 percent). The Saudi Central Bank then decided to cut its repo and reverse repo rates by a further 75 basis points, from 1.75 percent to 1.00 percent for the repo rate, and from 1.25 percent to 0.50 percent for the reverse repo rate.

In response to the two policy rate cuts, the average 3- month Saudi Arabian Interbank Offered Rate (SAIBOR) decreased during 2020. As Chart 2.8 illustrates, the SAIBOR started decreasing in the first half of 2020, and then declined further to average 1.19 percent by the end of the year.

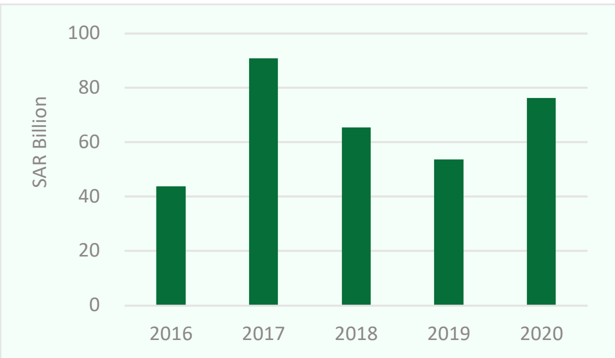
Chart 2.8: SAIBOR



Source: Saudi Central Bank

Reverse repo transactions increased in 2020. The monthly average reverse repo witnessed a notable rise from SAR 53.7 billion in 2019 to SAR 76.4 billion in 2020 (Chart 2.9). Reverse repo levels remained within comfortable levels, despite the COVID-19 outbreak. This can be explained by the Saudi Central bank's programs in support of liquidity provision, including an injection of SAR 50 billion of liquidity. It should be noted that Saudi Central Bank also launched a complementary Open Market Operations (OMO) tool to its current offering of SAMA Bills to enhance short-term liquidity management in the local banking system to maintain domestic monetary and financial stability.

Chart 2.9: Reverse Repo Transactions Performance

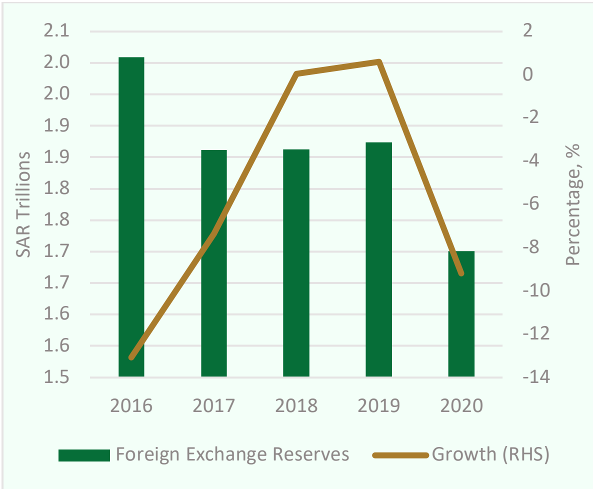


Source: Saudi Central Bank

Saudi Central Bank's foreign exchange reserves decreased by 9.2 percent in 2020, compared to the previous year, to stand at SAR 1,701 billion by the end of 2020. The decline was largely due to the transfer of SAR 150 billion from the central bank's foreign exchange reserve to the Public Investment Fund (PIF) in March and April (Chart 2.10).

Saudi Central Bank's foreign exchange reserves are used for meeting Saudi Arabia's external obligations, import demand, non-residents' remittances, besides serving the purpose of maintaining monetary and financial stability. Saudi Central Bank's foreign exchange reserves remain sufficient to meet all demands of the national economy for foreign exchange, with foreign exchange reserves covering 41.4 months of imports and 79.2 percent of M3.

Chart 2.10: Foreign Exchange Reserves



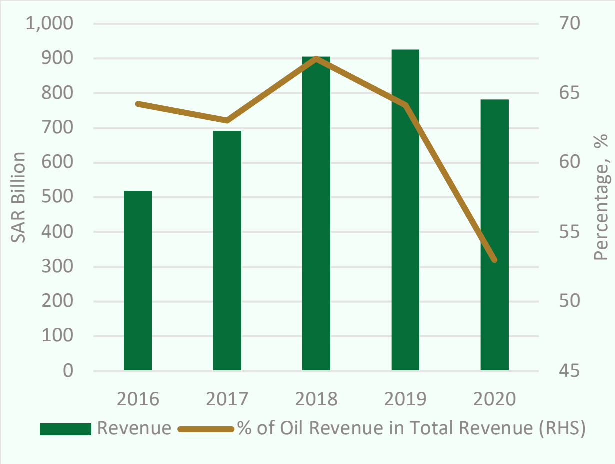
Source: Saudi Central Bank

2.6 Fiscal Developments

2.6.1 Government Revenue

Government revenues decreased in 2020. Total revenues reached SAR 781.8 billion in 2020, a decrease of 15.6 percent compared to the previous year, as a result of the decline in global oil demand, which reflected in a decrease in oil revenues by 30.5 percent compared to last year. Non-oil revenue reached SAR 368.7 billion, an increase of 10.9 percent compared to 2019 data. The increase of non-oil revenue can be explained by the increase in tax revenue (by 2.9 percent) compared to last year to reach SAR 226.4 billion. This increase, notwithstanding the economic downturn, resulted from the rise in the VAT rate by 10 percentage points in the second half of the year. On the other hand, the General Authority of Zakat and Tax (GAZT) issued a relief for late tax filing penalties during 2020, which limited the growth of non-oil revenue (Chart 2.11).

Chart 2.11: Government Revenue

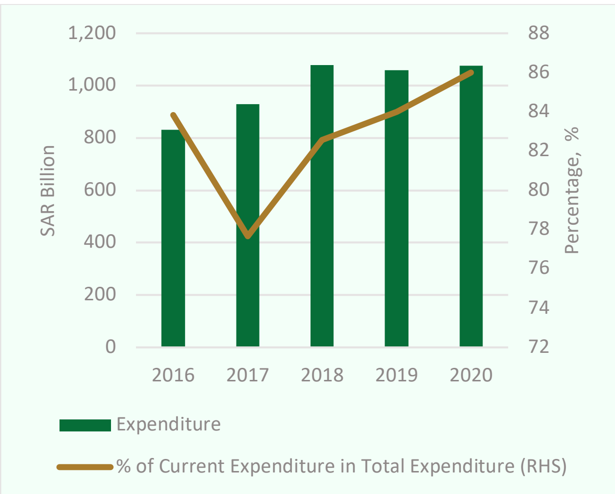


Source: Ministry of Finance

2.6.2 Government Expenditure

Government expenditure exceeded SAR 1 trillion for the third year in a row in 2020. It increased by approximately 1.5 percent compared to the previous year, reaching SAR 1.07 trillion in 2020. Salary expenses represent the largest share of current expenditures at SAR 494.7 billion. The increase in spending was mainly due to the government's efforts to support the impacted sectors, as well as its initiatives to support Saudi employment during the COVID-19 crisis. Capital expenditures reached approximately SAR 155.1 billion by the end of 2020, representing a decrease of 8.5 percent compared to the previous year. This was the result of a reduction in the allocations of funds to some activities under Vision 2030 realization programs and projects, as well as cancellation, extension over time or postponement of some capital initiatives (Chart 2.12).

Chart 2.12: Government Expenditure

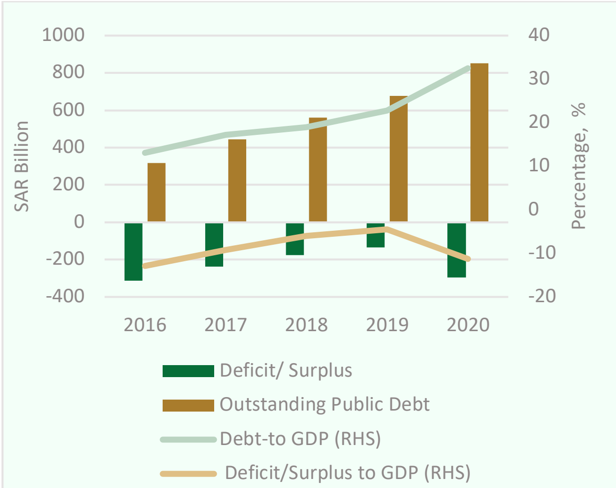


Source: Ministry of Finance

2.6.3 Budget Deficit and Debt

The budget deficit significantly increased to reach SAR 293.9 billion in 2020. This represents an increase of 121.6 percent compared to the previous year. In addition, the debt-to-GDP ratio increased to 32.5 percent as the outstanding public debt level reached SAR 853.5 billion. Although the public debt has increased, its overall level remained moderate. Moreover, the additional risk involved is limited as most of the borrowing took place domestically and carried low interest rates. The government borrowing need was attributable to both lower revenues and higher expenditure, all of which were essentially the result of the COVID-19 induced economic downturn and the need to respond to it (Chart 2.13).

Chart 2.13: Budget deficit

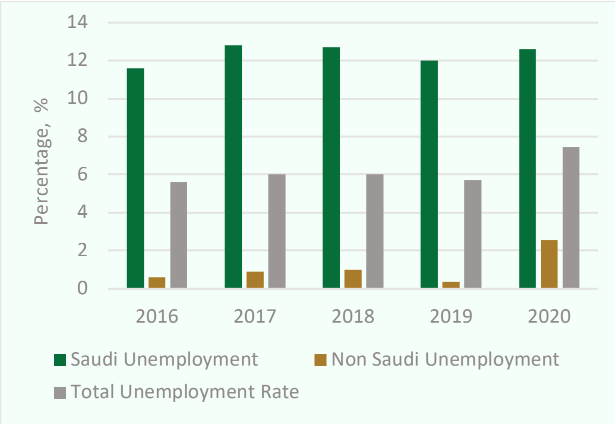


Source: Ministry of Finance

2.7 Labor Market Performance

The unemployment rate increased during 2020 compared to 2019. The Saudi unemployment rate increased to 12.6 percent in 2020 from 12.0 percent in 2019, reflecting the impact of the COVID-19 pandemic (Chart2.14). However, government programs, such as SANED contributed to reducing the impact of the pandemic on the labor market. The rebounding economy in the second half of the year led to a decline in the unemployment rate in Q4 2020 compared to Q3 2020. Saudi male unemployment decreased from 7.9 percent to 7.1 percent; the female unemployment rate declined from 30.2 percent to 24.4 percent.

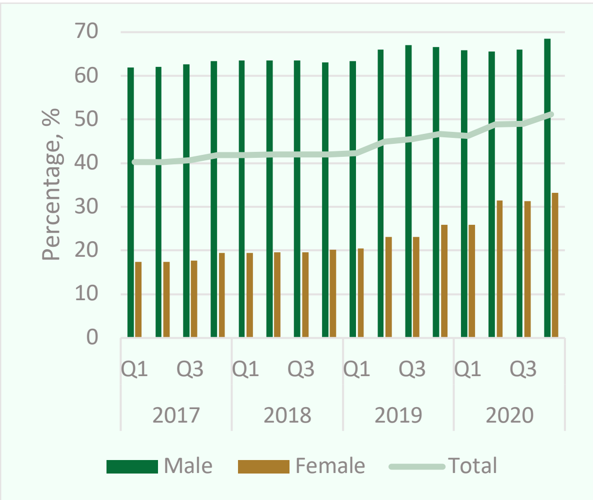
Chart 2.14: Unemployment Rate



Source: General Authority for Statistics

The labor market participation rate among Saudis increased in 2020. The Saudi labor force increased on the back of a higher participation ratio, which rose from 49.0 percent in 2019 to 51.2 percent in Q4 2020 (Chart 2.15).

Chart 2.15: Saudi Labor Force Participation Rate



Source: General Authority for Statistics

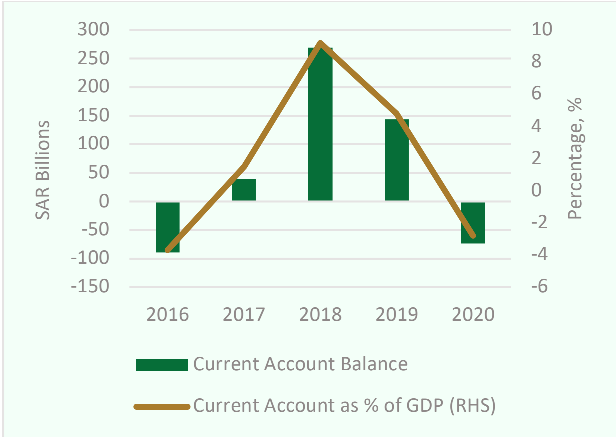
2.8 External Sector

2.8.1 Balance of Payments

2.8.1.1 Current Account

The current account recorded a deficit during 2020. Estimated data suggest a deficit of SAR 73.7 billion compared to a surplus of SAR 143.4 billion in 2019 (Chart 2.16). This is mainly attributable to the decline in oil revenues, but there was also an impact of the COVID-19 pandemic on non-oil imports and exports.

Chart 2.16: Current Account

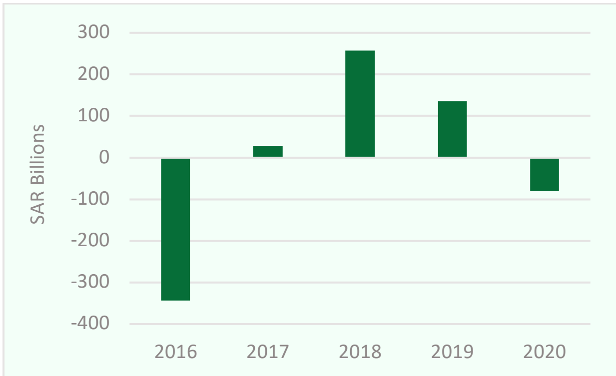


Source: Saudi Central Bank and General Authority for Statistics

2.8.1.2 Financial Account

The financial account recorded an inflow of SAR 80.9 billion in 2020, compared to an outflow of SAR 135.6 billion in 2019 (Chart 2.17). This was due to the decline in reserve assets by SAR 172.2 billion, and an inflow of SAR 2.4 billion in direct investment. On the other hand, portfolio investments registered an increase in 2020 reaching SAR 77.1 compared to a decline of SAR 43.2 billion in 2019.

Chart 2.17: Financial Account



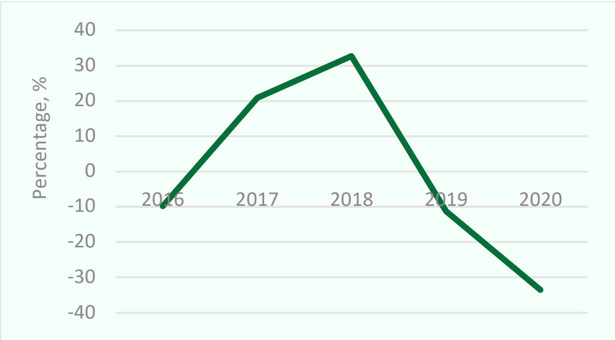
Source: Saudi Central Bank

2.8.2 External Trade

2.8.2.1 Exports

Exports recorded a decrease due primarily to the combined effect of lower oil production and lower oil prices. In value terms, overall exports dropped by 33.5 percent in 2020 (Chart 2.18). Oil and non-oil exports were both down by 40.5 percent and 10.8 percent respectively, in 2020. This drop in oil exports was primarily driven by the lower oil demand. Additionally, there was a decline in oil production that aimed at stabilizing prices in the face of the economic impact of the pandemic. The decline in non-oil exports is mainly attributable to the lockdown and precautionary measures taken by the government to limit the spread of the COVID-19, which affected the private sector and the economic activity.

Chart 2.18: Export Growth

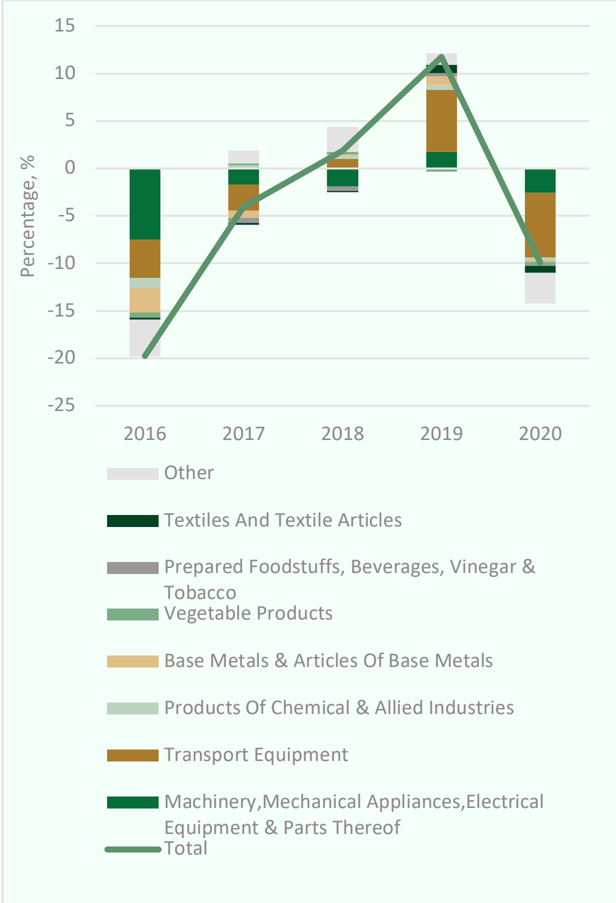


Source: General Authority for Statistics

2.8.2.2 Imports

Imports registered a decline during 2020. Imports fell by 9.9 percent in 2020 compared to 2019. The decrease in private sector growth was reflected in the main import drivers, such as transport equipment (Chart 2.19). This development was mainly attributable to the decline in economic activity in the Kingdom on account of the lockdown and the other foreign trade-related effects of the pandemic on the Saudi economy.

Chart 2.19: Import Growth by Contribution



Source: General Authority for Statistics

2.9 Saudi Economic Growth Outlook and Risks

The domestic economy is expected to regain some upward traction amid several uncertainties that could dampen the pace of the recovery. The fiscal and monetary policy measures taken in 2020 have mitigated the negative impact of the COVID-19 event as indicated among others by the IMF in its latest WEO (April 2021). According to the IMF, the Saudi economy is projected to show an annual GDP growth of 2.9 percent in 2021, following a 4.1 percent contraction last year. The economy started to show an improvement with policy measures and initiatives taken by the Saudi authorities in support of non-oil private sector activity. Accordingly, the 2021 outlook for the non-oil sector is more positive as precautionary measures can be lifted domestically, which should stimulate the wholesale and retail sectors, and as the vaccine rollout proceeds.

On balance, a combination of the oil market recovery and policy measures should bode well for growth in 2021, eclipsing any transient risks.

Box 2.1: Measuring the Productivity of the Manufacturing Activity in Saudi Arabia[2]

The manufacturing industry in the Kingdom is one of the sectors that are of particular importance in the country's economic development. It plays an important role in raising the rate of economic growth with a view to reaching a sustainable economy with a diversified production base. The Kingdom has an appropriate infrastructure for investment in the manufacturing industry, in terms of the availability of national workers willing to work, the accessibility of appropriate financing opportunities, and the low energy prices compared to other countries.

The manufacturing industry contributes to enhancing the local content of production, thus achieving one of the goals of the Kingdom's Vision 2030. It assists in improving the balance of payments by increasing non-oil exports and substituting for commodity imports, especially through the production of consumer goods that can create many jobs in several sectors. A value chain is created by which the commodity passes through production stages in several sectors to the final consumer.

A study was undertaken that aims to estimate the production function of the manufacturing industry in the Kingdom using panel data during the period 2010-2018 and based on data of the industrial activity survey issued by the General Authority for Statistics. The vital role that manufacturing plays in economic growth is illustrated by the fact that the volume of manufacturing activity has doubled about 12 times since 1970 in Saudi Arabia. Transformational activity has an important role to play in supplying goods to the local market. The value of goods sold in the local market constitutes about 62.9 percent of total sales. It also contributes to providing consumer goods, such as food and beverages, which constitute about 12.4 percent of total sales locally.

Despite the declining share of manufacturing industrial activity globally, the study recommends continuing to support this activity as it constitutes a large part of economic development and is linked to other economic activities that have a high added value to the national economy. Furthermore, the study discusses supporting enterprises wishing to transform by facilitating the procedures for importing machinery and equipment and overcoming the difficulties facing them, in addition to attracting foreign investment in the manufacturing industry that provides high added value and sustainable jobs by providing an attractive investment environment and working on long-term plans to localize these industries. Finally, localizing employment in the manufacturing industry in Saudi Arabia will require creating a match between the skills needed by the industry and the output of education.

[2]For additional information, please refer to the working paper published on Saudi Central Bank's website.

BANKING SECTOR DEVELOPMENTS

3

3. Banking Sector Developments

3.1 Overview

The Saudi banking sector has been resilient to the dual economic shock triggered by the COVID-19 pandemic and the significant fall in oil prices during the first half of 2020. Although the banking sector experienced a slight deterioration in credit quality, strong pre-pandemic capital and liquidity positions as well as the Saudi Central Bank's support measures during the height of the economic downturn provided a robust base for banks to continue supporting the economy's demand for credit. The banking sector is expected to register a better performance in 2021 compared to the previous year against a background of the expected recovery in economic activity, the further rollout of vaccines and its impact on confidence, as well as the ongoing structural reforms in the Kingdom.

3.2 Banking Sector Assets

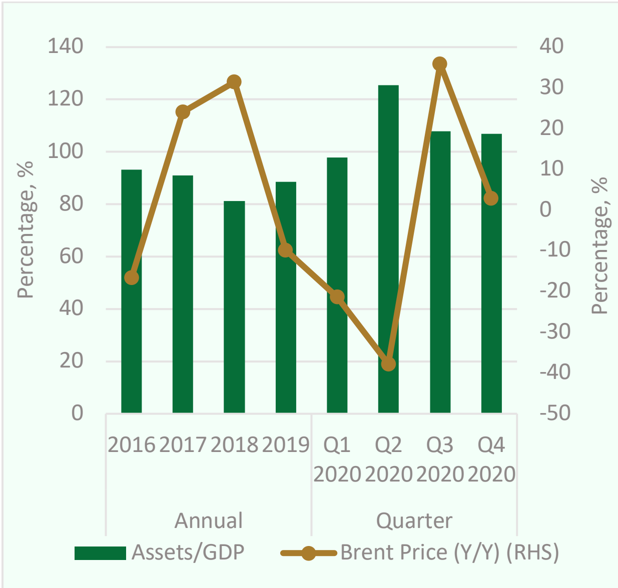
The banking sector continued to be resilient despite the economic downturn generated by the COVID-19 pandemic with the sector's assets recording their highest quarterly year-on-year growth rates of the past 5 years in 2020, ranging between 13.2 percent in Q4 2020 and 14.9 percent in Q3 2020 (Chart 3.1). The growth rate of total assets consistently increased throughout the first three quarters of the year. Claims on the private sector remained the main driver of bank assets growth. Asset growth is expected to continue, underpinned by continued strong loan growth, primarily mortgage loan growth.

Chart 3.1: Domestic Banking Sector Asset Growth (Y/Y)

Source: Saudi Central Bank

Despite weak or even negative GDP growth, which was mainly driven by the global health restriction measures that halted supply and demand alike in many economies, data shows that total assets continued to grow steadily in 2020. For the past three years, the annual growth of banking sector assets exceeded the GDP growth as reflected in the rising assets-to-GDP ratio (Chart 3.2). Overall loan growth contributing to banking sector asset growth was mostly driven by a significant growth in real estate mortgage lending – mainly supported by government initiatives to increase homeownership in the Kingdom.

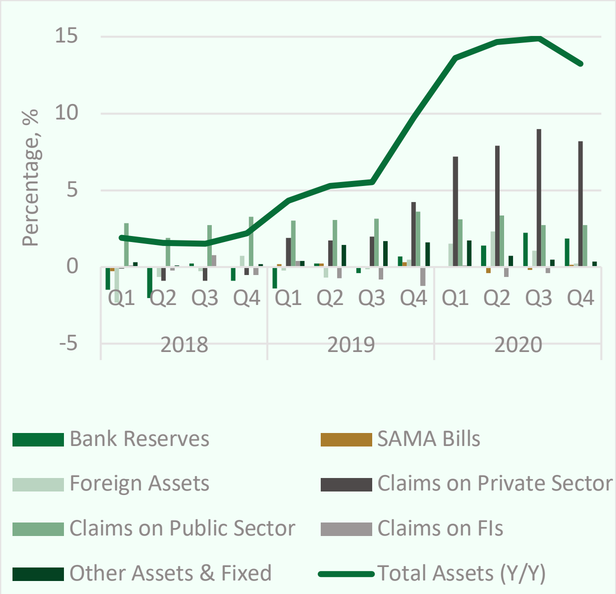
Chart 3.2: Bank Assets to Total GDP



Source: Saudi Central Bank, Bloomberg and General Authority for Statistics

Claims on the private sector growth remained the largest component of bank asset growth, accounting for 8.2 percentage points of the sector's 13.2 percent total assets growth compared to 4.2 percentage points of the total 9.7 percent growth rate a year earlier. The growth of claims on the public sector component of banks' total assets declined marginally to 2.7 percentage points from 3.6 percentage points in 2019. This decline is attributable to the increase in banking sector total assets led by government support to mortgage lending, which outpaced public sector growth contribution. The share of claims on financial institutions decreased in 2020 while the 'other total assets' components showed a modest increase (Chart 3.3).

Chart 3.3: Sectoral Contribution to Asset Growth (Y/Y)

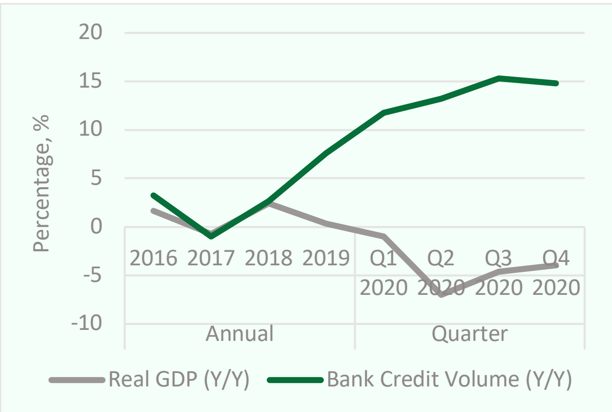


Source: Saudi Central Bank

3.3 Banking Sector Credit

Despite the downturn caused by the COVID-19 pandemic, credit extended by the banking sector continued to grow sharply from 7.6 percent in 2019 to 14.8 percent in 2020 (year-end data) (Chart 3.4). This strong rise in credit was mostly due to high demand for mortgages alongside increases in short-term funding requirements from businesses during the pandemic.

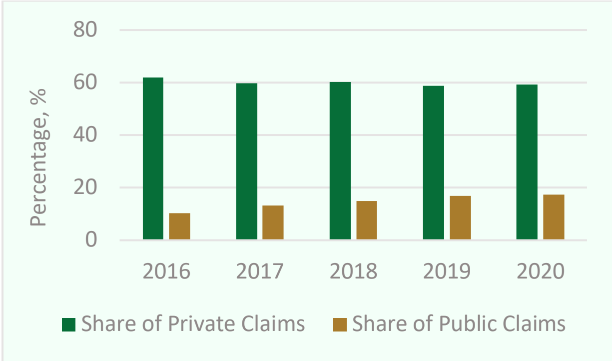
Chart 3.4: GDP and Total Banking Credit Growth Rates



Source: Saudi Central Bank, General Authority for Statistic

As shown in Chart 3.5, private claims continued to have the largest share of overall banking sector credit, registering an increase to 59.2 percent in 2020, up from 58.7 percent in 2019. The increase was mostly related to the expansion in government stimulus measures to boost private sector growth in response to the COVID-19 pandemic. The public credit share showed a similarly modest increasing pattern, growing from 16.9 percent at the end of 2019 to about 17.4 percent by year-end.

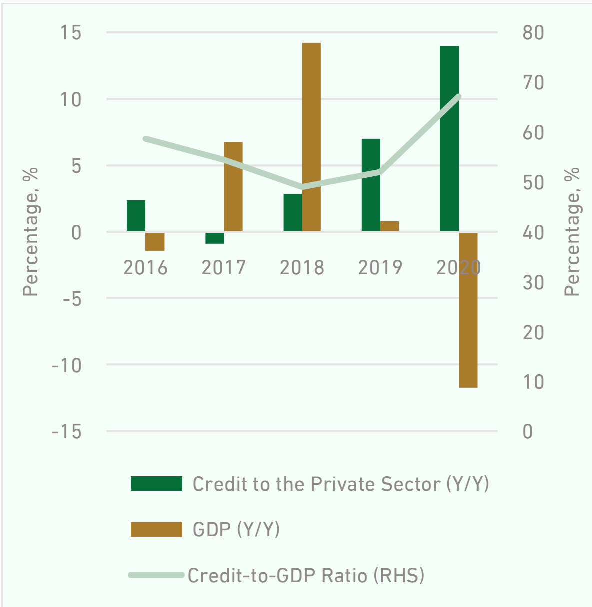
Chart 3.5: Average Claim Shares of Private and Public to Assets



Source: Saudi Central Bank

The private credit-to-GDP ratio, which indicates the level of private sector leverage, stood at 67.1 percent at the end of 2020, showing a significant increase from 52 percent recorded for the same period last year. This was primarily attributable to the double-digit growth in real estate financing as well as the Private Sector Financing Support Program of the Saudi Central Bank. The negative GDP growth in 2020 further boosted the ratio (Chart 3.6).

Chart 3.6: Credit-to-Nominal GDP Ratio

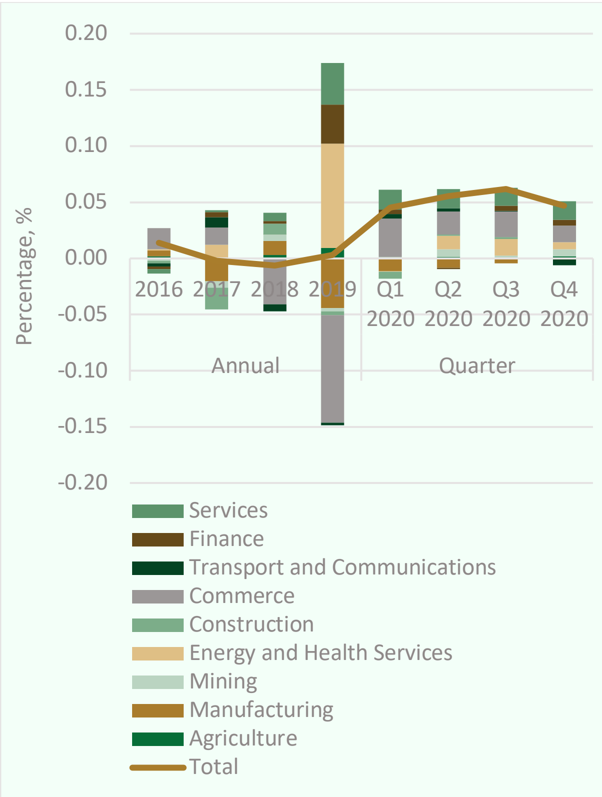


Source: Saudi Central Bank

3.3.1 Corporate Credit

Banks' corporate credit continued to register an upward trend and hit a record high in 2020 as the COVID-19 pandemic increased demand for loans by companies in order to secure their short-term liquidity needs. Total corporate loan growth exceeded a 4.5 percent year-on-year growth rate in each of the four quarters of 2020. This growth was primarily induced by credit extension in commerce (by 1.5 percent in Q4 2020 compared to a year earlier) and in services (by 1.6 percent). Other corporate sector components also showed positive credit growth except for manufacturing and construction as well as transport and communication (Chart 3.7).

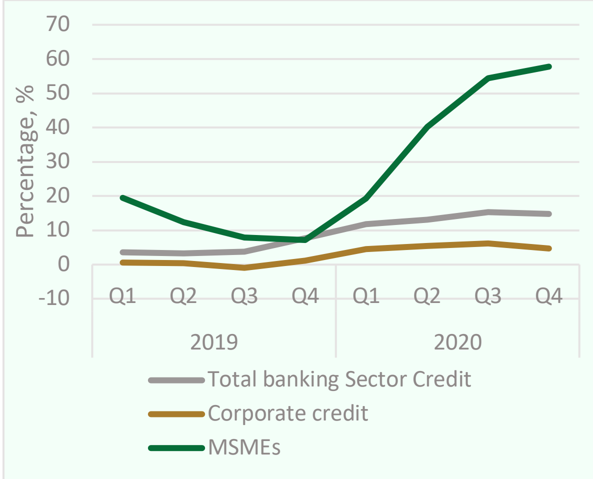
Chart 3.7: Contribution to Corporate Credit Growth



Source: Saudi Central Bank

There was a notable increase in bank lending to Micro, Small and Medium-sized Enterprises (MSMEs), which reached a historically high year-on-year growth of 57.8 percent in Q4 2020 compared to 7.2 percent in a similar period last year (Chart 3.8). This sharp growth is in line with the Kingdom's Vision 2030 goal of raising the MSMEs' contribution to GDP from 20 percent to 35 percent, and the overall private sector contribution from 40 percent to 65 percent.

Chart 3.8: MSMEs Credit Growth

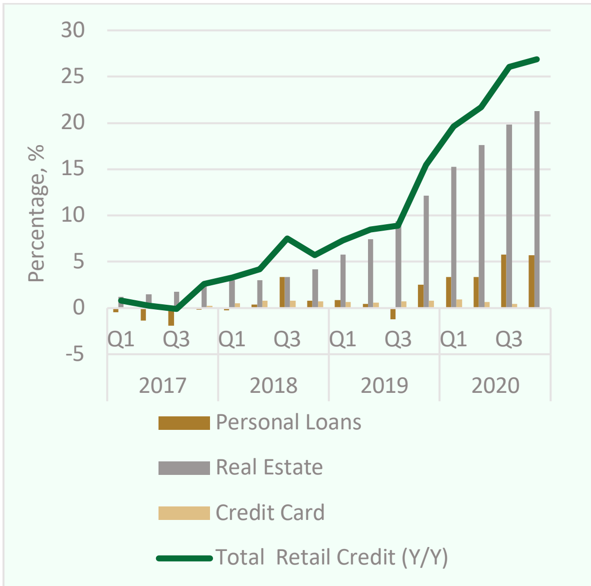


Source: Saudi Central Bank

3.3.2 Retail Credit

Retail loans remained on an upward trend and witnessed a year-on-year double-digit growth of 26.9 percent between Q4 2020 and the same period last year (Chart 3.9). While an increase was observed for all loan types, the key drivers were real estate and personal loans with corresponding year-on-year growth rates of 21.3 and 5.7 percent, respectively, at Q4 2020. The retail lending growth is expected to remain high , largely driven by government subsidies on retail real estate, and lower impairments compared to corporate credit, which can benefit banks' risk profiles.

Chart 3.9: Quarterly Contribution to Retail Credit Growth



Source: Saudi Central Bank

Lending to the residential real estate sector continued its expansion, showing resilience in the face of the COVID-19 pandemic, and benefiting from the Real Estate Transaction Tax (RETT) introduced in Q4 2020. Compared with the preceding year, there was some slowdown in the pace of growth, with total residential real estate loan growth registering year-on-year growth of 61.3 percent compared to 173.6 percent seen last year. Mortgages to buy houses made up the bulk of loans (Chart 3.10). The high growth in demand for residential real estate is partly driven by one of the Saudi government's Vision 2030's objectives to increase home ownership to 60 percent in 2020 and 70 percent by 2030. The target was achieved, exceeding 62 percent in 2020.

Chart 3.10: Residential Real Estate Growth

Source: Saudi Central Bank

3.4 Asset Quality

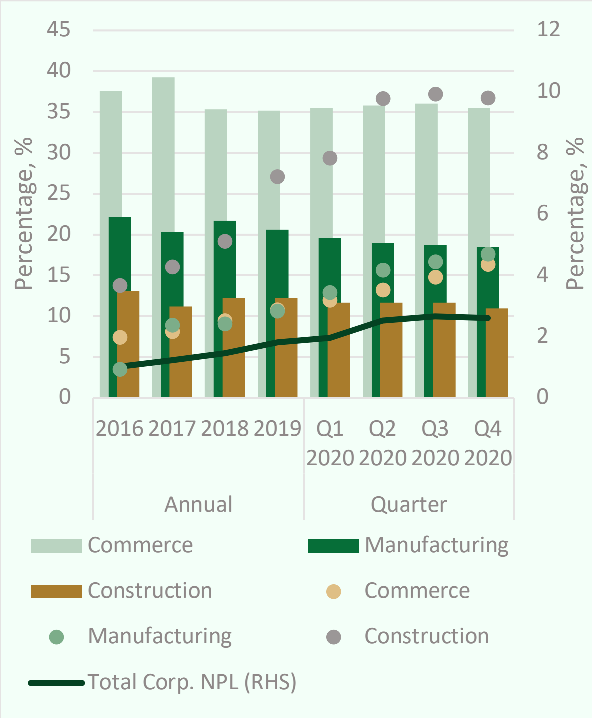
Non-Performing Loans (NPLs) in the banking system continued to rise as a result of the economic impact from the pandemic, however the NPL ratio remains comfortably low at 2.2 percent by the end of 2020. Indeed, the banking system is well positioned for a deterioration in asset quality given the sector's high provisioning levels. Moreover, banks have built provision reserves to mitigate any potential asset quality deterioration from loans that have been granted payment deferrals (Chart 3.11).

Chart 3.11: Banking System's Total NPL Ratio

Source: Saudi Central Bank

Corporate credit was the largest source of NPLs in 2020. The impact of COVID-19 on corporate credit varies between industries with commerce, construction, and manufacturing sectors remaining the highest contributors to the corporate sector's NPL ratio. As Chart 3.12 shows, NPLs in the construction sector registered a notable increase to 9.8 percent in 2020, up from 7.2 percent in the previous year. The NPL ratio in the manufacturing sector recorded more than doubled increase from 2.4 percent in 2019 to 4.7 percent by the end of 2020. As for the commerce sector, the NPL ratios also rose, reaching 4.3 percent compared to the previous year's 2.9 percent. NPL ratios may be somewhat distorted by the corporate sector's loan deferrals as loans have been extended under the Deferral Payment Program until the end of the first half of 2021. NPL ratios could therefore increase when the unwinding of these deferral measures takes place. The sector has continued to build provisions for post COVID-19 deferral loan performance , which could also limit the downside risk once the Deferral Payment Program end.

Chart 3.12: Largest Share of Corporate Credit and NPL Rates



Source: Saudi Central Bank

Chart 3.13: Retail Loans NPL Ratio

Source: Saudi Central Bank

The retail sector's NPL ratio remained relatively stable compared to the overall corporate sector NPL ratio, registering a slight increase to reach 0.7 percent by year-end (Chart 3.13). This increase has coincided with a significant rise in retail lending, particularly in mortgage lending. The retail credit portfolio has not been adversely affected as the loans are mostly salary assigned, and because during the COVID-19 pandemic, salaries were mostly supported by government measures including a wage subsidy of 60 percent (up to SAR 9,000 per employee per month) for Saudi employees' salaries in the private sector. Evidently, this has helped maintain the retail sector's NPL levels to stay modest.

3.5 Banking Sector Resilience

The banking sector's healthy capital and liquidity positions prior to the COVID-19 outbreak have enabled it to better absorb the economic and financial shock of the ensuing pandemic. Looking ahead, challenges will increase as the support measures taper and loan moratoria comes to an end. The Saudi Central Bank will continue to closely monitor developments in the real economy against the backdrop of COVID-19, and will on that basis assess the need for a continuation of its support programs.

3.5.1 Capital Adequacy

3.5.1.1 Capital Adequacy Ratio

The banking sector's Capital Adequacy Ratio (CAR) increased marginally in 2020, standing at 20.3 percent at year-end compared to 19.4 percent recorded at the end of the previous year (Chart 3.14). Despite the recent deterioration in credit quality, the CAR remained well above its average level of 18.4 percent over the past decade. It did register a drop from 19.4 percent in Q4 2019 to 18.6 percent in Q1 2020. The fall was mostly a result of the growth in Risk Weighted Assets (RWAs) that outpaced the growth in total capital. The medium to longer term CAR trajectory will likely be determined by three factors: the unwinding of the support measures in place, banks' behaviour in terms of risk taking and the macroeconomic fundamentals and recovery outlook.

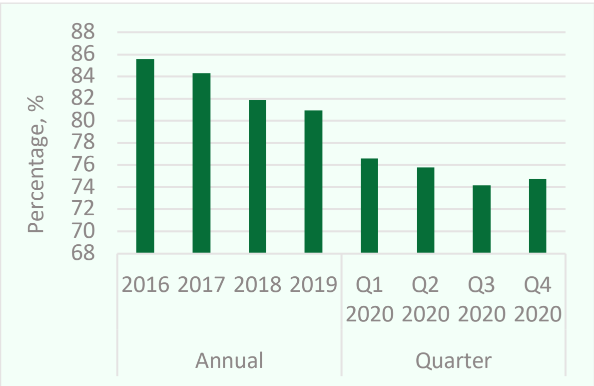
Chart 3.14: Capital Adequacy Ratio

Source: Saudi Central Bank

3.5.1.2 Pillar I Risk Weighted Assets

The ratio of Pillar I RWAs to total assets has fallen considerably on the back of an increase in retail real estate loans as well as the government's relief measures in the context of the COVID-19 pandemic. It reached 74.7 percent by year-end (Chart 3.15).

Chart 3.15: Risk-Weighted Assets to Total Assets

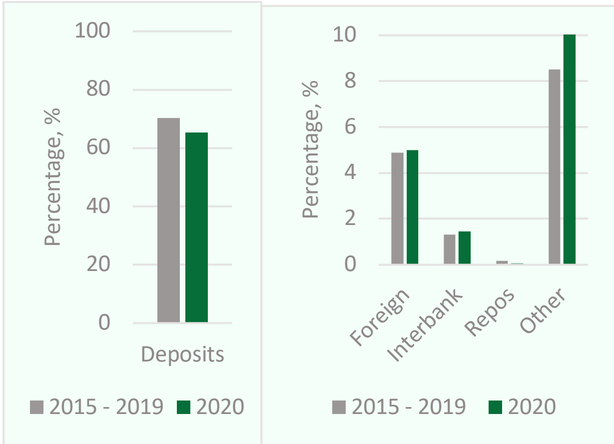


Source: Saudi Central Bank

3.5.2 Funding and Liquidity

Banks' total liabilities continued to expand in 2020, with deposits remaining the primary funding source for the banking system. Banks' deposits represented 65.2 percent of banks' total liabilities as at end-2020, significantly declining from the 68.2 percent recorded the previous year (Chart 3.16). This decline was mainly offset by an increase in the share of the components 'other liabilities' and 'foreign liabilities'.

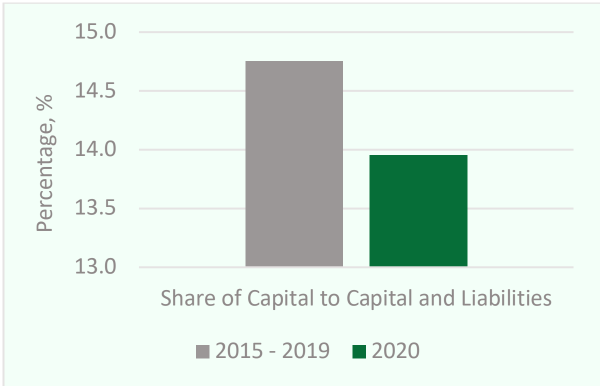
Chart 3.16: Component Shares of Banking Liabilities



Source: Saudi Central Bank

The growth in banks' capital account dropped to around half that of the previous year from 11.9 percent to 6 percent at 2020 year-end. The capital account as a share of banks' balance sheet declined to 14.0 percent compared to the 14.8 percent average over the previous five-year period (Chart 3.17).

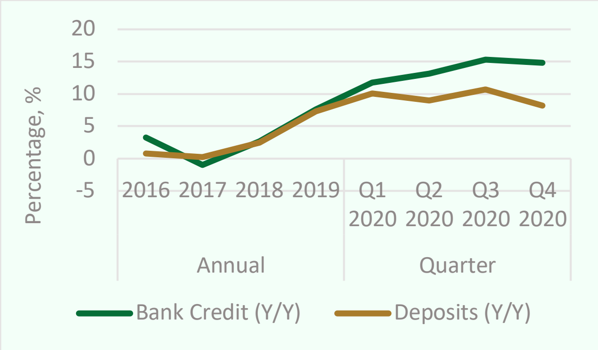
Chart 3.17: Share of Capital as a % of Total Capital and Liabilities



Source: Saudi Central Bank

A record SAR 1.9 billion increase in cash was recorded for the deposit accounts of the Saudi banks. Banks' total deposits grew by more than 8 percent in each of the four quarters of 2020, compared to the previous five-year period average of 2.5 percent. Still, as mentioned above, credit growth increased at an even faster pace, reaching 14.8 percent at the end of last year (Chart 3.18).

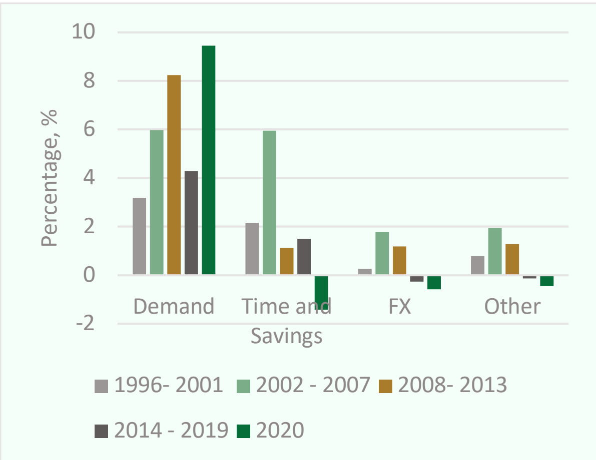
Chart 3.18: Deposits and Credit (Y/Y)



Source: Saudi Central Bank

While the other types of deposits all declined, as their growth rates entered negative territory, demand deposits grew significantly, doubling compared to the past six-year period average (Chart 3.19). This sharp increase in deposits is bound to be temporary and is likely to dissipate as containment measures are lifted gradually and pent-up demand is satisfied.

Chart 3.19: Six-Year Average of Contribution to Deposit Growth by Type of Deposits



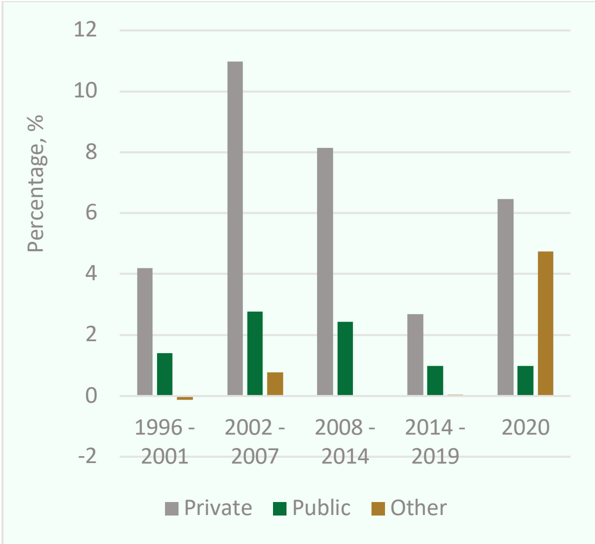
Source: Saudi Central Bank

Deposit growth has declined for all categories except for demand deposits. Total public sector deposits decreased by 4.7 percent with demand deposits being the major contributor to this decline (Chart 3.20).

Private sector total deposit growth has risen significantly by 6.5 percent in 2020 (Chart 3.20). This increase is more in line with the rapid growth in credit to the private sector. Although the growth rates of time and saving deposits and other deposits were negative, they were offset by an increase in demand deposits (Chart 3.21).

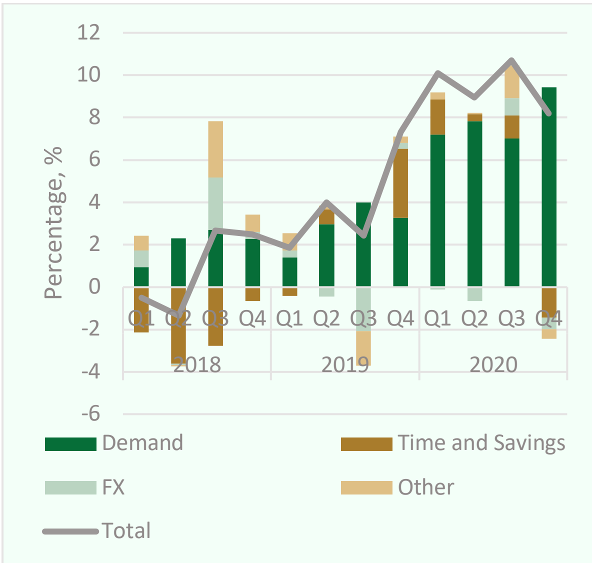
Solid growth in private deposits, along with the pandemic-related funding made available by the Saudi Central Bank, has helped ensure the ample funding environment that the banking sector experienced in 2020.

Chart 3.20: Six-Year Average of Contribution to Deposit Growth by Sector



Source: Saudi Central Bank

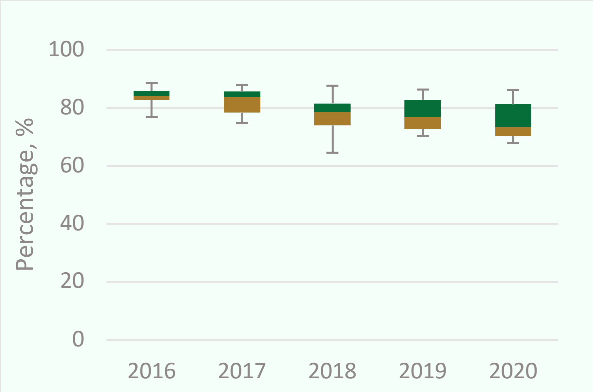
Chart 3.21: Contribution to Deposit Growth by Type



Source: Saudi Central Bank

With both credit and deposits witnessing increased growth, the banking sector's Loan-to-Deposit Ratio (LDR) showed only a slight decline registering 75 percent compared to the sector's average of 77.5 percent recorded in the previous year. This generally indicates low funding liquidity risks for the banking sector (Chart 3.22).

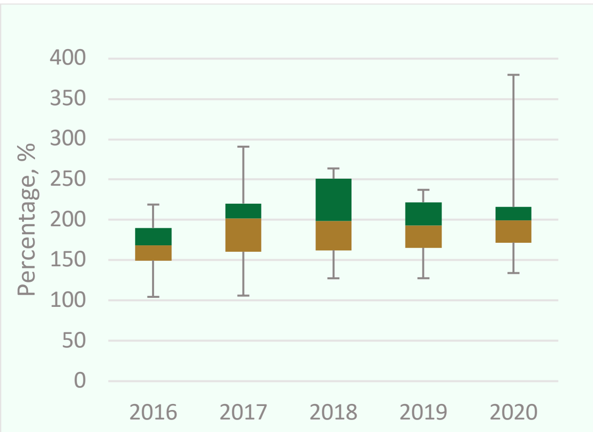
Chart 3.22: Distribution of LDR



Source: Saudi Central Bank

The sector's Liquidity Coverage Ratio (LCR) - defined as the ratio of the stock of High-Quality Liquid Assets (HQLA) to the projected net cash outflows during a 30-day stress period - remained comfortably above the regulatory requirement of 100 percent and at stable levels averaged 198.4 percent in 2020 compared to the average of 198 percent seen in the previous year. The high deposit growth and the Saudi Central Bank's monetary policy measures have supported the strong liquidity position of the banking system (Chart 3.23).

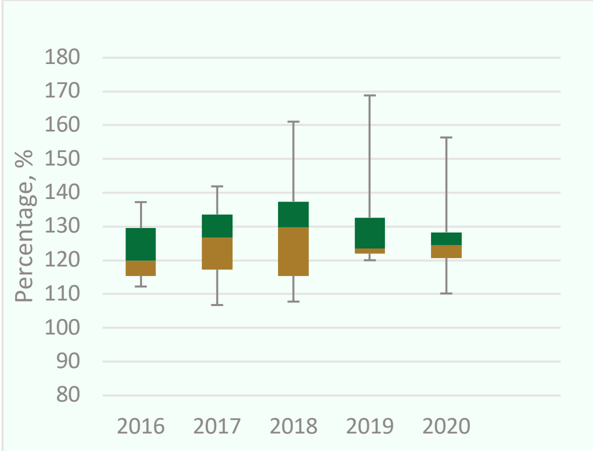
Chart 3.23: Distribution of LCR



Source: Saudi Central Bank

The long-term liquidity position of the banking sector remains sound, despite heightened risks and uncertainty stemming from the COVID-19 pandemic. The Net Stable Funding Ratio (NSFR), which declined at the beginning of 2020, improved in the second half of the year, reaching 127.2 percent at year-end (Chart 3.24).

Chart 3.24: Distribution of NSFR



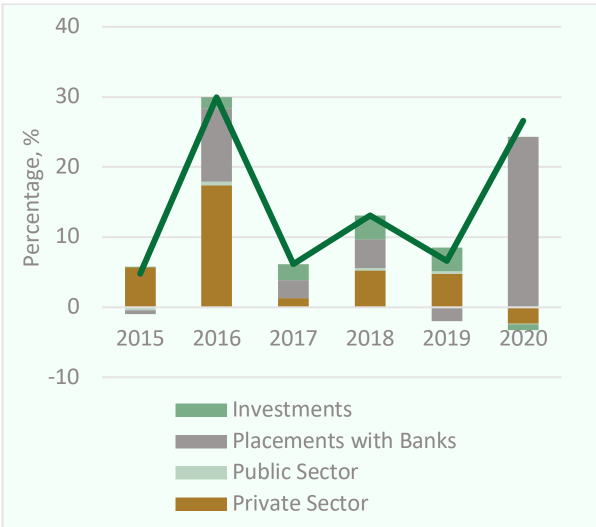
Source: Saudi Central Bank

3.5.3 Profitability

The profitability of the banking system witnessed pressure in 2020 amid the economic fallout from the COVID-19 pandemic, the global low interest-rate environment, and low oil prices.

The growth of revenue on funds has risen significantly to 26.6 percent in 2020 up from 6.6 percent recorded in the previous year. All components of revenue encountered a decline except the placement with banks, which therefore became the only driver of total growth (Chart 3.25).

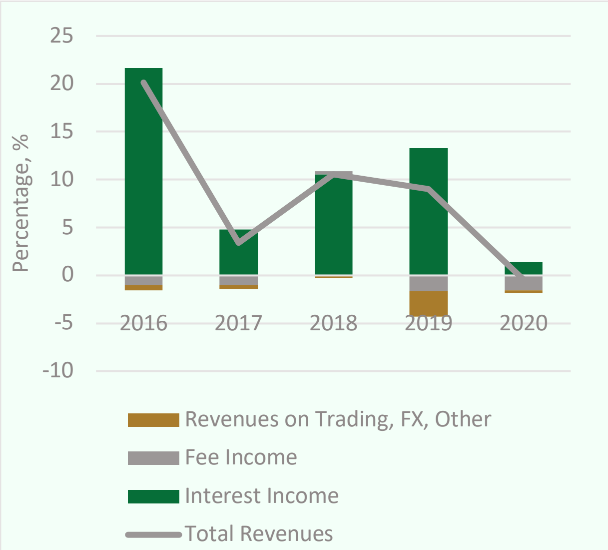
Chart 3.25: Contribution to Revenue on Funds



Source: Saudi Central Bank

Other sources of revenue for the banking sector have been impacted negatively by the policy rate cuts resulting in margin compression. Chart 3.26 shows a deterioration in total revenue, shrinking by -0.4 percent, mainly under the influence of the compression in Net Interest Income (NII). Its contribution to total revenue growth fell to just 1.4 percentage points , driven by a combination of low interest rate effects as well as payment moratoria through the Saudi Central Bank's Deferral Payment Program.

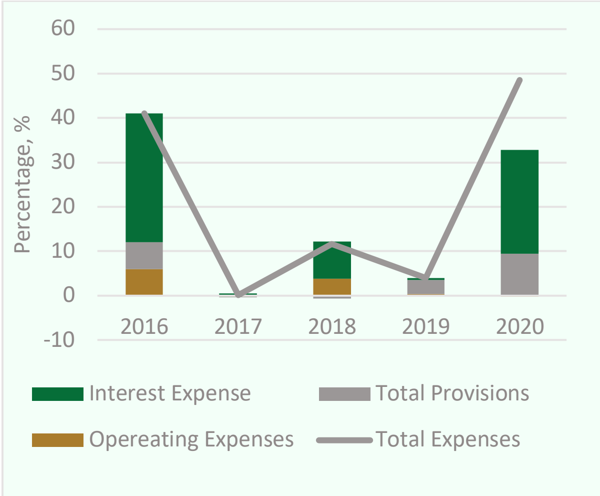
Chart 3.26: Contribution to Total Revenues Growth



Source: Saudi Central Bank

Total expenses registered a stronger growth in 2020. Most total expense components grew except for operating expenses' which recorded a negative growth of 0.1 percent. As indicated earlier, these developments were mostly attributable to the COVID-19 related measures such as the national lockdown and curfew. The interest expense and total provision components were the key drivers of the growth in total expenses registering rises of 23.4 and 9.4 percent, respectively (Chart 3.27). The growth in total provisions was mainly triggered by the uncertainties surrounding the COVID-19 pandemic.

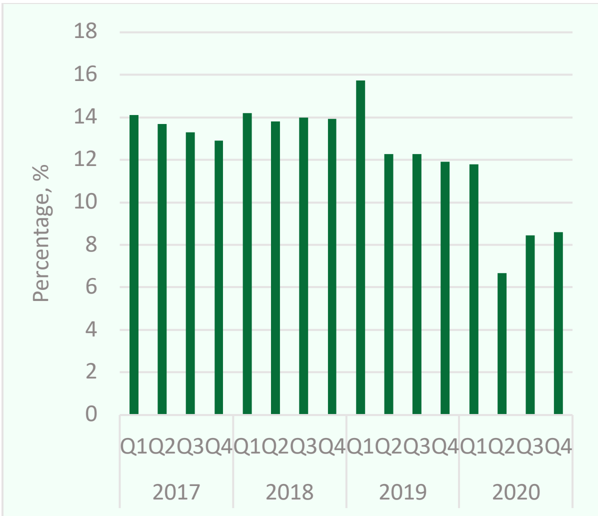
Chart 3.27: Contribution to Total Expense Growth



Source: Saudi Central Bank

The aggregate Return on Equity (ROE) of the banking sector decreased substantially to levels not seen since the Global Financial Crisis, reaching 6.7 percent at the end of Q2 2020 (Chart 3.28). This drop was caused predominantly by higher loan loss provisions and impaired income generation. The ROE improved in the second half of 2020 but remained distinctly below the levels of previous years.

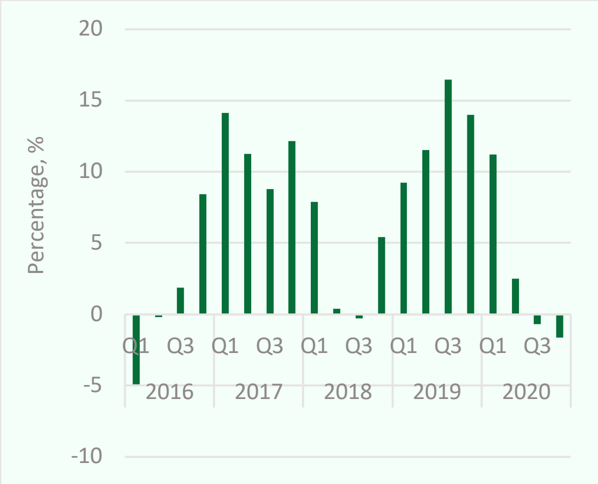
Chart 3.28: Return on Equity



Source: Saudi Central Bank

In line with the previous analysis of total revenues and expenses, NII declined by the end of 2020. NII entered the negative territory in the second half of the year. This was mainly driven by a narrowing net interest spread in the context of declining interest rates (Chart 3.29).

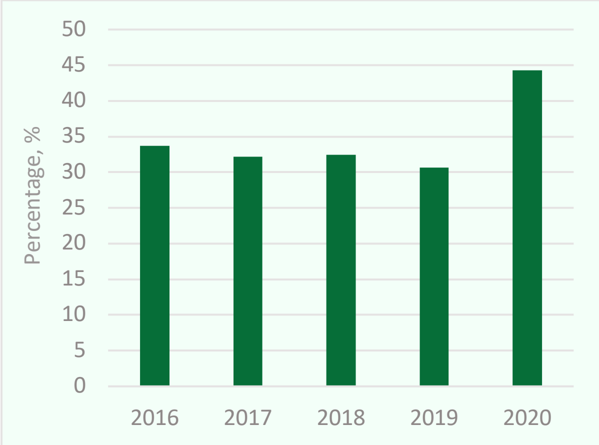
Chart 3.29: Net Interest Income Growth



Source: Saudi Central Bank

As a result, 2020 witnessed a rise in the ratio of interest expenses to interest income, which had displayed relative stability over the preceding three years. This ratio climbed distinctly to exceed 44.2 percent last year, where in 2019 it had recorded 30.6 percent (Chart 3.30). Increased provisioning and COVID-19-related management overlays may have contributed to the increase in the sector's interest expenses.

Chart 3.30: Interest Expense to Interest Income Ratio



Source: Saudi Central Bank

Box 3.1: Interest Rate Benchmark Reforms, a Transition Towards Risk Free Rates

In 2014, the Financial Stability Board (FSB) had issued several recommendation, on the backdrop of several financial misconducts, aimed at strengthening Interbank Offered Rate (IBOR) to make it more reflective of market conditions, as well as identifying alternative near-risk-free rates (RFRs). Moreover, in 2016, the FSB has introduced additional initiative to enhance contract robustness to address of discontinuation of widely used interest rate benchmarks. The FSB and member authorities through the FSB Official Sector Steering Group (OSSG) are working to implement and monitor these recommendations.

Globally, the London Interbank Offered Rate (LIBOR), which comprise five major currencies (USD, GBP, EUR, JPY and CHF) encounters a challenge of being an inaccurate representation of interest rates due to the lack of transactions and activities. The already challenging liquidity conditions were further exacerbated by developments in March 2020, where in many cases these rates were left reliant on judgement-based submissions rather than market transactions. These developments underscore that these markets are not the main markets that banks rely upon for funding and highlight the challenges when seeking to develop robust credit measures drawing upon unsecured wholesale funding costs[3]. Therefore, the FSB continues to emphasize that financial and non-financial sector across all jurisdictions should continue their efforts in developing RFRs in order to reduce reliance on IBORs where appropriate.

More recently, the Financial Conduct Authority (FCA) has announced that all LIBOR settings for all currencies will either cease or no longer be representative immediately after December 2021 (for GBP, EUR, CHF, JPY and specific settings for the USD) and June 2023 (for the remaining USD settings)[4]. Significant work has been done by national working groups in developing alternative benchmark rates to replace the IBORs. These working groups are also considering how to support a transition to alternative rates and the development of new products referencing them.

The new alternative rates will be characterized by its shorter maturity, encompassing secured transactions, or in some cases anchored by a credible transaction that reflect the wholesale uncensored overnight borrowing costs. Well as encountering higher volume activities due to the inclusion of non-bank market participants[5]. Jurisdictions have taken steps in RFR implementation; there has been an identified alternative in the five largest currency areas. The Secured overnight financing rate (SOFR), the alternative RFR administer by Federal Reserve Bank of New York (FRBNY), in addition to the Swiss average overnight rate (SARON) will be based on secured repo transactions. Liquidity and volume of transactions could be important factors in determining secured or unsecured RFR a policymaker would adopt.

FRBNY started publishing 30-day, 90-day, and 180-day SOFR averages in March 2020, to facilitate a transition away from USD LIBOR. Despite the existence of Euro short-term rate (ESTR)[6], it would only take effect as a replacement of the current overnight benchmark (EONIA) by January 3, 2022. Regarding GBP, sterling overnight index average has been in existence since 1997, and publication on reformed SONIA started on BoE website in 2018. SARON compounded rate was published in March 2020 by SIX Swiss Exchange (SIX) to facilitate a more away from CHE LIBOR, which is expected to take place late 2021. Finally, JPY LIBOR would be replaced by TONA by 2021 end.

Challenges ahead of the transition are large, but most prominently would be legacy contracts. The legacy of LIBOR-existing exposure after cassation of LIBOR will be subject to fallback contractual clauses. Shifting towards a fallback for the remainder of the contract was an issue investigated by the FSB, in consultation with International Swaps and Derivatives Association (ISDA). Recently, ISDA launched the IBOR Fallbacks Supplement and IBOR Fallbacks

[3] Reforming Major Interest rate Benchmarks: 2020 progress report.

[4] FCA announcement on future cessation and loss of representativeness of the LIBOR benchmarks – March 2021.

[5] This includes money market funds (MMF), investment funds, and insurance companies.

[6] Administered by ECB.

Protocol. The Supplement amends ISDA's standard definitions for interest rate derivatives to incorporate robust fallbacks for derivatives linked to certain IBORs. These changes came into effect on January 25th, 2021. The IBOR Fallbacks Protocol facilitates multilateral amendments to include the amended floating rate options, and therefore the fallbacks, in legacy derivative contracts. The fallback rates comprises two main components; the Adjusted Reference Rate and the Spread Adjustment:

- The Adjusted Reference Rate: is the overnight 'risk-free' rate compounded to provide a term rate and it is set in arrears.
- Spread Adjustment: which is the median spread between IBOR and the adjusted reference rate over a five-year historical period which is fixed when the IBOR cessation is triggered (January 25th, 2021).

The newly adopted system may bring about or highlight certain vulnerabilities on financial institutions, such as operational risk as systems referencing LIBOR should be replaced and processes updated to fit the new calculation methodology of compounded RFR, as well as account for any fallback amendments. Legal risk would also be evident to rise as effect of legacy contracts start to unfold. As for institutions with hedging positions, they may face higher difficulties due to exposure to new basis risk as a result of phased-transition of positions or at different rates of fallback.

The FSB has published the Global Transition Roadmap (GTR) that is intended to inform those with exposure to LIBOR benchmarks of some of the steps they should be taking now and over the remaining period to end-2021 to successfully mitigate these risks. These are considered prudent steps to take to ensure an orderly transition by end-2021 and are intended to supplement existing timelines/milestones from industry working groups and regulators.

In Saudi Arabia, SAIBOR is currently the primary interest rate benchmark. The Saudi Central Bank has been a facilitator of the transition process; LIBOR Migration Working Group was established with senior banking sector representation along with the Saudi Central Bank aiming to put forth a platform where market participants and policymakers can discuss challenges encountered by members in addition to potential vulnerabilities, participants also discuss regularly global updates on migration process and best practices.

INSURANCE SECTOR DEVELOPMENTS

4

4. Insurance Sector Developments

4.1 Overview

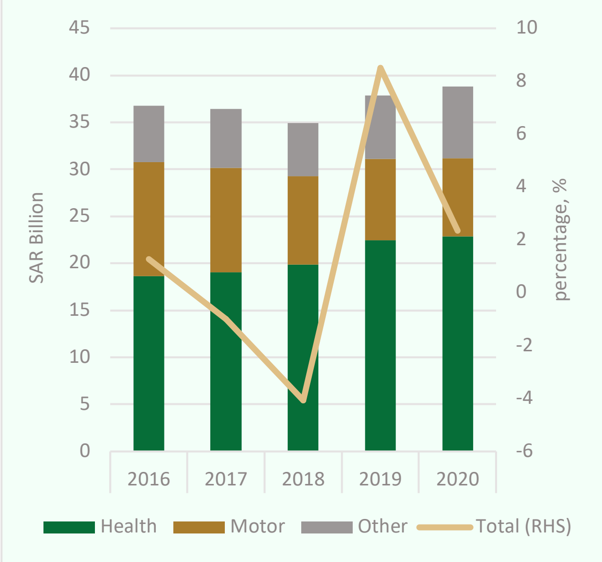
The insurance sector demonstrated its resilience in 2020. Despite facing challenges due to the COVID-19 pandemic, including a slowdown in insurance premium growth, the insurance sector achieved positive yearly results. The sector has seen institutional reforms and development programs implemented in recent years. The sector's outlook is heading positive. Furthermore, the Vision 2030-related economic activities and mega infrastructure projects all provide promising underwriting opportunities to grow the sector. However, the recent macroeconomic developments due to COVID-19 are expected to dampen this outlook. During the year 2020, a total of ten insurance companies have started merger negotiations, two mergers deals took place, and the rest are in different stages of the mergers.

4.2 Market Trends

4.2.1 Market Growth

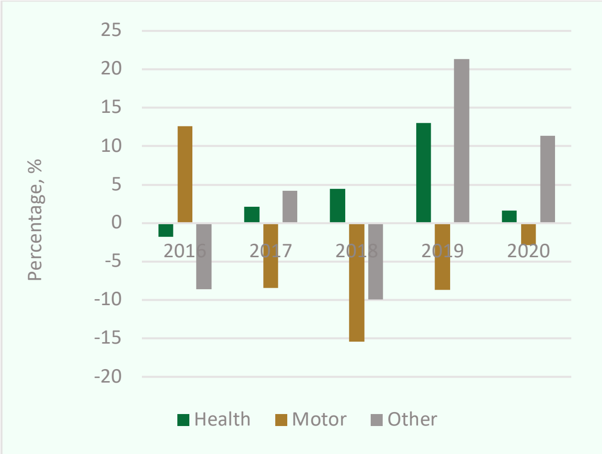
The overall insurance Gross Written Premium (GWP) increased by 2.3 percent in 2020 compared to the last year, reaching SAR 38.8 billion. Health insurance has been consistently growing over the past few years. By 2020, premiums still grew but at a slightly slower pace of 1.6 percent. The relatively modest increase in health premium compared to prior years was driven by a decline in the number of non-Saudis insured particularly those in low-income workers leaving the country due to the economic pressures caused by COVID-19. Motor insurance premiums on the other hand saw a slight decline of 2.9 percent compared to 2019, which can be attributed to a continued reduction in average price of coverage as well as to the two-month free coverage offered by motor insurers to retail policyholders as a gesture of goodwill in light of the reduced vehicle usage during periods of lockdown in 2020 (Chart 4.1) and (Chart 4.2).

Chart 4.1: Segments Contribution to GWP



Source: Saudi Central Bank

Chart 4.2: GWP Annual Growth Rate



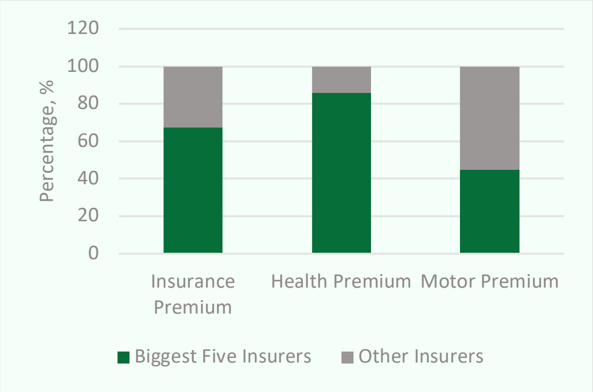
Source: Saudi Central Bank

4.2.2 Market Concentration

The health and motor lines of business continue to dominate the insurance market, as they collectively represent 80 percent of GWP in 2020. Health insurance slightly reduced its share of GWP to 58.9 percent compared to 59.3 percent in 2019, whereas the share of GWP for motor insurance sector declined from 22.7 percent in 2019 to 21.6 percent in 2020. Supported by a double-digit growth in 2020, the "Other" class comprising Property and Casualty (P&C) and Protection and Savings (P&S), increased its share to 19.5 percent compared to 17.9 percent in 2019.

The bulk of market premium sits with the largest five insurers, which represents around 67.5 percent of total GWP in 2020. In health insurance, the largest five companies attract 86 percent of the business. The motor segment is noticeably less concentrated as it is well spread between retail and corporate segments, which in turn drives high competition in this segment. The largest five companies acquire 45 percent of the motor premium (Chart 4.3).

Chart 4.3: GWP Concentration by Largest Five Companies

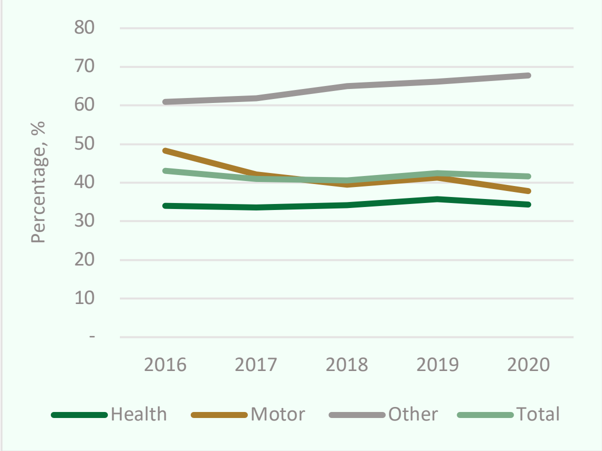


Source: Saudi Central Bank

4.2.3 Insurance Intermediation

Around 41.6 percent of the market premiums in 2020 were written through insurance brokers and insurance agents compared to 42.5 percent in 2019. Health insurance was the line least dependent on intermediary services as brokers and agents wrote 34.3 percent of the premium, with a decline of 2.4 percent compared to 2019. As for motor insurance, 37.8 percent of premium were written through intermediaries, showing a decline of 11.1 percent compared to 2019, while for P&C, which usually depends heavily on brokerage services, 69.9 percent of the business was written through brokers and agents (Chart 4.4).

Chart 4.4: Contribution of Intermediaries to GWP

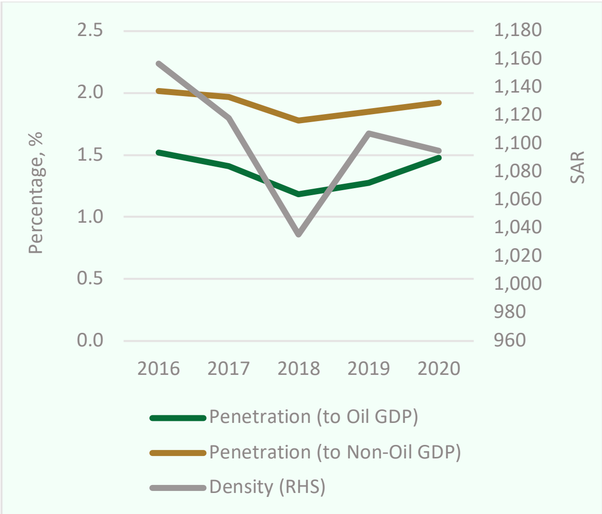


Source: Saudi Central Bank

4.2.4 Insurance Penetration and Density

Insurance contribution to total GDP increased in 2020, though it is still very low; it represented 1.48 percent of GDP in 2020 compared to 1.3 percent in 2019. Health insurance segment contributed 0.9 percent of total GDP in 2020, compared to 0.8 percent in 2019, and the Motor insurance contributed 0.3 percent of GDP in 2020 compared to 0.3 percent in 2019. The penetration ratio to non-oil GDP increased slightly, moving up from 1.85 percent in 2019 to 1.92 percent in 2020. Insurance density (i.e. average spending on insurance services per capita) decreased slightly, moving down from SAR 1,107 in 2019 to SAR 1,095 in 2020 (Chart 4.5).

Chart 4.5: Insurance Penetration and Density



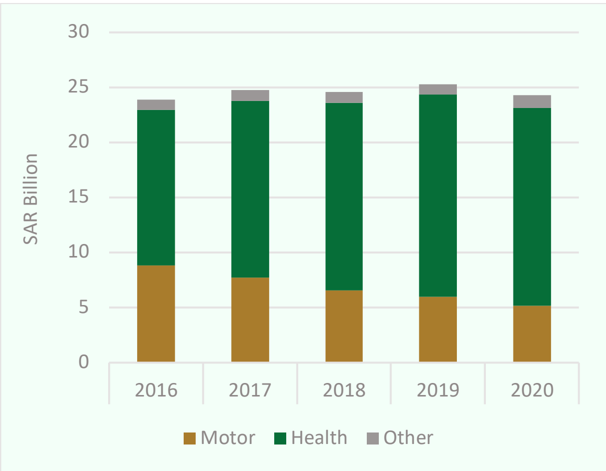
Source: Saudi Central Bank

4.3 Insurance Market Performance

4.3.1 Underwriting Performance and Profitability

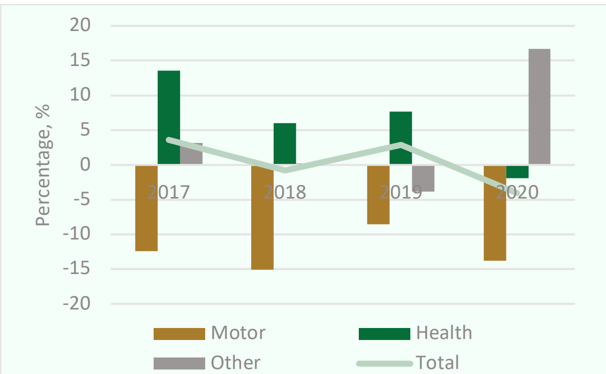
Net Claims Incurred (NCI) by insurance companies in 2020 totaled SAR 24.3 billion, representing a reduction of 4 percent compared to 2019. In terms of market segments, health insurance NCI had a reduction of 1.9 percent, moving from SAR 18.3 billion to SAR 17.9 billion, mainly due to lower tendency among people insured for non-essential medical treatment during COVID-19 pandemic and due to the government taking over responsibility for the treatment of COVID-19 patients. There was a more significant decline in NCI for motor insurance, reducing by 13.8 percent, moving from SAR 5.99 billion to SAR 5.17 billion, mainly due to (i) more efficient claims management practices, (ii) regulatory reforms, and (iii) the impact of the lockdown (Chart 4.6) and (Chart 4.7).

Chart 4.6: Segments' Share in NCI



Source: Saudi Central Bank

Chart 4.7: NCI Growth Rate

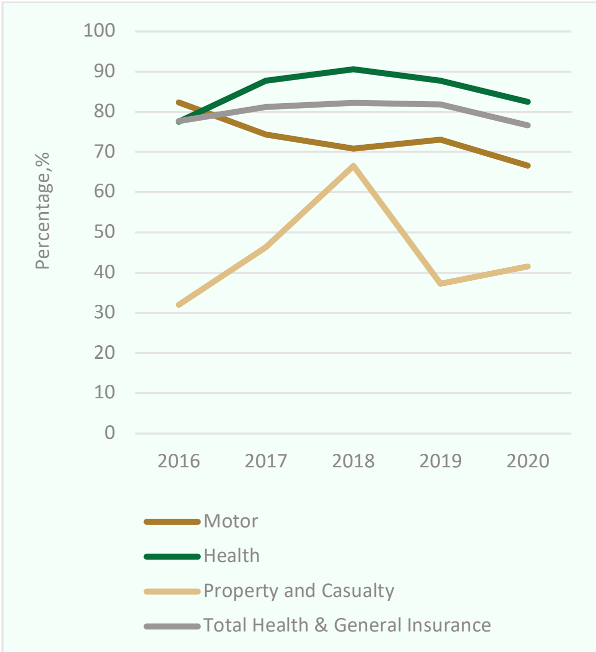


Source: Saudi Central Bank

Moving to the loss, which measures the net incurred losses in relation to the net earned insurance premium, the insurance market experienced favorable movements in loss ratio during 2020. The overall ratio reduced by more than 5 percent, from 81.9 percent in 2019 to 76.7 percent in 2020.

Loss ratio for health insurance reduced from 87.8 percent in 2019 to 82.6 percent in 2020. As for motor insurance, the loss ratio also reduced, from 73.1 percent in 2019 to 66.6 percent in 2020. Moving to the P&C sector, the loss ratio remained at a relatively low level despite recording some increase during 2020, reaching 41.6 percent compared to 37.3 percent in 2019, caused by an increase in NCI for energy insurance (Chart 4.8).

Chart 4.8: Loss Ratio

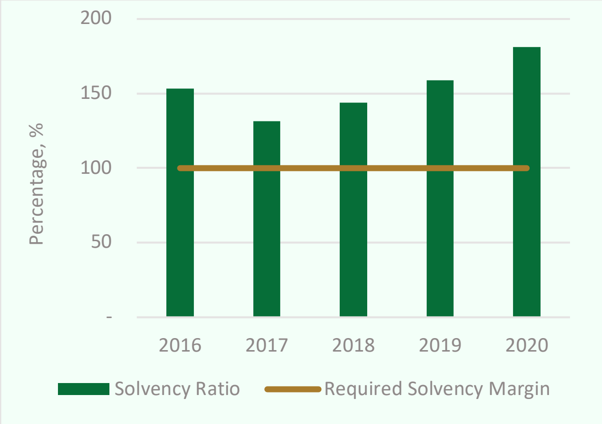


Source: Saudi Central Bank

4.3.2 Adequacy of Capital and Provisions

The overall solvency ratio for the insurance sector has consistently increased over the last few years, demonstrating growing resilience of the insurance sector. The insurance sector is well above the regulatory capital requirement, with the available capital reaching 181 percent of the required capital in 2020 compared to 158 percent in 2019 (Chart 4.9).

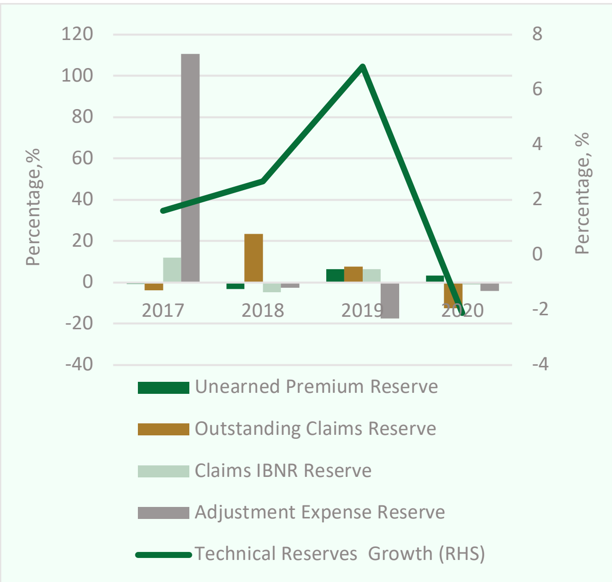
Chart 4.9: Solvency Ratio



Source: Saudi Central Bank

Technical reserves have experienced a small reduction, partly attributable to favorable claims experience during 2020 and also to a strong regulatory push for health insurers to settle claims faster. The total technical reserve of the market declined by 2.1 percent in 2020 compared to 2019. The Unearned Premium Reserve (UPR) saw an increase of 3.3 percent compared to 2019, while Outstanding Claims Reserve (OCR) declined by 12.3 percent compared to 2019. Claims Incurred but not Reported (IBNR) Reserve and Adjustment Expense Reserve experienced reductions of 1.1 percent and 3.9 percent, respectively (Chart 4.10).

Chart 4.10: Technical Reserves



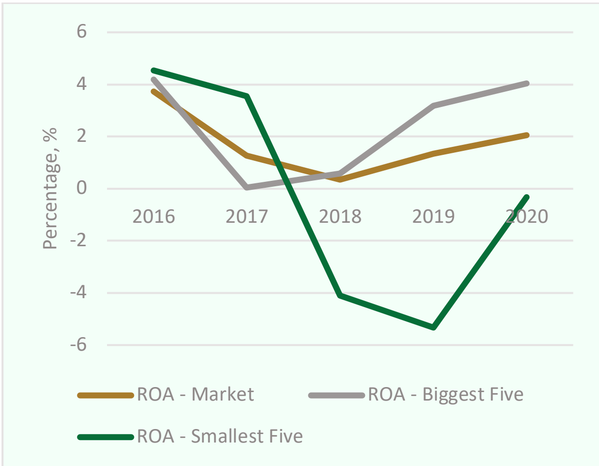
Source: Saudi Central Bank

4.3.3 Profitability

The year 2020 recorded an increase in the overall profitability of the insurance sector compared to 2019. Return on Assets (ROA) increased from 1.3 percent in 2019 to 2.1 percent in 2020. Insurance companies also improved their ROE, moving up from 5.3 percent in 2019 to 7.5 percent in 2020 (Chart 4.11) and (Chart 4.12).

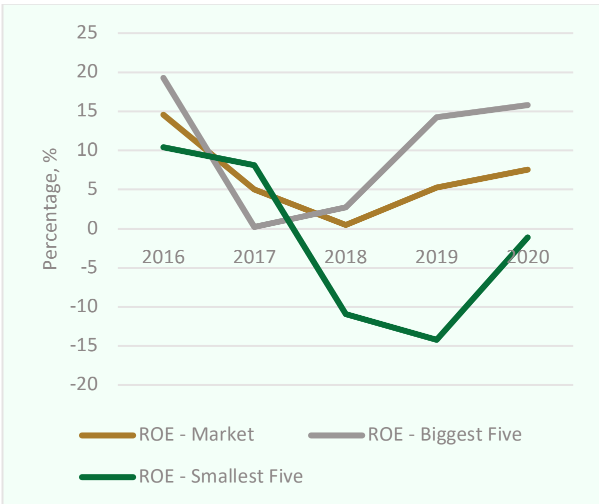
Large insurance companies have posted positive ROA and ROE results over the past five years, which increased even further in 2020. On the other hand, small insurers have struggled due to losses in the last couple of years; though the ROA and ROE measures remained negative for those small insurers, large improvement in those measures was observed in 2020.

Chart 4.11: Return on Assets



Source: Saudi Central Bank

Chart 4.12: Return on Equity



Source: Saudi Central Bank

Box 4.1: The International Financial Reporting Standard 17 and COVID 19

The International Financial Reporting Standard 17 (IFRS17) will be effective from 1st January 2023. The Standard is deemed fairly sophisticated and complex, and it is expected to require significant technical and operational changes by insurance companies for adoption. Once in force, it is expected to enhance transparency of reporting by insurance companies and harmonize reporting across different geographical locations, thus facilitating comparability of financial statements of insurance companies operating under different regulatory regimes.

Recognizing the challenges that lied ahead in adopting the Standard in Saudi Arabia, the Central Bank made early preparations, rolling out its IFRS17 roadmap comprising four phases in December 2018. Since then, the Central Bank has worked closely with the insurance sector and relevant stakeholders to ensure steady progress. Clear instructions and guidelines were issued for each phase, multiple seminars/webinars have been held, Saudi Arabian IFRS17 Working Group was constituted to promote professional discussion and collaboration among industry experts, and timely feedback to insurance companies has been issued after every phase. The latest major event in this series of activities was holding a market webinar in January 2021, which was attended by over 400 participants from 21 countries, reflecting considerable interest in the effective implementation approach adopted by the Saudi Central Bank.

The Phase 1, titled “Gap Analysis” was completed in 2019, and the Phase 2, titled ‘Financial Impact Assessment’, was completed in 2020. The Phase 3, titled ‘Implementation Plan’ is currently in progress, due for completion in April 2021. This will be followed by the final phase comprising ‘Implementation and dry runs’ until the Standard goes live.

The steady and collaborative approach during this journey has enabled the Central Bank to identify and address issues and challenges in a timely manner, and to create awareness of vital focus areas among the key stakeholders through issuance of ‘Dear CEO’ letters and benchmark comparisons to each insurance company. The Dear CEO letter issued to summarize the results of Phase 2 had the following key observations and messages:

- Material change in profit emergence pattern between IFRS17 and the current accounting regime can be expected for various lines of business, which should be taken into consideration by company management for the business planning purposes.
- Principle-based nature of IFRS17 requires insurance company management to make important decisions regarding policy and methodology choices. It is imperative that management develops adequate understanding and implication of each option available, and make informed choices. External auditors should be involved early in the process in order to avoid late surprises.
- Since the majority of insurance companies planned to buy a vendor model for IFRS17 calculations, requiring significant investment, management should ensure full understanding of the capabilities and limitations of the selected system.
- Given the complexity of the new Standard, significant upskilling and training is required for the insurance sector. Therefore, comprehensive training plans should be designed and executed for each relevant function. While noting that majority of insurance companies planned to increase their actuarial resources, recruitments should be carried out in a timely manner.

Box 4.2: Regulatory Response to Circumstances Emerging Due to COVID19

In the face of reduction in motor claims during the COVID-19-related lockdown, the insurance sector voluntarily announced 2-month extension, free of charge, for all motor retail policies. The Central Bank required all insurance companies to make adequate provision towards that extension in coverage. Since the creation of the above provision in Q2 2020, the Central Bank has been actively monitoring its run-off pattern in order to ensure adequate provisions remain on books until all policies benefitting from this extension have expired.

Due to Due to the lockdown measures and the public concerns around seeking medical care during the pandemic, the utilization of non-COVID-19-related medical services experienced a sharp decline during 2020. It was anticipated that treatments deferred during the period, especially elective ones, would be availed in future quarters. The Central Bank therefore instructed all insurance companies to make provisions for deferral of medical claims. Since then, the Central Bank has been actively monitoring the emerging experience, the impact of previously deferred claims on the following quarters and the run-off pattern of the initial provision in order to ensure adequate provisions remain in place. This timely action by the Central Bank prevented pre-mature profit declaration by insurance companies and reduced volatility of financial statements.

In March 2020, the Central Bank promptly carried out a stress test exercise to evaluate the potential impact of COVID-19 on insurance companies' claims liabilities and solvency ratio. As expected, health insurance was identified as the class likely to have the biggest impact. Credit insurance, business interruption , and life insurance were other lines of business where potential impact was identified, though of a lower magnitude due to the relatively small sizes of those segments. The subsequent announcement from the government to bear the cost of treating COVID-19 patients provided significant relief to the insurance sector. In Q1 2020, the Central Bank established quarterly reporting requirements for all insurance companies to report claims incurred due to COVID-19, directly or indirectly, under various lines of business. To date, the impact on claims has been limited, with majority of claims payment relating to life insurance policies.

FINANCE COMPANIES DEVELOPMENTS

5

5. Finance Companies Developments[7]

5.1 Overview

Finance companies have faced some difficulties in 2020 due to the effects of COVID-19, similar to many sectors in the economy. Finance companies started to recover towards the end of 2020 as the NPL ratio decreased to reach 8.2 percent. The government support programs have assisted finance companies in going through this pandemic with minimal losses. In regards of support packages, Saudi Central Bank had announced on 14 March 2020 a Private Sector Financing Support Program. This program was aimed at both banks and finance companies. Its specific objective was to enable them to continue extending credit during the COVID-19 pandemic and thereby support the private sector, notably SMEs. Different types of support were provided under this program. First, a Deferred Payments Program, making available an amount of about SAR 30 billion to banks and financing companies to finance a delay in their payment dues from SMEs. Second, a Funding for Lending Program, which provided concessional finance of about SAR 13.2 billion so that banks and finance companies could continue lending to the SME sector in support of their business continuity and sector growth. The funds extended under these support programs for the benefit of the SME sector has instead of have also allowed the finance companies to continue performing well during the pandemic. The programs provided finance companies with interest free liquidity that would otherwise not have been available to them to support SMEs and also micro enterprises.

Irrespective of the impact of COVID-19, the finance companies sector saw a broad stabilization in terms of the number of companies. In terms of growth in total assets, however, the sector remained on a path of continuing expansion (Table 5.1).

Table 5.1: Development of Finance Companies

	2018	2019	2020
Total number of licensed companies	37	37	36
Real estate companies	6	6	6
Non- real estate companies	29	29	28
Refinance company	1	1	1
Micro finance	1	1	1
Consumer Microfinance	0	0	1

In terms of structural developments involving non-finance companies, several elements are worth noting during the past year. First, finance companies were connected to the “Nafeth” platform in 2020. This platform provides the service of issuing and managing executive bonds electronically. Second, the Saudi Central Bank licensed the “Tawtheeq” company for financial lease contracts. ‘Tawtheeq’ allows finance companies to register financial lease contracts. In addition, it allows for registration with any of the companies that do licensed financial lease contracts resulting in an easier gathering of data and confirmation of lease contracts (Table 5.2).

Table 5.2: Development of Non-Finance Companies

	2018	2019	2020
Registry company	1	1	2
Finance support activity	0	1	1

Third, against a background of solid mortgage credit growth, the Saudi Real Estate Refinance Company (SRC) continued its expansion. The SRC was established in 2017 to develop the housing finance market in Saudi Arabia by enabling loan originators to offer long-term and short-term financing solutions to home buyers. Since its establishment in 2017, the company has seen its portfolio acquisitions increase, thereby establishing its growing role in the domestic mortgage market. Related to the financing of those acquisitions, SRC’s capital structure is reflecting an increase in borrowing. However, the SRC’s total assets still only represent 0.3 percent of GDP. To fund its growth, it is continuing to issue new Sukuk.

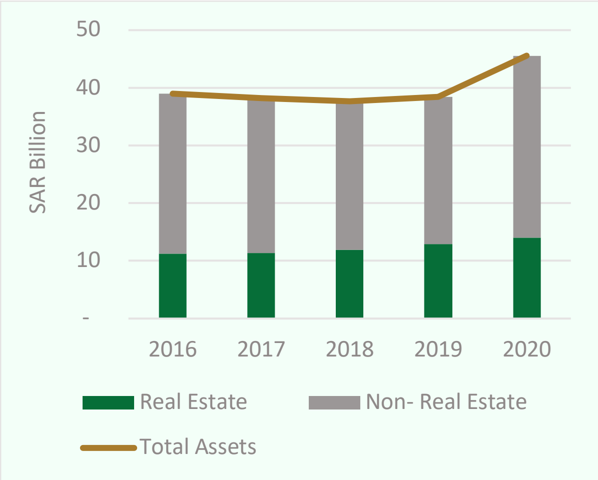
5.2 Finance Companies Assets

Despite the COVID-19 crisis, finance companies’ assets increased by 18.6 percent in 2020. This increase was driven by a 23.4 percent rise in non-real estate assets along with a 9.0 percent increase in real estate assets compared to 2019. Total assets reached SAR 45.6 billion at end-2020 compared to SAR 38.4 billion at end-2019 (Chart 5.1). The main reason for the rise is the licensing of a company whose assets approximately amounted to SAR 3.3 billion in non-real estate companies. The sector continues to represent a

[7] All data in this chapter does not include Saudi Real Estate Refinance Company

small share of the banking system, covering approximately 1.1 percent. Real estate and non-real estate assets accounted, respectively, for 31 percent and 69 percent of total finance companies' assets, respectively.

Chart 5.1: Size of Finance Companies



Source: Saudi Central Bank

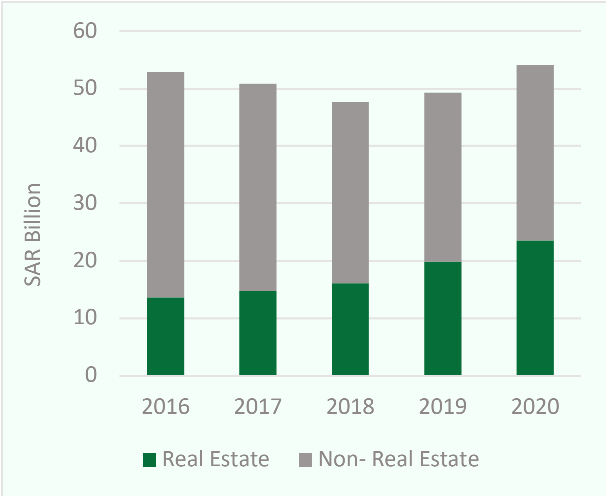
5.3 Finance Companies Portfolio

Total credit on and off balance sheet in finance companies has increased from SAR 49.3 billion in 2019 to SAR 54.1 billion in 2020, representing an increase of 9.8 percent. Real estate companies' credit witnessed a rise of 18.0 percent, moving up from 19.9 billion in 2019 to reach SAR 23.5 billion in 2020. Non-real estate companies' credit witnessed a rise of 4.1 percent, increasing from 29.4 billion in 2019 to reach SAR 30.6 billion in 2020 (Chart 5.2). Real estate lending has recorded persistent growth, driven by the availability of new real estate developments and also by government support. As a matter of fact, the primary driver of the increased real estate lending is now the partial support offered by government initiatives such as the Sakani program. In addition, finance companies' real estate credit growth is consistent with developments in banking sector real estate lending.

With respect to risks and vulnerabilities that could arise in the finance companies' sector, the steep upward trajectory of real estate lending may lead to concentration risk over the medium term as it currently represents 43.5 percent of overall finance companies lending. This effect has to be put in perspective given the relatively small size of the finance companies lending portfolio. Finance companies' overall credit is equivalent to 3.0 percent of total credit in the banking system.

At the macro level, therefore, the risk remains minimal. However, given the persistent increase in real estate lending across both finance companies and banks, the Saudi Central Bank continues to closely monitor developments in the real estate market and its financing.

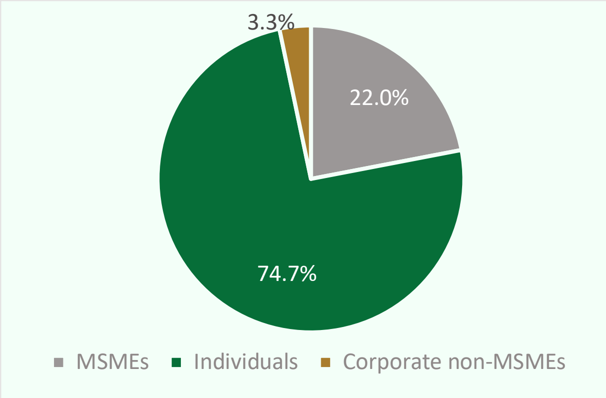
Chart 5.2: Total Credit of Finance Companies



Source: Saudi Central Bank

The lending portfolio of finance companies is concentrated in lending to individuals, representing 74.7 percent of the total portfolio. Lending to individuals increased by 8.1 percent between 2019 and 2020. MSMEs lending now has a share of 22 percent in the total portfolio, having witnessed an increase of 26.7 percent between 2019 and 2020. Corporate non-MSMEs lending takes up only 3.3 percent of total finance companies' portfolio, having witnessed a decline of 28.5 percent in 2020, compared to last year (Chart 5.3).

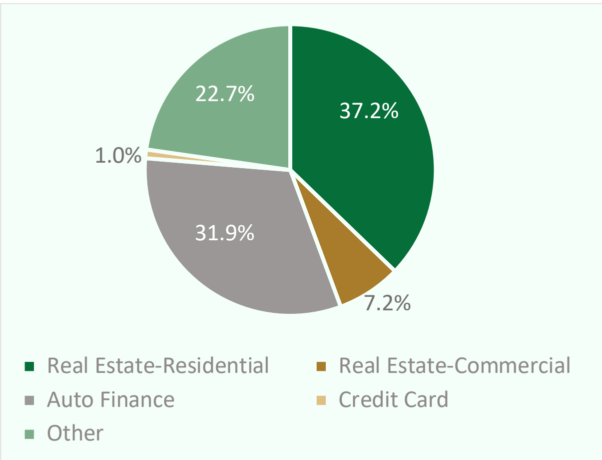
Chart 5.3: Total Finance Companies Portfolio by Borrower Type



Source: Saudi Central Bank

The composition of finance companies' portfolio has started to change under the influence of real estate lending outpacing other market segments, whereby the influence of government support has played a role. In 2019, the largest business line was auto finance representing 42.2 percent of total lending, while this share has declined to stand at 31.9 percent in 2020, and has been surpassed by the expanding share of residential real estate lending, which represented 37.2 percent in 2020 compared to 34.3 percent in 2019. Commercial real estate lending represented 7.2 percent of the total, compared to 8 percent in 2019; Credit card lending took up just 1 percent and the remaining 22.7 percent consisted of other types of lending (Chart 5.4).

Chart 5.4: Finance Portfolio by Line

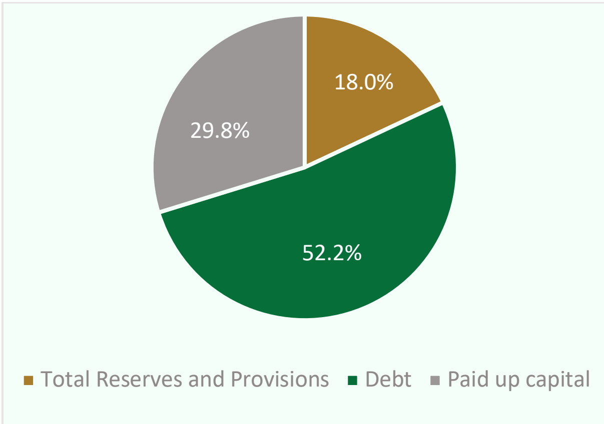


Source: Saudi Central Bank

5.4 Sources of Funds

The defining difference between finance companies and banks is that banks take up deposits whereas finance companies are non-depository institutions. In this regard, they are more sensitive to interest rate movements given their dependency on debt to finance their lending. Indeed, debt funding continues to represent the largest proportion of funding for finance companies. By end of 2020, overall sources of funding totaled SAR 43.1 billion. Debt funding represented 52.2 percent of that total, amounting to SAR 22.5 billion. The past year saw an increased recourse to debt funding, caused mainly by lower interest rates, which gives finance companies a higher appetite to borrow and lend more. Paid-up capital stood at SAR 12.8 billion, representing 29.8 percent of total funding. The SAR 7.8 billion of reserves and provisions amounted to 18.1 percent (Chart 5.5).

Chart 5.5: Breakdown of Sources of Fund

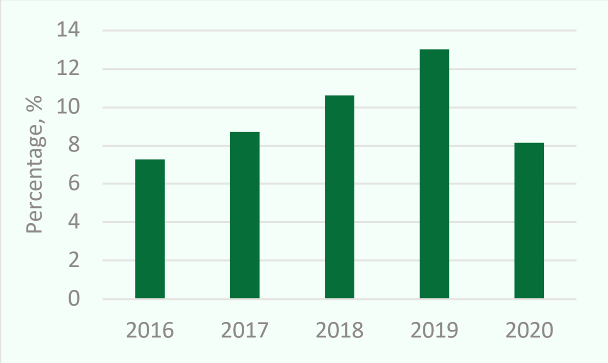


Source: Saudi Central Bank

5.5 Risk Outlook of Finance Companies

NPLs of finance companies have decreased from 13 percent in 2019 to 8.2 percent in 2020. This reduction can be attributed to the close follow-up by financing companies of bad debts that could be treated. In addition, the programs of the Saudi Central Bank in support of SMEs during the pandemic, notably the Deferred Payments program, gave SMEs the needed financial breathing space to continue serving their debts during 2020. This also had a positive effect on the development in NPLs (Chart 5.6).

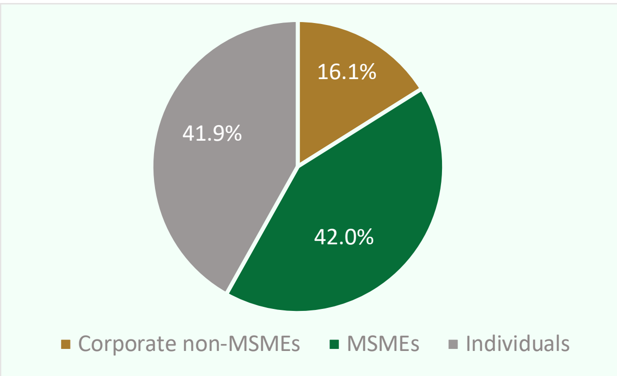
Chart 5.6: NPL Ratio of Finance Companies



Source: Saudi Central Bank

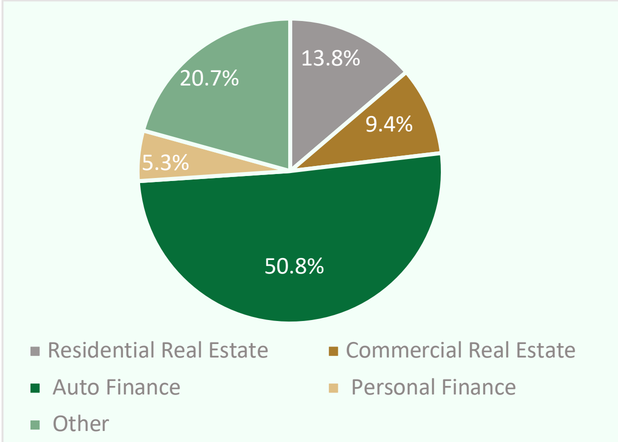
When looking at NPLs amount broken down by sector, the MSMEs sector continues to represent a big share in total NPL, now standing at 42.0 percent compared to 45.7 percent in 2019. The declining share can be attributed to government support packages in the face of the pandemic. NPLs of individuals represent about the same share as the MSMEs sector now, standing at 41.9 percent in 2020 compared to 42.3 percent in 2019. As for corporate non-MSMEs, their NPLs represented 16.1 percent of the total compared to 12.1 percent in 2019 (Chart 5.7). When examining NPLs by business line, the biggest contributor in 2020 is auto finance, standing at 50.8 percent of total NPL in 2020, followed by real estate-residential and real estate-commercial, which accounted for 13.8 percent and 9.4 percent, respectively. The NPLs share of personal finance stood at 5.3 percent. Developments in sectoral NPLs are consistent with developments in credit activity (Chart 5.8).

Chart 5.7: NPLs Amount for Finance Companies by Borrower Type



Source: Saudi Central Bank

Chart 5.8: NPLs Amount of Finance Companies by Activity



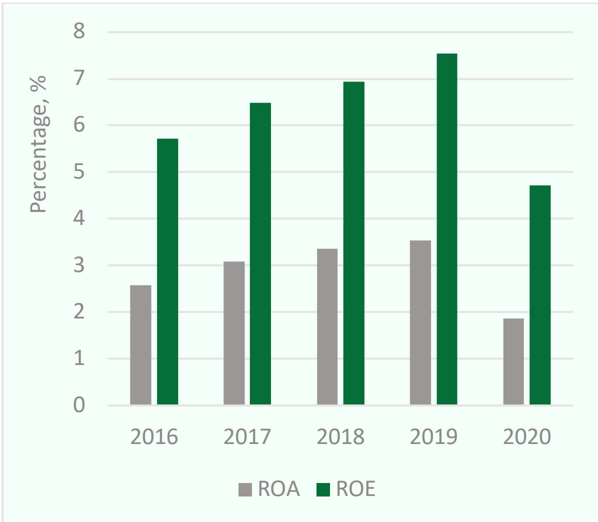
Source: Saudi Central Bank

5.6 Finance Companies Resilience

5.6.1 Profitability

Finance companies' profitability has declined significantly in 2020. The decline can be attributed to the COVID-19 event. The biggest declines were attributable to four companies active in auto finance, credit cards, and SMEs. Looking at the annual evolution, profitability moved from SAR 1,356 million in 2019 to reach SAR 852 million by end of 2020. Both ROA and ROE decreased in 2020 compared to one year earlier, standing at 1.9 percent and 4.7 percent, respectively (Chart 5.9).

Chart 5.9: Profitability of Finance Companies

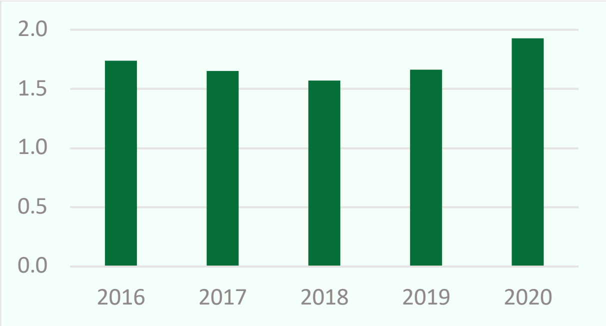


Source: Saudi Central Bank

5.6.2 Leverage

The finance companies' leverage ratio remained well below the regulatory maximum requirement.[8] It stood at 1.9 in 2020, representing an increase in comparison with the 1.7 in 2019. This increase can be attributed to both real estate and non-real estate lending. All in all, despite an increased leverage ratio, it remains at an acceptable level (Chart 5.10).

Chart 5.10: Leverage Ratio of Finance Companies



Source: Saudi Central Bank

[8] Saudi Central Bank'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 Saudi Central Bank'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 Saudi Central Bank.

Box 5.1: Non-Bank Financial Intermediation

Non-bank Financial Institutions (NBFIs) have grown in importance since the Global Financial Crisis and their impact on financial stability has increased. Today, these institutions play an important role by providing financial services, and in doing so, they contribute to supporting the real economy and enhancing financial inclusion. However, to the extent that they engage in activities similar to those practiced by banks, such as transforming maturities, providing liquidity and establishing financial leverage, NBFIs may contribute to the occurrence of systemic risks, either directly or through their interconnection with the banking sector. While the banking sector is subject to a strict regulatory framework, many NBFIs are not governed by adequate regulations and legislation.

At the request of the G20 leaders at their 2010 Seoul Summit, FSB began to conduct an annual monitoring process for these institutions and started publishing its results in an annual report since 2011. In 2013, the FSB issued a policy framework that allowed authorities to discover and assess the risks of NBFIs from a financial stability perspective. To complement these efforts, the FSB's Standing Committee for Vulnerability Assessment (SCAV) in 2016 established the NBFI Monitoring Experts Group (NMEG).

NBFIs pose risks to the financial system by increasing the level of risks in their portfolios, along with transferring liquidity and increasing leverage in a pro-cyclical manner. Securitization, in which NBFIs are active, contributes to lowering the lending standards of the originator of securities, which in the long term leads to higher rates of default. Securitization also increases product risk - through the design of structured products - when assets are positively correlated. The investment fund business model in particular, which relies to a large extent on wholesale funding, makes it vulnerable to liquidity scarcity in financial markets. In addition, NBFIs that use derivatives or engage in securities lending are subject to the risk of counterparty failure to fulfill their obligations.

Many NBFIs are active in lending. These operations that take place outside of traditional banking regulations raise concerns about the risks they may pose to the financial system. Non-bank credit has expanded significantly worldwide in recent years as NBFIs have entered this area of activity. NBFIs encourages an accelerated increase in debt, thus inflating asset prices. There are serious concerns about the quality of its assets, extent of financial leverage and low levels of capital. In addition, there are concerns about its interconnectedness with the traditional banking system and the ambiguity and complexity of its activities. These institutions offer also more suitable facilities than the banking system to conduct money laundering, tax evasion and other illegal financial operations. Because of the absence of a formal safety net to support them (such as a deposit insurance system and the ability to borrow from the central bank), NBFIs are more likely to run into a rush to withdraw funds (so-called runs) during times of loss of confidence.

Countries vary widely in terms of the size of their non-bank credit provision. In general, non-bank credit plays a larger role in advanced economies than in emerging market economies. On the other hand, non-bank credit has grown faster since the Global Financial Crisis in some emerging markets and countries with relatively small non-banking sectors. In recent years, policymakers have embarked on gaining a better understanding of the nature of various NBFIs and their potential impact on financial stability, as well as on putting in place better legislation and more controls over them. The COVID-19 crisis - which exacerbated the negative impact of this sector on the rest of the markets - also prompted the regulators to look more closely at this sector.

At the local level in Saudi Arabia, financing companies and other financial institutions have grown and increased in terms of size and interconnectedness with the banking sector, but their size is still relatively small, as the assets of institutions in the category "other financial institutions" amounted to less than 4 percent of the total assets of the financial sector by the end of 2019. As for NBFIs (according to the comprehensive measure of the FSB), their assets reached about SAR 257 billion by the end of 2019. This amount includes the assets of finance companies, insurance companies, money market funds, other investment funds, and real estate investment funds. It should be noted that these institutions do not engage in direct financing activities with the exception of financing companies, which represent about 15 percent of the total assets of NBFIs.

In the legislative domain pertaining to NBFIs, the FSB has enacted a set of principles and related policy tools, and the local regulators – the Saudi Central Bank and the Capital Market Authority - have enacted legislation and regulations aimed at regulating and supervising financing companies and investment funds of various kinds.

Given the risks posed by non-bank financial intermediation to financial stability, some recommendations are to be taken into consideration. The most important of these are: 1) using some tools that have been developed for the purpose of prudential control over the banking sector and applying them to the NBFI sector (such as: early warning indicators, stress tests, and other elements), 2) using methods for measuring the non-bank credit cycle and studying its relationship with the bank credit cycle, 3) studying the effects of monetary policy and other economic-financial variables on the non-bank credit cycle.

ASSETS MARKET DEVELOPMENTS

6

6. Assets Market Developments

6.1 Overview

By the end of 2020, risks and vulnerabilities arising from the COVID-19 outbreak had subsided significantly in the domestic and international asset market, while the outlook for 2021 had also shown considerable improvement. After a significant sell-off amid the ongoing uncertainties related to the pandemic effects that became visible during the first half of 2020, a rebound in asset prices took place.

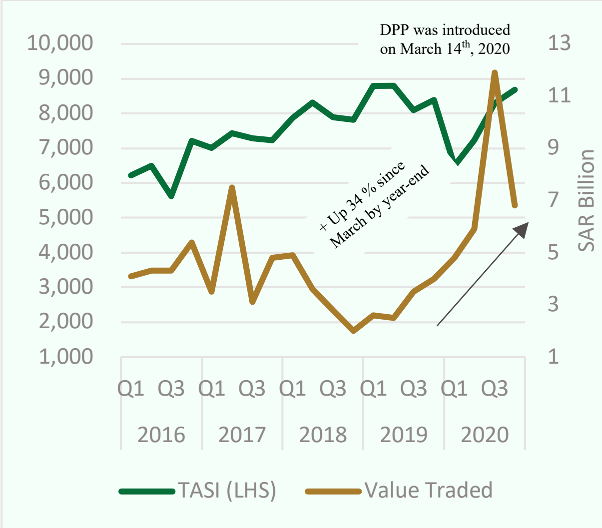
6.2 Equity Market

The Saudi Central Bank's measures to support liquidity provided to the domestic financial system have largely mitigated the impact of capital flows volatility. The Saudi banking sector – the second largest sector of the Saudi Stock Exchange (Tadawul) by market capitalization (7.6 percent of the total market)- remained robust, due to sufficient capital, high liquidity buffers, and diversified funding profiles.

Despite macroeconomic challenges, the Saudi main market Index (TASI) ended the year 2020 with around 4 percent year-on-year growth, thus reaching a higher than the pre-pandemic level, demonstrating the domestic market resilience and capacity to withstand shocks. The stock market volatility in the Saudi market has shown the same rate of decline as the MSCI Emerging Market Index, from 32 percent in March to 14 percent in December 2020. Moreover, the Saudi index witnessed a steady recovery with a 34 percent increase in December compared to March 2020, whereas the MSCI increased by 52 percent in the same period.

The essential measures put in place to mitigate the impact of the pandemic, including a suspension of domestic and international flights and domestic containment measures, have negatively impacted private consumption and demand in the country, which was also reflected in the overall market performance during the first quarter 2020, before the recovery observed by the second quarter of 2020 (Chart 6.1).

Chart 6.1: TASI Movement

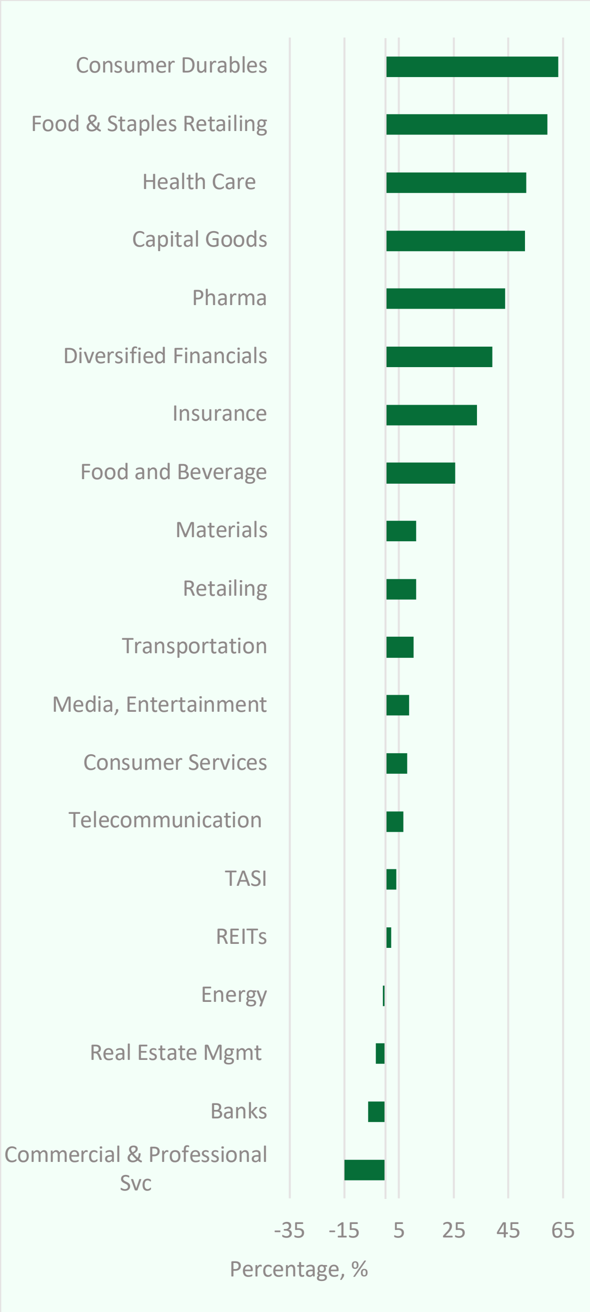


Source: Capital Market Authority

According to the IMF Global Financial Stability Report (GFSR), foreign investment outflows in emerging market securities rose sharply, reaching USD 100 billion from mid-January until the end of the first quarter of 2020. The Saudi stock market, however, witnessed foreign investment inflows totaling more than SAR 18.7 billion in 2020. The stock market witnessed net outflows only in March 2020 for an amount less than SAR 3.5 billion (i.e. less than one billion USD), which is equivalent to only 2.3 percent of the total equity ownership of foreign investors in Saudi Arabia.

In terms of sectoral stock market performance, the lowest performing sectors were Commercial & Professional Services and Banking (down by 14.9 percent and 6.4 percent, respectively). Aside from the pandemic effects, a lower interest rate environment resulted in less favorable outlook for the banking sector in terms of profitability (Chart 6.2).

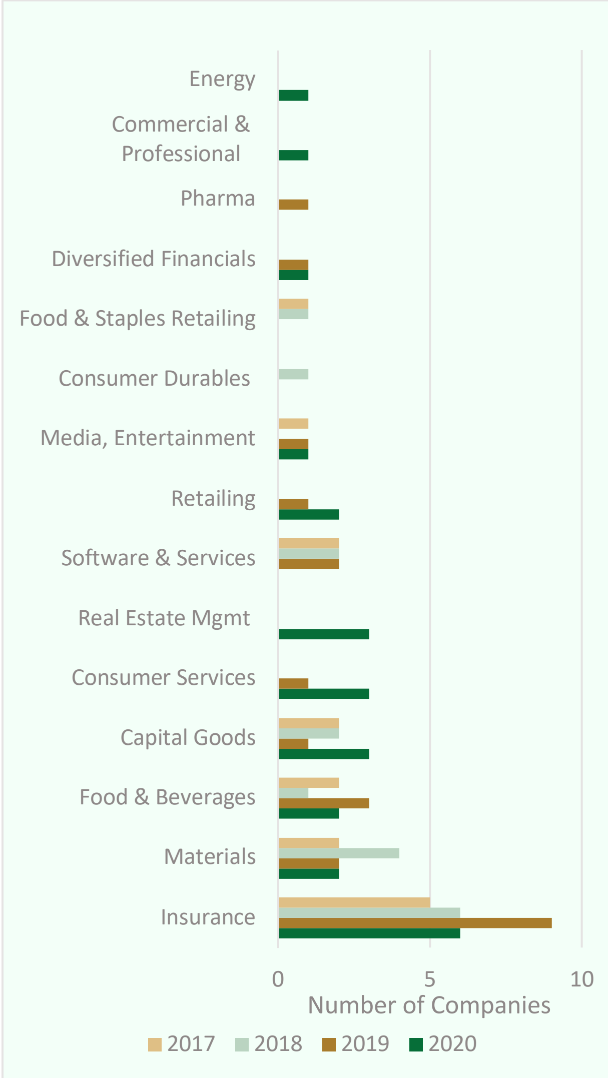
Chart 6.2: Market Performance by Sector (Y/Y)



Source: Capital Market Authority

The total number of listed companies with accumulated losses surged by 13.6 percent compared to 2019 to reach 25 companies. This is partially attributable to the lower net profit of the Insurance sector as the pandemic continued to weigh on margins in the sector (Chart 6.3).

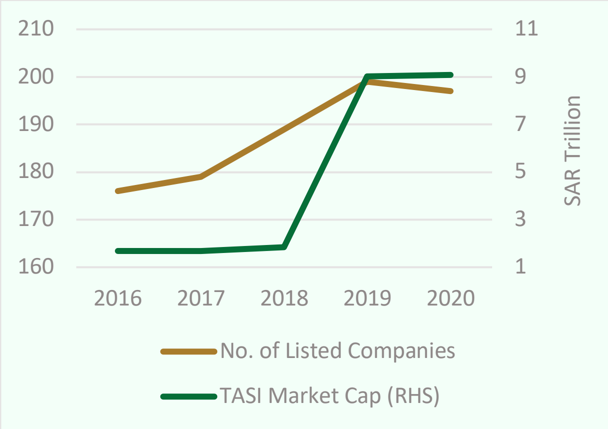
Chart 6.3: Companies with Accumulated Losses by Sector



Source: Capital Market Authority

The equity market's overall capitalization stood at SAR 9.1 trillion, up 0.8 percent year on year. During the year, three companies made an IPO, with a total value of SAR 53.7 billion, which represented 0.6 percent of total market capitalization (Chart 6.4).

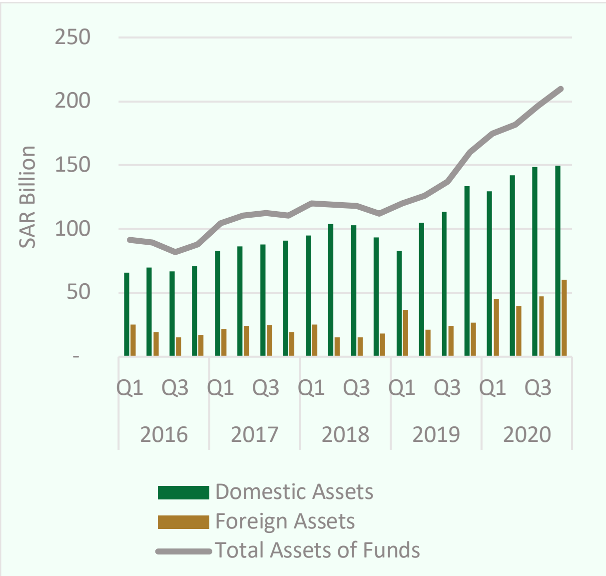
Chart 6.4: Market Depth



Source: Capital Market Authority

Total domestic assets of investment funds also witnessed an increase in 2020, by 12.1 percent, to reach SAR 150 billion (Chart 6.5).

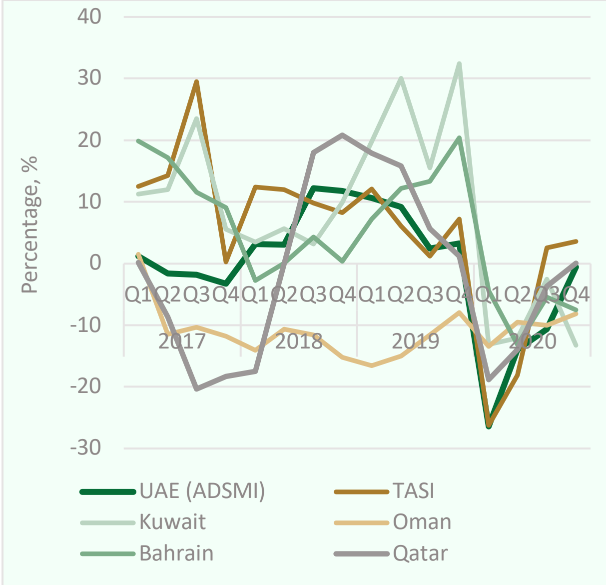
Chart 6.5: Domestic Investment Funds



Source: Saudi Central Bank

Regionally, the TASI exhibited a divergent pattern from that of its regional peers. It was the only index to register positive growth among its peers in the region between end-2019 and end-2020 (Chart 6.6).

Chart 6.6: Regional Performance (Y/Y)

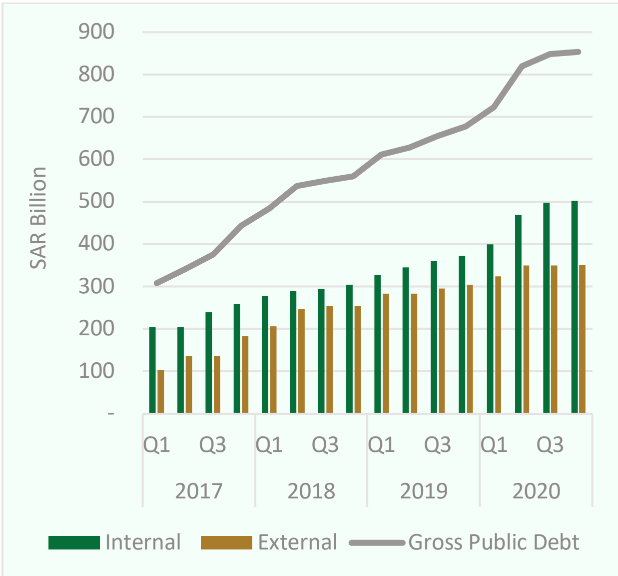


Source: Bloomberg

6.3 Debt Market

As of Q4 2020, total outstanding direct indebtedness amounted to SAR 853.5 billion, comprising SAR 502.6 billion of private-sector indebtedness and SAR 350.8 of public-sector indebtedness (Chart 6.7).

Chart 6.7: Public Debt



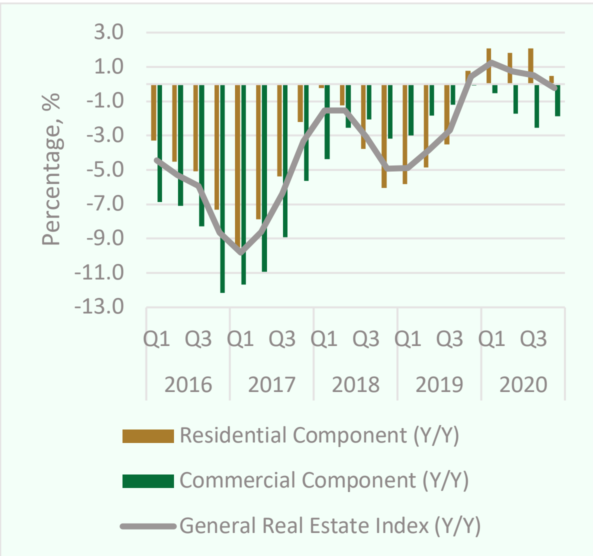
Source: Ministry of Finance

6.4 Real Estate Market

The real estate market in the Kingdom is rapidly changing. In view of the growth in population, the demand for housing is increasing. Moreover, a number of initiatives have been taken in line with Vision 2030 that aim at increasing homeownership in the country, thus further strengthening the residential real estate sector going forward. In addition, the exemption of the VAT rate of 15 percent and replace it with RETT of 5 percent, which is calculated on the value of the real estate transaction, is expected to further support the real estate sector.

During 2020, real estate prices decreased, after having increased in 2019. The real estate index averaged 80.6 (basis 100 = 2014) in the fourth quarter of 2020, representing a decrease of 0.2 percent compared to the same period last year (Chart 6.8). The decline in prices was driven mainly by commercial real estate prices, which decreased by 1.9 percent in the fourth quarter of 2020 year on year.

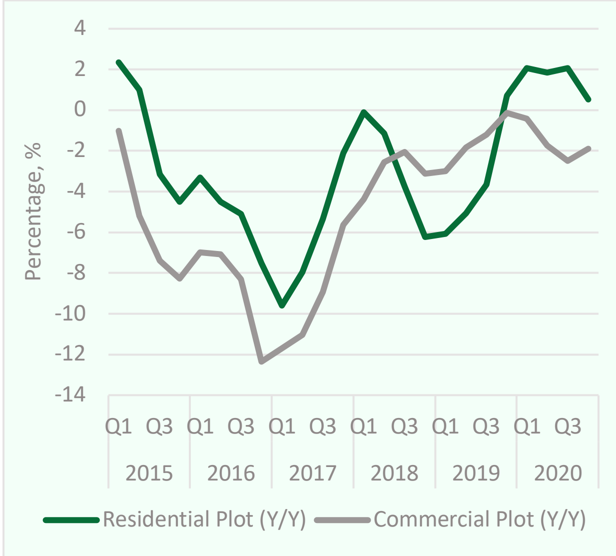
Chart 6.8: Real Estate Price Index



Source: General Authority for Statistics

Residential plot prices still rose slightly by 0.5 percent year on year by Q4 2020, but commercial plot prices fell by 1.9 percent over the same period (Chart 6.9). The decline in prices might be attributed to the lockdown, which mainly affected the commercial sector.

Chart 6.9: Commercial and Residential Plot Price Indices



Source: General Authority for Statistics

Box 6.1: Derivative Financial Market

In light of the Saudi Capital Market Authority (CMA) strategic and continuous efforts to enhance the capital market's attractiveness and improve its readiness for further investments and liquidity, the launch of the first exchange-traded derivative product - MSCI Tadawul 30 index (MT30 Futures) – took place in Q3 2020 in coordination with Tadawul, marking the beginning of derivatives trading in the Kingdom.

The launch of the first MT30 Futures is another milestone achievement that is expected to increase equity volumes traded and attract regional and international capital by adding more depth and breadth to the products offered in the market. It is also a key milestone for Vision 2030.

Although the derivatives market currently offers only a sole product, the Saudi Stock Exchange is planning to gradually launch additional derivatives products as part of its diversification strategy. This diversification will limit the risk of exposure to a certain type of investment products, or securities, which aims to make the market less susceptible to fluctuations.

Overview on Financial Derivatives

Financial derivatives are contracts between two parties, whose terms and conditions are set at the time of purchasing the contract, to deliver a certain asset at a future date. Those assets are commonly in the form of stocks, bonds, Exchange Traded Funds (ETFs), Real Estate Investment Trusts (REITs), commodities, currencies, and market indices.

I. **Financial derivatives are used for various purposes, mainly:**

- Investments or Portfolio Hedging purposes.
- Financial Speculation.

II. **Rewards and risks of financial derivatives practice**

Rewards	Risks
Offers liquidity injection into the market, which subsequently, increases market depth	Leverage risk; risk of realizing higher losses than the capital invested
Represents a hedging tool to help investors manage their risks and diversifying their investment portfolio	Volatility risk; investors should be aware of the impact on market volatility and possible margin calls
Provides new local employment opportunities within the derivatives space, such as for market makers and brokers	Liquidity risk; a lower volume of buyers and sellers in the market might result in difficulties to liquidate an open position, which could amplify the losses

III. **Types of derivative contracts**

- Futures contracts: an obligation to sell or buy something in the future at a predetermined price.
- Forwards: the difference between forward and future contracts is that forward contracts are not standardized.
- Options: the buyer of the contract has the option to buy or sell at a predetermined price.

- Swaps: an agreement between two parties to exchange a sequence of future cash flows.

IV. Uses of derivatives

- Manufacturers to help lock in the cost of issuing debt to finance new investments.
- Exporters to achieve certainty in the rate they can convert future overseas revenue.
- Energy producers and distributors to manage changes in energy prices.
- Banks to manage the volatility in earnings through interest rates (ALM programs).
- Airlines to manage fluctuations in fuel prices.
- Food producers and distributors to manage fluctuations in crops, livestock & fuel prices.

V. Features of derivatives market

- Reacts faster to international and domestic events.
- Derivatives market opens thirty minutes earlier than the cash market and closes after the cash market closes.

Box 6.2: Measures Taken by CMA in Response to COVID-19

CMA has taken measures in the light of the significant impact of the pandemic to support capital market activities, financial institutions, and entities subject to CMA supervision. These included:

- Reducing the trading hours for all listed securities temporarily.
- Exempting listed companies from CMA's fees and extending the period for submitting statutory and regulatory requirements.
- Extending the deadline to meet the conditions and requirements for companies that obtained a Financial Technology Experimental Permit.
- Suspending the freezing of investment accounts.
- Urging financial market institutions to take precautionary measures towards COVID-19 by implementing remote work for all market institutions.
- Holding listed Companies' Assemblies Remotely and Suspension of physical attendance.

Aiming to enhance financial framework and increase the efficiency of the financial market while reducing systemic risk, CMA has implemented the following to enhance the regulatory framework:

- Approval of the Securities Central Counterparties Clearing (CCPs) Regulations and licensing the first Securities Clearing Center Company (Muqassa).
- Approval of the Derivatives Exchange Trading and Membership Rules and Procedures.
- Tadawul, Muqassa, and the Saudi Securities Depository Center Company (Edaa) published the drafts for public consultation of: (1) the amended Trading and Membership Rules; (2) the amended Securities Clearing Center Rules; and (3) the amended Securities Depository Centre Rules.
- Approval of amendments to the Securities Business Regulations, Authorized Persons Regulations, and Glossary of Defined Terms Used in the Regulations and Rules of CMA.
- Publication, for public consultation, of the draft amendments of the Market Conduct Regulations.
- Publication, for public consultation of the draft amendments to the Investment Funds Regulations and Real Estate Investment Funds Regulations, as well as the draft amendments to the Rules on the Offer

of Securities and Continuing Obligations, and the draft amendments to the Rules for Special Purpose Entities.

- Tadawul published, for public consultation, the draft of the amended Listing Rules.

In addition, CMA undertook efforts to improve the capital market; further initiatives have promoted market activity:

- Increased listing of government fixed income securities and exchange-traded funds investing in government Sukuk, which has enhanced the liquidity of the domestic financial market.
- Increased the number of listed companies after three new Initial Public Offerings (IPOs) in 2020. More listings are expected in 2021 as 20 companies with applications for listing are currently being processed.
- Increased secondary offerings, as equity rights issues increased from SAR 0.1 billion during 2019 to SAR 6.0 billion in 2020.
- Increase in private sector debt issuance from SAR 8.3 billion in 2019 to SAR 28.0 billion in 2020, which represents a growth rate of 236 percent.
- Inclusion of Saudi Arabian stocks into the FTSE Russell Emerging Market Index in the first half of 2020.
- Increase in debt market traded values from SAR 5.1 billion to SAR 37.5 billion in 2020, which represents a growth rate of 640 percent.
- Increase in main market traded values by 146 percent, which is equivalent to SAR 1.2 trillion.
- Allowed foreign investors to invest directly in Saudi debt instruments.
- Issued exceptions to the Companies Law provisions.

FINANCIAL REGULATORY AND POLICY DEVELOPMENTS

7

7. Financial Regulatory and Policy Developments

7.1 Saudi Central Bank Law

The Royal Decree, which issued the new Law, provides that the Saudi Central Bank will continue to use the acronym "SAMA" due to its historic significance and relevance both locally and globally. In addition, the banknotes and coins of all denominations bearing the name of the Saudi Arabian Monetary Authority will remain in circulation and keep their status as legal tender, and the “Saudi Central Bank” name replaces the name of “Saudi Arabian Monetary Authority” whenever the name appeared in related Laws, Ordinances, Orders, and Resolutions; in addition, the Bank replaces the Authority in its rights and obligations. The new Law confirms the responsibilities of the Saudi Central Bank over institutions under its direct supervision (banks, finance companies, insurance companies, the credit information sector, and the financial technology (FinTech) sector), as well as the Saudi Central Bank’s role in formulating monetary policy and choosing its instruments and procedures, and managing cash reserves. The Law does not require any change in the Saudi Central Bank’s current monetary policy, it indicates that the Saudi Central Bank holds the sole responsibility for formulating and implementing monetary policy.

The new Law identifies the objectives, functions, and powers of the Saudi Central Bank, taking into consideration the significant development of the financial sector, including FinTech and payment systems. In addition, it addresses the relationship between the government, other central banks, and international organizations. The objectives of the Saudi Central Bank is stated in the new Law, as follows:

1. Maintain monetary stability.
2. Support financial sector stability, and promote trust therein.
3. Support economic growth.

The new law states that the Bank shall have a legal personality and financial and administrative independence. The Saudi Central Bank's direct reporting to the King reinforces its independence from the government and its executive bodies. It also reflects the leadership’s pursuit to grant the Saudi Central Bank the highest levels of independence to carry out its mission through necessary tools. In addition, the new law states that the Saudi Central Bank's assets, revenues, and properties shall enjoy immunity and may not be searched, blocked, seized, confiscated, or expropriated, and may not be subject to bankruptcy procedures in any form whatsoever.

According to the new Law, the Saudi Central Bank will conduct research, studies, and publish statistics within Saudi Central Bank's competence. It will publish a report that includes the latest financial and economic developments in the Kingdom on a yearly basis. Furthermore, the new Law updates and strengthens the governance framework of the Saudi Central Bank's operations and decisions. The new law increases the number of the central bank’s board of directors to seven members (chairman, vice-chairman, and five non-government members) from five members (chairman, vice-chairman, and three non-government members). In addition, the member’s term will be seven years instead of five years. Moreover, the new Law stipulates the level of transparency and accountability through by-laws, the framework of conflicts of interests and disclosures at the board and staff level. The Saudi Central Bank is required to publish the external auditors’ reports on a yearly basis.

7.2 Saudi Central Bank's Prudential Regulations Updates

Saudi Central Bank implemented micro- and macroprudential measures that ensured the resilience of the financial system during the COVID-19 outbreak. Accounting and supervisory treatment takes into account the pandemic's effect in its forecasts of credit loss as a result of the pandemic for timely intervention.

The Saudi Central Bank assesses the effectiveness of prudential tools implemented and evaluates the need for strengthening prudential regulation. Appropriate use of Saudi Central Bank's powers in the face of the pandemic shock contributed to financial stability and enhanced monetary policy effectiveness.

7.3 Financial Institutions Policy Developments

7.3.1 Banking Regulations and Laws

The Saudi Central Bank issued guidelines on managing problem loans associated with large corporates, and MSME, besides updated guidelines on the Internal Liquidity Adequacy Assessment Plan (ILAAP).

The Saudi Central Bank issued the Regulatory Treatment of Banks' Exposures to CCPs to reduce systemic risk.

In February 2020, the Saudi Central Bank took proactive action and issued additional licensing guidelines and criteria for digital-only banks in Saudi Arabia. In addition, as part of its responsibilities, the Saudi Central Bank issued a regulation for Foreign Banks Branches (FBBs) in September 2019. The regulation covers regulatory requirements such as funding ratio requirements and liquidity requirements.

7.3.1.1 Basel III Reforms

The Saudi Central Bank's efforts in implementing Basel III reforms aim to strengthen the banking sector’s prudential regulations and measures. Adoption of some of the reforms was to take effect from January 2022. However, due to the outbreak of COVID-19, the Group of Central Bank Governors and Heads of Supervision (GHOS) endorsed a decision to postpone implementation until January 2023 in order to provide more operational capacity for banks and regulatory authorities.

Moreover, the Saudi Central Bank adopted a structured methodology to assess and designate Significant Financial Institutions (the Significant Financial Institutions Treatment System or SFITS). The process enables the Saudi Central Bank to effectively supervise and control important financial institutions to ensure the preservation of monetary and financial stability and protect the financial system from any adverse effects.

For the purposes of providing the necessary support to SMEs, Saudi Central Bank implemented Basel III reforms related to exposure to unrated corporate SMEs so that the RWA ratio for those firms becomes 85 percent instead of 100 percent, with continued application of the RWA ratio for retail SMEs at 75 percent.

7.3.2 Insurance Regulations and Laws

The year 2020 saw brisk activity by the Saudi Central Bank to refine the existing regulations and introduce new regulations to respond to the evolving business environment in a timely manner.

In the first half of the year, the new Actuarial Work Rules came into effect, significantly enhancing the role of actuarial expertise in the sector, commensurate with the increasing market sophistication, and setting the roadmap for the growth of the actuarial profession in the Kingdom. The new rules governing insurance aggregators' activities also became effective, which are expected to streamline this rapidly growing segment's operations and facilitate easy access to affordable insurance cover for the general public. Moreover, in line with the insurance sector's national objective to support economic growth, the Standard Policy for Inherent Defects Insurance was issued. The standard policy is intended to provide a safety net to all stakeholders in the housing and construction sector, with this sector being deemed an important contributor towards Vision 2030. Additionally, the Saudi Central Bank issued rules encompassing bancassurance activities with the objective of increasing the awareness and attractiveness of insurance savings products and facilitate their sale across the country, including in remote areas.

In the second half of the year, the most important regulatory development was the issuance of the Rules for Comprehensive

Insurance of Motor Vehicles Financially Leased to Individuals. This was a major step towards implementing a fair pricing framework for motor leasing customers and regulating the contractual relationship between motor leasing companies and their customers.

In addition to implementing the above new rules, Saudi Central Bank also issued draft regulations during the year relating to comprehensive motor insurance and pooling of health insurance risks of MSMEs, both of which have gone through a public consultation phase and are now in the process of being finalized. The intense regulatory activity in the recent past underscores Saudi Central Bank's resolve to be proactive in responding to the sector's evolving needs and developing a sustainable insurance market in Saudi Arabia.

7.3.3 Finance Companies Regulations and Laws

In November 2020, Saudi Central Bank issued rules governing credit risk exposure classification and provisioning. These rules set out the minimum requirements and enable finance companies to evaluate the degree of credit risk associated with exposures. A further development was the issuance of the Deposit Taking Finance Companies (DTFCs) regulation. The DTFC is restricted to collecting saving and time deposits from non-individual customers. Noting that the regulation covers many important aspects such as the prudential requirements.

The Saudi Central Bank issued Debt-Based Crowdfunding rules as part of Saudi Central Bank's efforts to support and organize modern financing activities. The rules aim to regulate licensing provisions for this type of company and regulate its conduct.

The Saudi Central Bank issued rules governing microfinance companies. The issuance of these rules is part of Saudi Central Bank's efforts to enhance financial inclusion by providing more financing products to meet consumer's needs.

7.3.4 FinTech Developments

The new Saudi Central Bank Law mandates and expedites the supervision and regulation of FinTech companies. One of the 2030 Vision programs is the Financial Sector Development Program (FSDP), which seeks to develop the financial industry, support the development of the national economy as well as support private sector growth. The implementation strategy for a domestic FinTech ecosystem aims to facilitate the FSDP objectives. As in 2020, the issuance of new licenses for FinTech reached a total of 11, serving in the field of payments, two licensed FinTech provide brokerage activities in insurance and one in financing activities. The share of non-cash transactions rose twofold to 36 percent under the FSDP implementation, well above the 2020 target of 28 percent. Noting that sixteen Saudi-based FinTech players are operating with a full license and the POS transactions grew 24 percent year-on-year to SAR 357 billion. Finally, E-wallet accounts opened by individuals and businesses grew by 149 percent year-on-year, exceeding 5 million accounts.

The Saudi Central Bank and the Central Bank of the United Arab Emirates launched the "Aber" Project, which is a joint digital currency and distributed ledger project and it confirmed that Distributed Ledger Technology (DLT) could enable cross-border payments between the two countries' commercial banks using a new, dual-issued digital currency as a settlement unit.

The Saudi Central Bank has designed a Regulatory Sandbox that has three objectives: (i) facilitate the introduction of new financial products to the market that meet consumers' demand and increase the efficiency and quality of services; (ii) help innovators within the financial services sector to shorten their time-to-market and address legal and licensing requirements; (iii) allow regulators to collect evidence that can be used to draft guidelines and regulations for upcoming technologies, protect consumer interest, stay abreast of the latest innovations in the sector, and mitigate any risk.

In January 2021, the Saudi Central Bank issued an Open Banking Policy, which articulates the main objectives of implementing open banking in Saudi Arabia and its positive effects on the financial sector. The issuance of this policy is also aligned with Saudi Central Bank's efforts to ensure the sector's infrastructural readiness to utilize the most prominent financial technologies and ensure leading supervisory practices for new and innovative technology-enabled financial services.

7.3.5 Payment Systems

The oversight function of payment and settlement systems has been developed to set up a regulatory framework focusing on Systemically Important Payment Systems (SIPSs) with the strategic objective of maintaining financial stability. As a regulatory update, the Saudi Central Bank issued in January 2020 the payment services provider regulations that cover capital requirements and aim to regulate the licensing of payment companies as well as their payment service activities in the Kingdom.

Also in January 2020, the Saudi Central Bank announced the provision of payment services licenses to NBFIs, followed by the issuance of the first license for an electronic money institution and the first license for a payment institution in the Kingdom. Additionally, the Saudi Central Bank collaborated with the CMA and Tadawul in many initiatives toward achieving Saudi Arabia’s Vision of 2030, such as setting up a CCP operated by Muqassa, followed by launching the Kingdom’s first derivative market on August 2020, which aimed at attracting a wider range of investors. With this launch, Muqassa also started its operations for the first time in the Kingdom.

In February 2021, the Saudi Central Bank launched the instant payment system Sarie as part of a series of Saudi Central Bank-led initiatives to promote the national payments' ecosystem and enhance its infrastructure, aiming to promote financial inclusion.

7.4 Cybersecurity

While the digital transformation helped promote the stability and efficiency of the financial system, it also demonstrated that enhancing cyber resilience is of central importance to promote financial stability.

The pandemic has helped accelerate the pace of digital transformation of finance, and the Saudi Central Bank has undertaken a series of actions to address cyber risks in 2020, such as establishing a cybersecurity advisory center to monitor global and regional cyber threats, particularly threats targeting the financial system.

During Saudi Arabia's Presidency of the G20, the Outlook Center team noted an increase in cybercrimes that targeted the cyberspace of the Kingdom in general and the financial system in particular.

Recently, phishing attacks that exploited the spread of COVID-19 have increased substantially worldwide. The Saudi Central bank joined the Global Forum for Incident Response and Security Teams (FIRST) that gathers 423 companies and public organizations in various vital sectors in 88 countries worldwide.

7.5 Systemically Important Financial Institution Law

The Law of Systemically Important Financial Institutions (SIFIS) came to preserve national gains, achieve the public good, and keep pace with international best practices, which enables the Saudi Central Bank and CMA (the competent authority) to effectively supervise and control important financial institutions in a manner that ensures the preservation of monetary and financial stability, and the protection of the financial system from any negative effects.

The Law defines SIFIS as “A financial institution classified by the competent authority as a systemically important financial institution based on a decision from the competent authority according to its own requirements, and it shall consider “the size of the financial institution, its complexity resulting from its internal and external interconnectedness with other financial institutions, business method and the relevant risks linked to it”.

The Law aims to enable the Central Bank to take actions in order to maintain the safety and stability of the financial sector, protect depositors' funds, clients' assets, and insurance policyholders. The Law includes special provisions that require the SIFIS to prepare a "recovery" plan, which are those procedures and steps that the important establishment will take to restore its position in the event of default or its possibility. The Central Bank prepares a "resolution plan" that includes the measures (bill in, sale of business, etc.) that will be taken when the institution is subjected to treatment -in accordance with the provisions of the Law- to achieve the aforementioned goals.

Box 7.1: Measures Taken by the Saudi Central Bank to Safeguard Financial System Stability

Saudi financial institutions' balance sheets were sound and robust going into the pandemic in early 2020 and there have not been any systemic solvency concerns since then. However, the risks have been rising in the face of great uncertainty. The Saudi Central Bank and more than 22 other public entities responded with the most appropriate support measures at their disposal. Two main phases can be distinguished: first, in February, the quick establishment of an internal task force to assess the potential impact of COVID-19; then, in the course of March, the introduction of stimulus package programs to support the economy. For the remainder of 2020, the stimulus package programs were renewed on several occasions to remain as a safety net for the economy. Even though the vaccine is rolling out in 2021, the impact of the pandemic on the Saudi economy will likely continue for at least the remainder of the year. This could still present risks to the Saudi financial sector.

The main measures the Saudi Central Bank has taken to mitigate the effect of COVID-19 include the following:

Table 7.1: Measures Taken by the Saudi Central Bank for Financial System Stability

03/03/2020 and 16/03/2020	Saudi Central Bank adjusts both its Repo and Reverse Repo rates by 50 basis points (the Repo rate changes from 2.25 percent to 1.75 percent, and the Reverse Repo rate from 1.75 percent to 1.25 percent); a second reduction by 75 basis points is implemented (the Repo rate changes from 1.75 percent to 1.00 percent, and the Reverse Repo rate from 1.25 percent to 0.50 percent).
14/03/2020	A comprehensive Private Sector Financing Support Program is launched. It included: - Loan Guarantee Program relieves SMEs from the Kafalah program's finance costs during the fiscal year 2020. By the end of June, the number of financing contracts provided to the loan guarantee program beneficiaries exceeded 2,092, with fees provided by creditors (banks and finance companies) totalling SAR 22.8 million. Also, 153 financing contracts were for micro-enterprises with an amount of SAR 588.5 thousand. Similarly, 1,619 contracts were for SMEs with an amount of SAR 12.4 million, and 320 for medium enterprises with an amount of SAR 9.8 million. - Funding for Lending Program, subsequently renamed as a Guaranteed Financing Program. - Deferred Payments Program to defer the financial sector's dues from SMEs. The increased number of enterprises requesting to benefit from the program led to a rise of the overall amount, with this program supporting more than 99 thousand contracts for SMEs in different sectors. - Fee Support Program for POS and e-commerce transactions.
24/04/2020	The Guaranteed Facility Program to support lending to SMEs stipulates that 95 percent of total finance provided to SMEs by commercial banks and finance companies is guaranteed according to the Kafalah program procedures. By the end of December 2020, the number of financing contracts granted under this program reached 4,553 with a total value of about SAR 4.09 billion; whereas 1,813 financing contracts were for micro-enterprises, 2,006 for small enterprises, and 734 for medium enterprises with a value of SAR 578 million, SAR 1,772 million, and SAR 1,742 million, respectively.
13/05/2020	Saudi Central Bank announces the extension of the Fee Support Program for POS and e-commerce transactions for all stores and private sector establishments for an additional three months ending on September 14, 2020.

31/05/2020	In efforts to further support SMEs, Saudi Central Bank issues a circular to banks that includes the early adoption of Basel III reforms “specific to credit risk - Corporate SMEs”; reducing the risk weight for unrated Corporate SMEs from 100 percent to 85 percent, and retail SMEs at 75 percent.
30/06/2020	- Saudi Central Bank decides to inject SAR 50 billion to enhance liquidity in the banking sector and enable it to continue its role in providing credit facilities to all its private clients, including the role of banks in supporting and financing the private sector by modifying or restructuring their finances without any additional fees, and supporting plans to maintain employment levels in the private sector, as well as exempting a number of electronic banking fees. - Saudi Central Bank launches complementary OMO to its current offering of SAMA Bills to enhance short-term liquidity management in the local banking system and also to address potential short-term liquidity needs in the local banking system due to COVID 19 ramifications.
01/09/2020	Saudi Central Bank extends the Deferred Payments Program for 3 months until December 14, 2020. The extension reflects Saudi Central Bank's keenness to enable the financial sector to support the private sector's business continuity which, in turn, supports national economic growth and employment.
29/11/2020	Saudi Central Bank extends the Deferred Payments Program for 3.5 months until the end of the first quarter of 2021. This extension continues to enable the financial sector to play its role in supporting MSMEs sector, and to contribute to supporting economic growth and maintaining employment in the private sector.
07/03/2021	- Saudi Central Bank extends Deferred Payments Program for 3 months until the end of Q2 2021. - Saudi Central Bank extends the Guaranteed Facility Program for an additional year until March 14, 2022.
Ongoing	As part of Saudi Central Bank continuous monitoring of the impact of COVID-19 on banks, Saudi Central Bank conducted an impact analysis on exposure classes, ECL and ultimate impact on KPI, KRIs and regulatory ratios of banks. In addition to stress testing scenarios (mild, moderate and severe) resulting from a combination of COVID 19 along with low oil prices. A regular assessment of economic and macro-financial developments is conducted to envisage the need for further actions to be taken and plan for a gradual unwinding of the support measures.