Saudi Arabian Monetary Agency

Kingdom of Saudi Arabia

Financial Stability Report

2015

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Executive Summary

Realizing the ever-rising significance of the financial stability especially in the post-crisis period, SAMA is publishing the Financial Stability Report (FSR) that evaluates external trends and domestic developments, and reviews financial soundness indicators of banks and non-banks financial institution with a view to promote stability of the Saudi financial market. SAMA defines financial stability as a state in which there are no, and there is confidence that there will be no, substantial discontinuities or disruptions in the functioning of the financial system which must have the ability to withstand shocks, process financial transactions and carry out its role of financial intermediation among all market participants smoothly. The FSR identifies and assesses burgeoning risks and threats, both domestic and global, in the Saudi financial system.

The global economy continued to grow but at a slower-than-expected pace in 2014. The weakness in recovery could be attributable to factors such as first-quarter weak economic activity on account of unusual cold weather in the US, weaker-than-expected growth potentially due to tight monetary conditions in some emerging markets including China, and second-quarter stagnation of growth due to weak investment and exports in the euro area, larger-than-expected decline in domestic demand caused by the increase in the consumption tax in Japan. However, growth in most GCC countries remained on track on account of strong public capital spending and accelerating credit growth that continued to support domestic non-oil economic activities.

Global financial conditions remained supportive of the ongoing economic recovery but with challenges in certain regions. They largely remained accommodative in the aftermath of the 2007-09 global financial crisis, and the euro debt crisis. In the US, growth has started to pick up. The euro area has also showed signs of economic recovery but is still facing major challenges that could threaten the sustainability of its growth prospect, including the risks from deflation and high debt levels. In Japan, the impact of the rise in consumption tax faded away and growth rates are starting to recover along with inflation. As for emerging economies, the impact of the recent drop in oil and commodity prices is not symmetric. Oil and commodity exporting economies are faced with higher risks and potential economic contractions. On the other hand, oil importers are likely to benefit as a result of the increased competitiveness arising from lower price levels and the appreciation of the US dollar. The growth in GCC countries' economies stayed on track in 2014 but may slow down in 2015 as a result of the recent oil market developments and reduction in government revenues. However, their financial markets are likely to stay immune to the global financial market developments such as the expected increase in the US policy rates and heightened volatility in FX markets.

Financial market conditions appear to have remained supportive of economic growth. Capital market indices around the world have reached record high levels with very low volatility. Additionally, governments in advanced economies continued to have access to the debt market with unprecedentedly low yield levels. FX rates reflected the underlying economic growth prospects with the US dollar appreciating against most major currencies. Finally, Investors confidence in advanced capital markets registered high levels.

While the global economy has grown at a moderate pace, it is subject to several key downside risks. First, many EMEs are particularly exposed to the eventual normalization of the policy rate in the US on account of strong financial linkages with the advanced countries. This may hamper growth especially in EMEs with weak economic fundamentals. Second, inflation levels are stubbornly low relative to target levels in many advanced economies. The risk of protracted low inflation or deflation compounds the prospect of ongoing recovery in many advanced economies, especially in Europe. Third, the scale of geopolitical tensions has risen in recent times, which may stress many markets including the oil market. Fourth, the record high global equity prices accompanied by very low volatility and modest economic growth may encourage excessive risk taking and raise concerns about potential formation of capital market bubbles.

In any case, the global economic recovery is projected to strengthen in both advanced and emerging economies in 2015, but under certain conditions. The projection for advanced economies is made primarily on the condition that both the gradual fiscal consolidation and considerable monetary accommodation remain in place to support recovery in advanced economies. The US Federal Reserve has already indicated its intention to maintain the policy interest rate at its current level for a considerable time even after the close of its quantitative easing program and achievement of mandate-consistent levels of employment and inflation. The ECB has also reinforced the need to have more monetary accommodation until the scale of unutilized capacity decreases significantly in the euro area. A case in point is the ECB's recent round of policy rate cuts on two occasions in 2014 and the launching of its quantitative easing program at the beginning of 2015.The projection for emerging markets is made broadly on the ground that structural bottlenecks to growth in many EMEs are eased or removed and that easy financial conditions in advanced economies are translated into higher external demand for EM products. GCC countries are expected to experience slower growth rates but their financial systems are expected to remain resilient to macroeconomic shocks in the short to medium terms.

Overall, the Saudi economy has continued to perform well despite the recent deterioration in oil prices. All key real and financial macroeconomic indicators showed sustained improvement. Persistent current account surpluses resulted in the strong build-up of foreign reserves, sizable budget surpluses for several years (with the exception of a marginal deficit in 2014), and significant reduction in the public debt. While the real GDP remained on a stable growth trajectory on account of accelerating non-oil activities, CPI inflation remained subdued especially due to the downward pressure on food price inflation in line with falling international food prices. Monetary policy settings also remained supportive of investment and growth. Policy rates remained low and the exchange rate peg to the US dollar continued to perform well as it continues to be supportive to monetary policy, trade, investment and financial assets.

The Saudi financial system has gone through significant regulatory developments and continued to strengthen in recent years. The banking sector, which is the largest segment of the Saudi financial system, remained highly capitalized, profitable, and liquid. While the risk profile of the Saudi banking system pointed to the dominance of the credit risk, banks' assets quality continued to show sustained improvement despite considerable credit expansion in recent years. The non-performing loan ratios continued to decline due to sound credit risk management and underwriting practices. Saudi banks' external exposure in terms of both external lending and borrowing also remained limited. SAMA continued to rely on a counter-cyclical provisioning policy to ensure higher resilience of the banking sector to withstand adverse developments. Saudi banks were among the first banks, at the international level to implement the Basel III capital, liquidity and leverage standards. They continued to show strong and comfortable capital and liquidity position by holding capital and liquid assets well above the regulatory requirements. Furthermore, the introduction of additional regulatory and macroprudential measures helped increase the resilience of the sector and ensure its stability. It is because of these supportive fundamentals coupled with strong government policy responses that the Saudi banking sector remained largely insulated from the global financial market volatility in recent years. The sector, however, remains connected to macroeconomic developments. So far, the recent drop in oil prices has not had an impact of the quality of the banking sector credit which is a result of the strong fiscal position, public debt sustainability, and sustained government spending. However, such macroeconomic developments call for close risk monitoring as history indicates some reactions by the financial system to oil market developments on the long run. Furthermore, credit concentration may represent a potential source of risk. Credit quality seems to vary across the sectors within the banks' credit portfolio which may amplify the chances for a build-up of systemic risk within sectors that are highly leveraged or have a high credit concentration ratio.

The insurance sector has also witnessed a substantial recovery in 2014 compared to its relatively weak performance in 2013. Profitability returned to the positive zone while capital increased resulting in an increase in the overall solvency of the sector. The sector, however, is still going through additional restructuring and regulatory developments that should ensure the sustainability of this recovery.

Indicators for the other financial sectors also reflected soundness and stability. The non-bank credit institution sector showed enhanced credit activity to cater to the needs of various important sectors of the economy. While the state owned Specialized Credit Institutions (SCIs) expanded their credit activities, their loans - unlike private credit institutions-are funded through capital allocation from the government rather than leveraging which contributes to minimizing systemic risk. Furthermore, SAMA took a major initiative to license and restructure non-bank finance companies in order to promote mortgage and lease finances. Rules and regulations were also issued to maintain the soundness and stability of these finance companies and minimize the size of shadow banking in the financial system. As for the capital market, regulators continued to take initiatives to introduce new investment instruments, to promote capital formation, and to diversify the investor base. The market has been gradually opened to foreign investments to ensure smooth and safe transition. Market infrastructure has also been improved. Initiatives were taken to strengthen the scope of existing payment and settlement systems to facilitate economic developments and promote financial stability.

Along with geopolitical risks, the Saudi macroeconomic outlook is subject to a key external risk of a downward pressure on global oil prices resulting from a supply-demand gap, the prospect of an economic slowdown in major EMEs, and the appreciation of the US dollar. It is important to note that EMEs account for a significant portion of the global oil demand. Thus a significant and protracted slowdown in major EMEs such as China could put downward pressure on global oil prices and hence jeopardize growth prospects of Saudi Arabia.

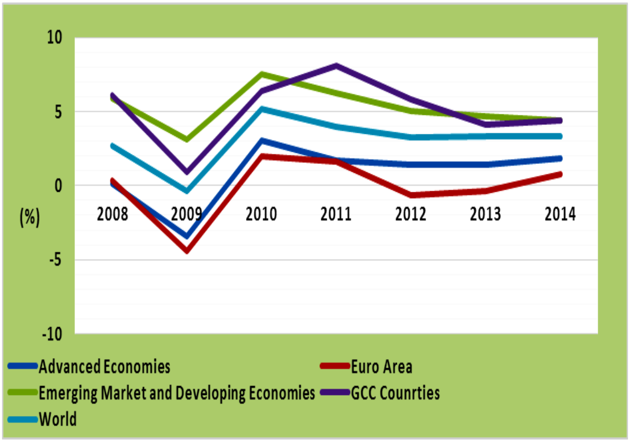
However, the Saudi economy is in a strong position to withstand the impact of such an adverse external development. The potential first line of defence is the strong capital and liquidity position of the Saudi financial system that would largely neutralize the impact of this unfavourable development. The second is the ability of authorities to back up domestic counter-cyclical growth initiatives by virtue of strong fiscal position and large holdings of foreign assets, and thereby mitigate potential negative consequences. In short, although growth may slow down, the Saudi financial system is expected to remain strong enough to provide the support required to dissipate the unfavourable impact of adverse future developments and to ensure financial stability

1. Global Economy: Trends, Risks and Growth Outlook

1.1 Recent Trends

Global economic activity continued to expand in 2014 despite weaker-than-expected growth in the first half of the year. This primarily resulted from renewed growth in some key advanced economies, aided by moderation in fiscal consolidation and private deleveraging, which have been two key factors constraining global growth in recent years **(Chart1.1**).

Chart 1.1: World and Regional Real GDP Growth Trends



Source: IMF.

Global financial conditions have continued to support growth as monetary policy remained stimulative in many advanced economies. In turn, this has helped improve consumer and business confidence, which is necessary to accelerate domestic economic activity. Yields on long-term government bonds have remained low by historical standards, and this has helped many equity market indices approach their all-time highs. Credit conditions, particularly those in the US, have remained accommodative, as firms have been greatly motivated to initiate strong debt issuance by low corporate spreads. The Federal Reserve's large holdings of longer-term securities have continued to exert downward pressure on longer-term interest rates, thereby supporting mortgage markets and enabling more accommodative financial conditions. The European Central Bank has also ensured the provision of additional monetary accommodation to the euro area markets in view of weak in the euro area growth prospects. It not only lowered its policy rates twice since June 2014 but also announced a major quantitative easing (QE) program in January 2015, which involves buying around €60 billion of assets per month, with about two-thirds of that amount likely to go for government bonds. Thus, despite the end of QE in the US, the worldwide purchase of government bonds by major central banks is almost as large as the issuance of these bonds – thus ensuring the full monetization of fiscal deficits of respective governments. The ECB has also started to purchase non-financial private sector assets to provide additional liquidity to the Eurozone economies, in order to facilitate credit flows at more affordable costs. Indeed, it appears that the advanced Eurozone economies are providing the continued monetary stimulus needed to bring their economies close to sustainable growth levels, while ensuring that inflation rates hit their annual targets.

In the US, economic activity continued to expand at a moderate pace at the end of 2014, **with real GDP growing at a subdued 2.4 percent.** Real consumer spending made its strongest contribution to growth in several years, but business and residential investment (housing) remained soft and federal spending was also weak. Consumption was well-supported by a steady pickup in job creation, as well as an increase in equity and home prices. The job market was particularly strong, with employment Charts better than expected. 2.95 million jobs were created by the end of 2014, according the US labor department published Charts. As a result, the unemployment rate declined to 6.2 percent by December 2014.

The euro area began to show signs of economic recovery starting from the third quarter of 2013 as domestic demand turned positive for the first time

after being in recessionary cycle for a number of years in the aftermath of euro debt crisis. This growth continued throughout 2014, albeit at a rather slow pace, varying between 0.1 and 0.3 percent at quarterly rates (corresponding to compound annual rates of 0.4-1.2 percent, respectively). Consequently, after contracting by 0.5 percent in 2013, the euro area economies grew by 0.9 percent in real terms in 2014. Because of this slow growth, the European Central bank announced a quantitative easing (QE) program in January 2015. This involved buying around €60 billion of financial instruments per month, with about €40 billion of this being government bonds. This easing is likely to keep euro area interest rates depressed well below rates in the US, where quantitative easing has largely ceased.

The Japanese economy started out the year 2014 with a solid growth of 1.6 percent growth (quarter-to-quarter at an annual rate) before it reverts back to a mild contraction. Most of year-start strength was due to a surge of consumer spending in the first quarter, in anticipation of a large sales tax hike in April 2014. The subsequent decline in consumer spending after the sales tax took effect plunged the Japanese economy into yet another recession. However, this downturn only lasted two quarters and the economy began to grow again in the fourth quarter. Unfortunately, this mid-year weakness caused the Japanese economy to show a slight decline of 0.1 percent for 2014 as a whole.

Emerging market and developing economies (EMEs)[1] continued to show sustained economic growth recording 4.6 percent in 2014. A major part of this growth was due to strong external demand, as domestic demand in many of these countries remained weaker than expected. Reasons for this weakness included tighter financial conditions, policy and/or political uncertainty, and structural bottlenecks. China continued to grow at a somewhat slower but sustained pace, despite gradual rebalancing toward consumption and away from investment and exports. It witnessed a growth of 7.4 percent year-over-year in the last quarter of 2014. India is growing at almost the same pace as China recording a 7.2 percent growth rates in 2014. This better growth was due primarily to increases in manufacturing output and higher export growth. Brazil, however, is still struggling with stagnation as GDP has barely grown at 0.1 percent.

Overall, GDP growth remained on track in most GCC countries with GDP growth averaging around 3.6 percent in 2014 despite the plunge in oil prices during the second half of the year. Such growth is largely due to strong public capital spending and accelerating credit growth. Indeed, private credit continued to expand and played a key role in supporting the non-oil economic activity in GCC countries. Inflation also remained moderate, due to declines in international prices of wheat and other food items, which offset upward pressure on housing costs. Import price inflation remained moderate due to better harvests in 2013, as well as slower growth in the trading-partner countries, most of which are advanced economies. In view of the rising public expenditures on health, education and infrastructure, most GCC countries appear well positioned to conduct countercyclical policy by virtue of having strong external financial balances and fiscal buffers to counterbalance a temporary and/or mild fall in oil revenues. In the long run, however, a prolonged low oil prices may create some vulnerabilities as reserves drain out and sensitivity to debt markets increases.

1.2. Global Financial Developments and Financial Stability Risks

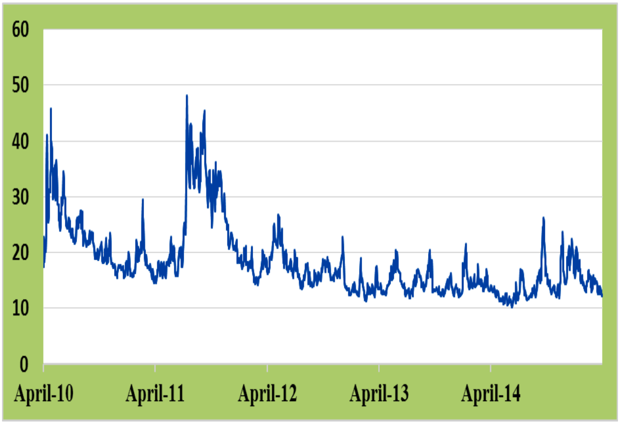
Recent developments in global financial markets constitute a range of both positive and negative macroeconomic and financial developments. On the positive side, global growth is picking up aided by lower oil and commodity prices and accommodative monetary policies. On the other side, deflation risks, increased liquidity risks, and divergence in monetary policies may pose some financial stability challenges.

[1]Based on the IMF definition.

High confidence, low volatility, and increasing equity prices may indicate signs of markets recovery, but may also indicate excessive risk taking and risk underpricing. Markets may be exposed to risk of sudden shifts in investors' behavior which can undermine global financial stability. Market confidence registered high levels in 2014 as reflected by low equity market volatility and Credit Default Swap (CDS) spreads. Equity markets continued their upward trends with some advanced markets reaching an all-time high price levels. Emerging market equity prices have also increased, overall, despite some fluctuations throughout the year due to slower growth prospects in major emerging economies such as China **(Chart 1.2 and 1.3**).

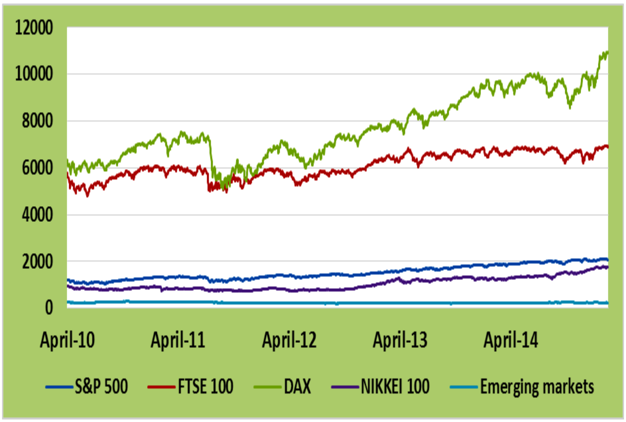
Fiscal authorities in advanced economies continue to have access to credit markets at low cost as the government bond yields continued on the downward trend in 2014. Sovereign bond yields are at historically low levels in advanced countries and relatively stable in emerging countries **(Chart 1.4** and **Chart 1.5**), despite some fluctuations in slowing economies like Brazil. However, public debt, although stabilizing, is still at high levels in Europe and advanced economies, which re-emphasizes the need for fiscal consolidation in many advanced economies especially in Europe with slow growth projections and deflation risk **(Chart 1.6**).

Chart 1.2: VIX index – the Chicago Board Options Exchange (CBOE) volatility index



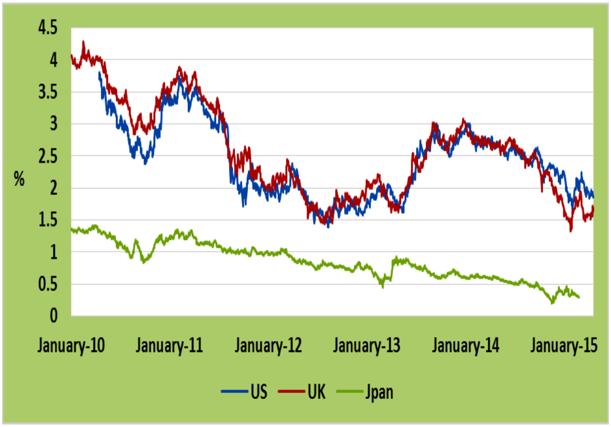
Source: Thomson Reuter

Chart 1.3: Global equity Indices



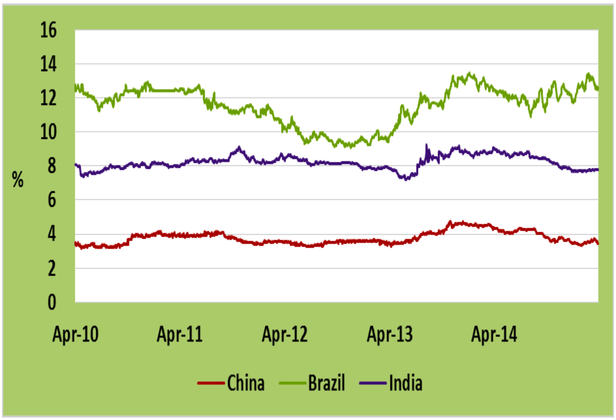
Source: Thomson Reuter

Chart 1.4: Bond Yields in Advanced Economies



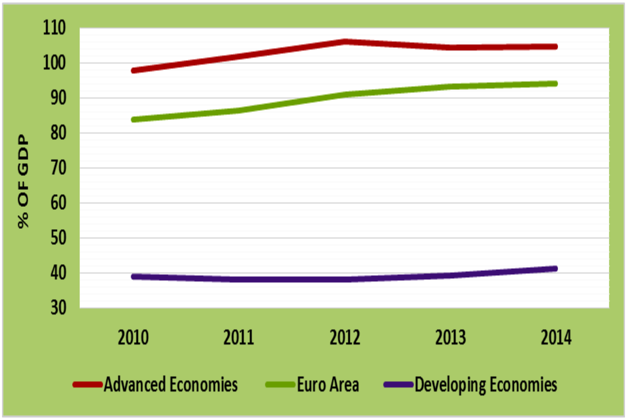
Source: Thomson Reuter

Chart 1.5: Bond Yields in Emerging Markets



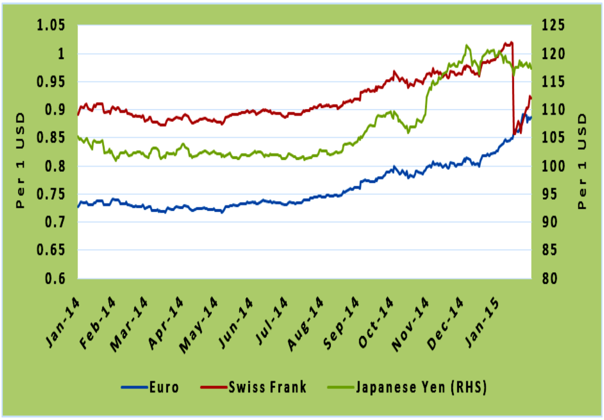
Source: Thomson Reuter

Chart 1.6: Public Debt



Source: IMF

Chart 1.7: USD FX Rate against major currencies



Source: Thomson Reuter

Unlike equity markets, FX markets witnessed higher volatility levels due to divergence in growth prospects and monetary policies. The USD has rallied during the second half of 2014 against most major currencies including the Euro and Japanese Yen. Later on, in January 2015, the Swiss National Bank (SNB) surprised the markets by lifting the cap on its CHF1.2 per Euro level. Although, such developments introduced additional uncertainty to the FX markets, their implications on advanced economies appeared to be limited. The dollar appreciation is seen to enhance competitiveness of the Euro area and help adding some inflationary pressures. Furthermore, the Euro-CHF rate has stabilized at a new equilibrium level. For emerging economies, however, this may constitute a considerable amount of risk. The amount of US dollar denominated debt issuance is large in emerging markets. This may result in a substantial increase in the debt burdens in these economies, thereby increasing the chances for defaults and financial stress **(Chart1.7)**.

Commodity prices have suffered the most in 2014 but their global net impact is likely to be positive. Crude oil lost around 40 percent of its average value by the end of the year. Other commodity prices have also dropped but by less than the drop in crude oil. The impact of the drop in commodity prices varies among countries as it negatively impacts commodity exporting countries while positively impacting commodity importers. The overall impact, however, is seen to be a net positive leading to a boost in global growth. However, the disinflationary pressure resulting from lower commodity prices remain a concern for some advanced economies **(Chart1.8**).

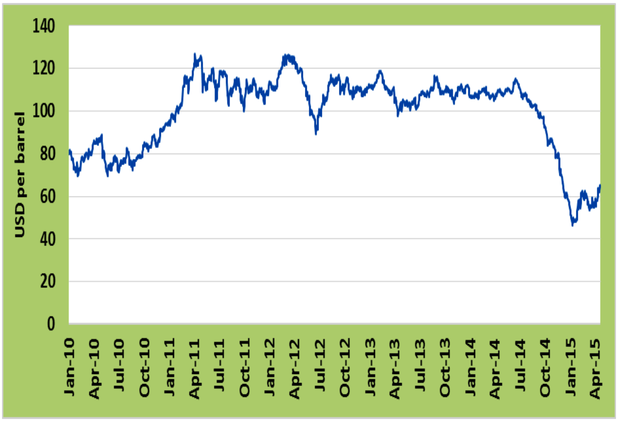
1.3 Global Growth Outlook

Economic outlook remains promising but is contingent on two key drivers of growth in advanced economies. The first requirement is the continuation of a high degree of monetary accommodation and moderation in fiscal consolidation. The second requirement is that the adverse impact of the normalization of U.S monetary policy proves short-lived and limited, particularly for EMEs. According to IMF estimates, global growth remained at 3.4 percent in 2014 and is expected to pick up to 3.5 percent in 2015. Growth in the advanced economies amounted to 1.8 percent in 2014 and projected to be 2.4 percent in 2015. Most of the contribution is likely to come from the US, which is projected to show higher growth of 3.1 percent in 2015, versus 2.4 percent last year. Growth in the euro area is expected to be 1.5 percent for 2015, with core countries performing strongly and countries with high debt (both private and public) and financial fragmentation performing weakly. Japan's economy is expected to recover moderately (due to fiscal consolidation) with its growth close to 1.0 percent during 2015, versus the 0.1 percent decline last year. Growth in emerging market and developing economies slowed to 4.6 percent in 2014 from 5.0 percent in 2013 and then is forecast to pick up to 5.0 percent in 2016.While growth is expected to get impetus from stronger exports to advanced economies, it is likely to be constrained by slow domestic demand growth due to tighter financial conditions. EMEs with strong fundamentals will need to continue to undertake structural reforms intended to close infrastructure gaps and raise productivity in order to strengthen the prospect of high and sustainable growth. China is expected to continue to contribute immensely. GCC countries are likely to sustain reasonable growth profile in 2015 on the back of expected improvements in oil production and exports in the wake of global economic expansion. In summary, growth in both advanced economies and emerging markets is forecasted to pick up in 2015, despite the weaker-than-expected growth realized in 2014.

Global oil market activity is also expected to gradually pick up in line with the projected global growth, which is projected to be around 3.5 percent in 2015. The International Energy Agency (IEA) has projected the global oil demand to continue to show year -over-year gains for each quarter throughout 2015, with world oil demand expected to rise to a total of 93.5 million barrels/day (mbd), a 1.0 percent increase from 2014. This is an improvement from the relatively low 0.7 percent growth in 2014, although not as high as the rise of 1.4 percent in 2013. Last year (2014) was an historic year for the worldwide oil industry. For the first time, non-OECD countries accounted for the majority of the world's oil demand. They consumed 50.6 percent of the 2014 total, and the IEA expects their share to rise further, to 51.2 percent in 2015. The major reason for this reversal is the absolute decline in OECD oil demand, from a peak of 50.4 mbd in 2005 down to an expected level of 45.6 mbd in 2015, a drop of 4.8 mbd, or 9 percent over the 10 year period.

In 2015, oil prices are expected to stabilize at higher levels as a result for the expect increase in demand. By the end of June 2014, the Brent oil price reached its peak at $112.36. Since then, it has declined substantially, reaching a low of $46.59 by mid-January of 2015, a drop of 59 percent. Since then, prices have recovered, exceeding $62 by mid-April 2015 (**Chart 1.8**).Oil prices are likely to continue to recover gradually as oil demand-supply imbalances dissipate due to continued strong global oil demand in the emerging and developing countries. The current lower oil prices are also acting to curtail non-OPEC oil production and exploration and development activities. In addition, continued geopolitical tensions may result in disruptions in oil production and supplies, helping to keep oil prices higher than otherwise.

Chart 1.8: Crude Oil - Brent prices



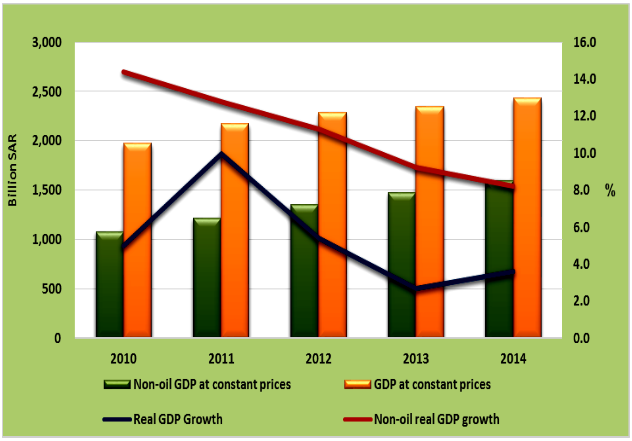
Source: Thomson Reuter

2. The Saudi Economy: Trends, Risks and Growth Outlook

2.1 Growth and Inflation Trends

The Saudi economy has enjoyed an unprecedented period of prosperity since the turn of the century fifteen years ago. Macroeconomic policies have been business-friendly, and supportive of private investment and job creation. The government has consistently implemented initiatives to achieve economic diversification and growth of the non-oil private sector. However, this effort has required considerable expenditures to improve education and skills of human resources, develop industrial clusters, upgrade transportation infrastructures and support housing projects. The Saudi economy has continued to take advantage of these state initiatives which have been complemented by robust non-oil private sector activity. As a result, real GDP growth has remained strong, averaging 5.2 percent growth over the past five years. (Chart 2.1). However, overall growth slowed down to 2.7 percent in 2013 and 3.6 percent last year, largely due to a reduction in oil production. The non-oil sector continued to show sustained dynamism, with an average growth of 6.8 percent over the last five years. Growth in this all-important sector stayed strong over the past two years growing by 6.4 and 5.1 percent in 2013 and 2014 respectively.

Chart 2.1: Pattern of Real GDP Growth



Source: Source: (CDSI)

Price pressures have remained subdued in Saudi Arabia over the past five years, as CPI inflation averaged 3.3 percent (Chart 2.2). Inflation fell to 2.7 percent in 2014 from 3.5 percent the year before. The reduction in inflation was widespread, with two of the categories (transportation and communications) actually declining for the year.

Chart 2.2: Inflation Trends

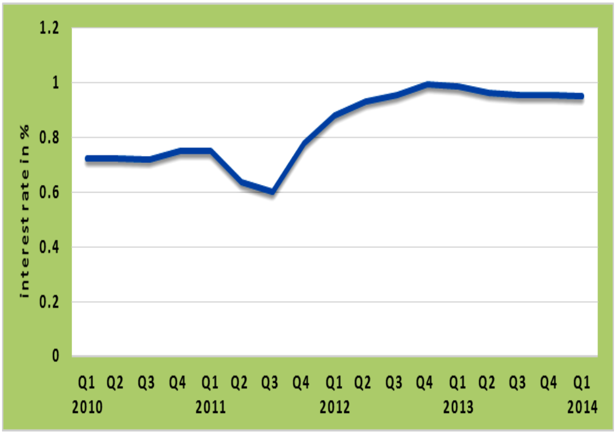
Source: CDS

2.2 Monetary Developments

Financial conditions in Saudi Arabia have remained stable and supportive of economic growth in recent years. While the monetary base expanded by 8.4 percent annually during 2010-14, M3, which comprises currency in circulation and aggregate bank deposits, grew at 10.7 percent annually during the same period. These conditions resulted primarily from rising current account surpluses (despite a decline in last year's surplus), a rapid growth of public spending, and low market interest rates that were set in line with

SAMA's accommodative policy stance. SAMA reduced its repo and reverse repo rates to 2.0 percent and 0.25 percent respectively, back in early 2009 and these rates have remained unchanged. Therefore, the average yield on the 16-week SAMA bills stood well down to 71 basis points in 2013. The average Saudi riyal money market rates also remained low. For instance, the 3-month SIBOR rate remained below 1.0 percent over the past five years, indicating the low level and stability of market interest rates (**Chart 2.3**). The persistence of low

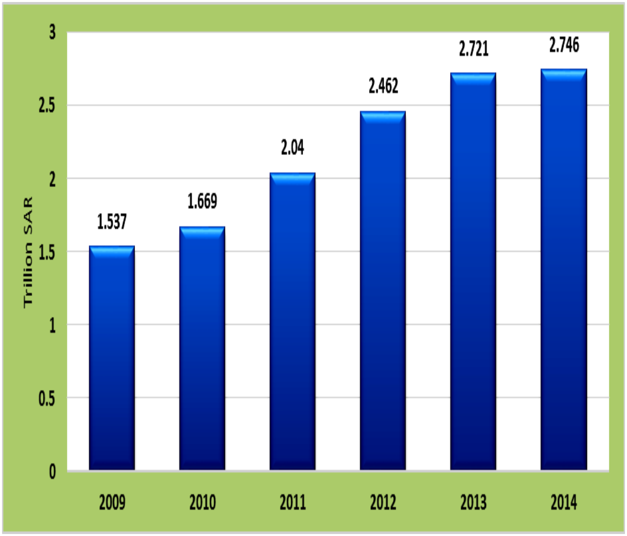
Chart 2.3: Pattern of 3-Month SIBOR Rate



market interest rates spurred the private sector activity as bank credit to private sector showed, on average, a high growth of 11.0 percent during 2009-13. More recently, it grew year-on-year by 12.9 percent in September 2014.

SAMA has continued to promote exchange rate stability and economic activity through effective use of liquidity management tools. The Saudi riyal peg to the US dollar that was adopted in the early 1980s has continued to serve as an effective platform, enabling authorities to minimize the risk of currency speculations and contain exchange rate volatility. This is demonstrated by the fact that SAMA intervened in the foreign exchange market only on three occasions since the adoption of the fixed rate regime about three decades ago. The exchange rate peg has worked well for the Kingdom, as the riyal-dollar parity has largely remained stable, hence boosting policy credibility and stabilizing monetary aggregates and financial flows. The recent buildup of SAMA's foreign reserves to the extent of SAR 2.8 trillion as of December 2014 is yet another positive development set to contribute to the stability of exchange rates (**Chart 2.4**).

Chart 2.4: SAMA's Reserve Assets

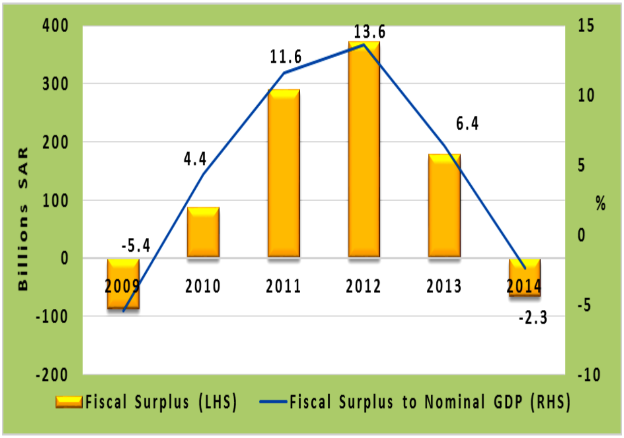


The Saudi financial sector has proved to be resilient against global interest rate volatility in recent times. This is due primarily to three factors. First, banks' foreign exposures, in the form of liabilities to foreign banks, are still moderate despite climbing above the pre-global-crisis peak. In 2014, banks' foreign liabilities accounted for 3.9 percent of total liabilities. Second, foreign participation in the Saudi capital market is very limited (equivalent to 4.6 percent of market capitalization in 2014), as foreign investment is allowed, thus far, only through equity swap arrangements and participation in mutual funds or exchange traded funds. Third, the presence of foreign banks operating in Saudi Arabia is minor, as their assets currently account for around 11.0 percent of total banking assets. These factors together have contributed to a stable and well-developed and regulated financial system. As proof of this stability, the Saudi financial system did not experience any visible upward pressure on domestic interest rates, or witness capital outflows in the aftermath of the Fed's announcement to start tapering late last year. In brief, banks operating in Saudi Arabia have been resilient to external shocks in recent years due to their sound liquidity and capital positions, as well as mitigating the impact of financial disturbances through timely implementation of various macro-prudential regulations.

2.3 Fiscal Developments

The Saudi government has benefitted from substantial oil exports in recent years. The scale of oil export receipts remained large enough in most years to enable the government to achieve budget surpluses despite the substantial growth of yearly expenditures (**Chart 2.5**). However, the budget surplus disappeared in 2014, to be replaced by a slight deficit amounting to 3.1 percent of GDP. The deficit was due to a 9.7 percent

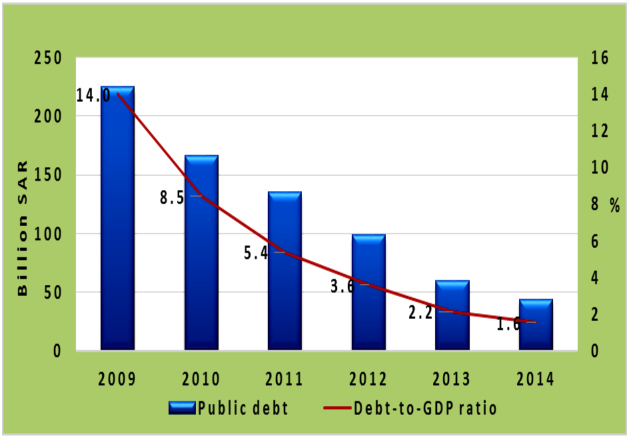
Chart 2.5: Trend of Fiscal Balance



reduction in oil revenues combined with a 13.8 percent increase in total expenditures. Oil revenues continued to dominate non-oil revenues as they accounted for 87.5 percent of the total revenues in 2014. Capital spending continued to grow strongly and constituted 34.7 percent of the total expenditure incurred in 2014.

Overall, public finances continued to improve over the past 13 years in line with the budget surpluses but moderately deteriorated in 2014. Accumulated budget surpluses enabled the government to reduce its debt by 93.5 percent since 2002, from that year's Chart of SAR 685 billion, down to SAR 44 billion in 2014. As a consequence, the debt-to-GDP ratio came down to a highly sustainable, record low level of 1.6 percent in 2014 from 96.4 percent in 2003 (**Chart 2.6**).

Chart 2.6: Pattern of Public Debt



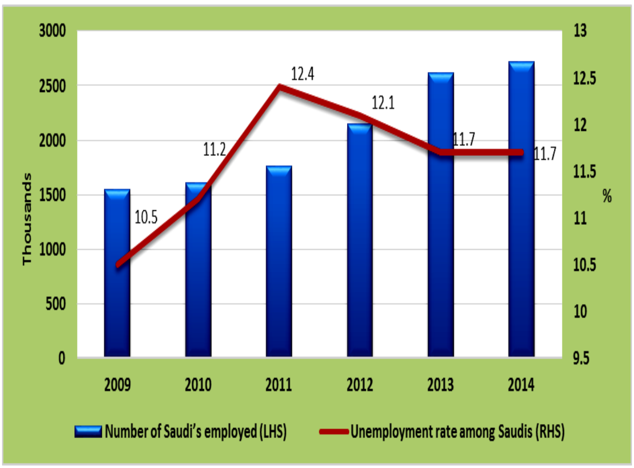
The sustained improvement in public finances went well for the country as international credit rating agencies have broadly maintained the same level of sovereign rating of Saudi Arabia in recent times. The outlook, however, mildly deteriorated as a result of the recent drop in oil prices. In 2013, S&P upgraded Saudi Arabia's long-term sovereign rating from A+ with stable outlook to AA- with positive outlook and kept it at this level but with a stable outlook in 2014. In 2015, the rating remained unchanged but the outlook was reviewed downward to "negative". Similarly, Fitch also announced an upgrade of Saudi Arabia sovereign rating from AA- to AA with a *stable* outlook in both of the years 2013 and 2014. This rating upgrade was the result of a combination of key economic positives such as low public debt, significant holdings of foreign reserves, and stable growth rates.

2.4. Labor Market Performance and Reforms

The unemployment rate among Saudi national remained constant at 11.7 percent despite the creation of around 237, 829new jobs in 2014. This is mainly due to the expansion in the labor force of Saudi nationals relative to the increase in job opportunities. (**Chart 2.7**). Nevertheless, the Saudi authorities continued to make efforts to enhance the participation rate of Saudi nationals in the private sector, which stood at an exceptionally low level of 15.1 percent of total workforce employed in the private sector in 2013. As a result of such effort, the number of Saudis employed in the private sector increased by 5.7 percent. The labor market authorities recently reinforced the Saudization program, and embarked on significant structural reforms to increase the employment levels of both Saudi females and males in the private sector. The reforms included the governmental campaign towards reorganizing the labor market, correcting the status of foreign workers, forcing private firms to employ Saudi nationals based on a specified formula, and the introduction of a minimum wage for Saudi nationals. These reforms are expected to create more jobs for national workers and thus reduce unemployment in the medium-to-long term.

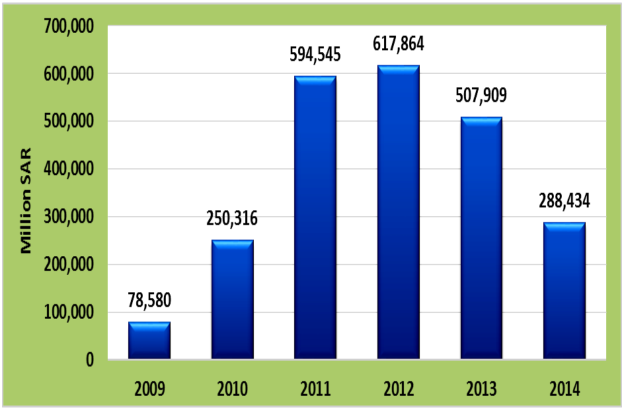
2.5. External Performance

Chart 2.7: Employment Trend of Saudi Nationals



The overall balance of payments position strengthened considerably in recent years despite the contraction current account surplus 2014. The current account surplus, largely driven by high oil prices and level of production, rose by about seven times in the space of three years to SAR 617.9 billion in 2012 from only SAR 78.6 billion in 2009. However, current account surplus shrank by 18.5 percent in 2013 and another 30.1 percent in 2014 to settle at SAR 288 billion, which is equivalent to 12.5 percent of GDP compared to a surplus of 22.4 percent in 2012 (**Chart 2.8**). The recent fall in current account surplus could be largely . attributable to three key factors including the reduction in average oil price, decelerating non-oil export growth and a continued increase in foreign remittance outflows

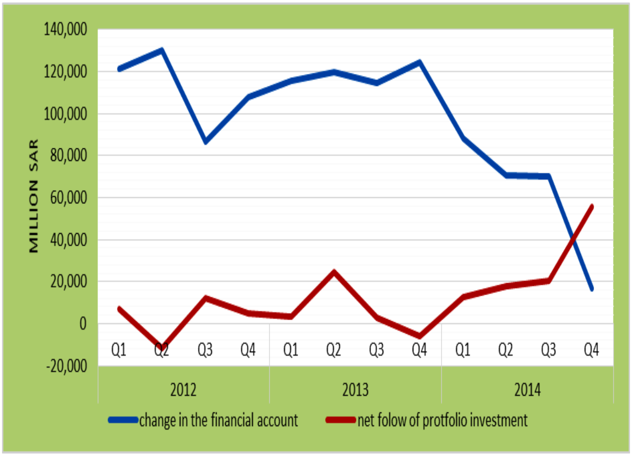
Chart 2.8: Pattern of Current Account Surplus



2.6. Pattern of Capital Flows

Net capital flows in Saudi Arabia remained relatively stable through 2013 despite heightened capital flow volatility caused by recent global developments (e.g., geopolitical tensions). Net capital flow, reflected by the country's financial account, increased during the third and fourth quarters of 2013, but considerably dipped in 2014. The movement is solely driven by the changes in the asset reserve levels as opposed to movements of capital in the financial market (hot money) which indicates less impact on the resilience of the financial market. This is evident from the fact that the net portfolio investment component of the financial account has been stable up to the end of 2013 and trending upward in 2014. (**Chart 2.9**).

Chart 2.9: Pattern of Net Capital Flows



2.7. Risks and Saudi Growth Outlook

As one of the world's largest oil exporting nations, Saudi Arabia is inherently exposed to external risks stemming from developments in the global oil markets. These risks can directly affect the growth trajectory of oil prices and oil revenues, government oil receipts and expenditures, and hence the growth path of economic activity in Saudi Arabia. In addition, both the quality and quantity of credit in the financial system tend to deteriorate with low levels of oil prices. The capital market is, also, sensitive to oil market volatility and, assuming other factors remain unchanged, normally resembles the movement in oil prices. These implications are aggravated when accompanied by a drop in government spending, which plays a significant role in economic and financial sector growth.

However, given the strong fiscal position and healthy financial system, the impact of the drop in oil prices may not materialize in the short to medium term. Government spending remained expansionary, public debt is at record low levels, and foreign reserve are at high levels which provides a buffer against macroeconomic shocks. Additionally, the quality of credit in the financial sector is high with defaults and non-performing loans at record low levels.

At the same time, the concern of a spillover impact from turbulences in global financial market to the domestic economy is limited. Saudi Arabia is relatively less susceptible to shocks emanating directly from global financial markets with adverse implications for global growth. This is because of the existence of relatively weak linkages of the Saudi financial system with those of the world economy due to such factors as limited foreign credit exposure, limited foreign portfolio inflows, and the relatively small size of foreign banks operating in Saudi Arabia.

The Saudi economy is currently confronted with the prospect of a sustained downward pressure on oil prices emanating from two different sources. First is the possibility of a prolonged period of depressed oil prices caused by the overproduction of oil by non-OPEC suppliers and/or lower oil demand as a result of slow growth rates especially in emerging markets. Second, the prospective normalization of global interest rates, might cause financial turbulence in world market and result in a protracted period of slower global growth, resulting in lower oil demand and weaker prices.

The impact of normalization of global interest rates is expected to be limited. A US normalization that manifests itself as a hike in the US policy interest rate, would tend to raise short-term interest rates in Saudi Arabia primarily owing to the exchange rate peg in place. However, a high level of liquidity in the Saudi banking system and the structure of funding channels that is skewed towards non-interest bearing deposits would moderate its transmission to bank lending rates and hence tone down its adverse impact on bank credit and real GDP growth. In addition, such normalization will most likely be gradual giving the financial sector enough time to adjust to any moderate hikes in interest rates.

However, the prospective interest rate normalization in the US may also lead to heightened global financial market volatility, and hence cause a

significant or protracted economic slowdown in emerging markets. This may have strong implications for the Saudi economy as EMEs account for a significant portion of global oil demand and a significant slowdown in major EMEs could put downward pressure on global oil prices and hence adversely impact growth prospects of Saudi Arabia. It is important to note that growth in Saudi Arabia has a lot to do with the growth performance of EMEs as there is a strong positive correlation of output cycles in Saudi Arabia with those of EMEs, particularly China. This correlation has markedly strengthened in recent years.

Concerning the second problem of excess supply of oil , it is becoming apparent that non-OPEC producers are not as responsive to low oil prices as had been thought, at least in the short-run. The main impact of the current lower prices has been to cut back on developmental drilling of new oil wells, rather than slowing the flow of oil from existing wells. Thus, the impact of lower prices today is expected to be on future oil production, rather than current production. This requires more patience on OPEC oil producers and a willingness to maintain steady production until the demand catches up with the current supply levels.

In summary, the Saudi economy is well positioned to counter the impact of these adverse occurrences. The Saudi economy has benefitted from sustained current account surpluses, sustained build-up of foreign assets, and persistent reductions in public debt in recent years. These factors have permitted authorities to continue to widen the fiscal space that could be put to work to back up domestic countercyclical growth initiatives during difficult times. Moreover, the banking system is highly liquid, well capitalized, and moderately exposed to external developments in view of limited foreign exposure in terms of both lending as well as borrowing. Therefore, Saudi authorities have the ability to largely mitigate the impact of adverse developments and promote financial stability.

As for the economic outlook of Saudi Arabia, the Saudi economy is likely to fare well in the long term, although real growth is expected to moderate in the short-run. Government spending in 2015 will continue to be strong; as of January 2015, there are 439 billion riyals (over $117 billion) in a special government account designated for capital projects such as public housing, schools, hospitals, public transportation, and other major projects. This, by itself, will continue to boost the Saudi economy and continue the strong growth in the private sector, which is projected to show a steady expansion of 6.0 percent in real terms through 2016.

3. Banking Sector: Operating Efficiency, Risks and Resilience

3.1 Overview

The Saudi banking sector, which is the largest segment of the Saudi financial system, is well capitalized, profitable and liquid. Its external exposure is also limited in terms of both external lending and borrowing. It is because of these supportive features coupled with strong government policy responses that the Saudi banking sector remained largely insulated from global financial market volatility in recent years. In the aftermath of the 2007-09 global financial crisis, credit growth in Saudi Arabia initially decelerated but picked up the pace in subsequent years without deterioration in banks' asset quality.

Macroeconomic policy framework remained supportive of economic growth in line with global trends. Moreover, high "post-crisis" oil prices and output resulted in sustained large external and fiscal surpluses and considerable buildup of international reserves. Although oil prices witnessed considerable deterioration in the second half of 2014, the fiscal policy remained supportive as government has been committed to its planned level of spending which will help sustain the resilience of the banking sector.

In recent years, while efforts are underway to deepen the Saudi financial system and promote mortgage and SME financing to diversify the economy, the macro-prudential framework has also strengthened in accordance with the Basel III regulations. These developments are set to contribute positively to economic and financial stability. They also ensure constant monitoring that helps to identifying systemic risks at early stages.

3.2 Balance Sheet Assessment - Banks Assets

The banking sector is the largest sector segment of Saudi financial system with total assets equivalent to 75.6 percent of thenational output. The number of banks operating in Saudi Arabia totalled 24 at the end of 2014 including 12 branches of foreign banks. All banks, combined, have an extensive network of 1,912 branches besides 15,516 Automated Teller Machines (ATMs).

Saudi Banks continued to achieve high asset growth rates on account on-going strong economic activities in recent years.Their asset base expanded by an annual compound growth rate of 9.3 percent to SAR 2.1 trillion during 2010-14. It was equivalent to 75.6 percent of GDP, and 133.2 percent of the non-oil GDP in 2014 (**Chart 3.1**). For the past three years, the annual growth of bank assets exceeded the growth of both the GDP and the non-oil GDP as indicated by the rising asset to the GDP ratios (**Chart 3.2**).

Chart 3.1: Growth Pattern of Bank Assets

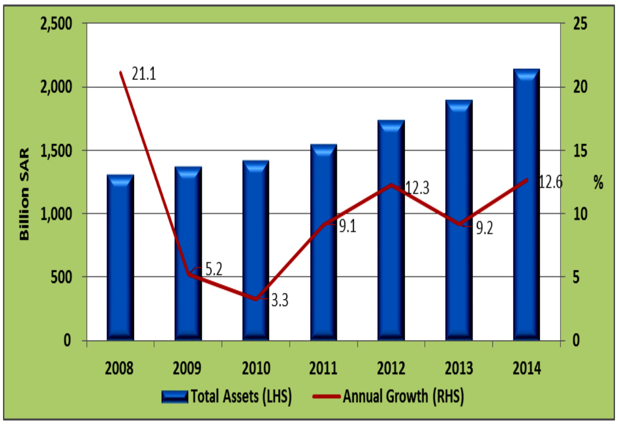
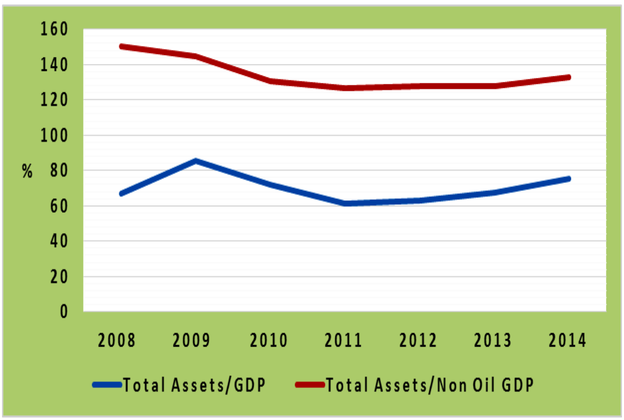


Chart 3.2: Bank Assets Relative to GDP and Non-Oil GDP



Saudi banks' business model remained focused on the domestic market and hence remained largely unexposed to international financial volatility. The domestic bank credit constituted the largest component of the banking sector assets, accounting for about 60.0 percent of the total banking sector assets in 2014. Foreign assets accounted for nearly 12.0 percent of the total banking sector assets (**Chart 3.3**). Claims on the private sector continued to serve as the main driver of bank assets growth (**Chart 3.4**).

3.2.1 Bank Credit

Bank credit continued to show steady growth, driven by robust economic activities and strong domestic demand. It rose by 56.3 percent to reach SAR 1.25 trillion in 2014 (**Chart 3.5**). Corporate lending accounted for 57.0 percent of the total bank credit in 2014, followed by consumer loans (25.8 percent), credit classified as *Other* (14.2 percent), and loans to government & Quasi government agencies (3.7 percent).

Chart 3.3: Distribution of Bank Assets (% of total assets) – 2014

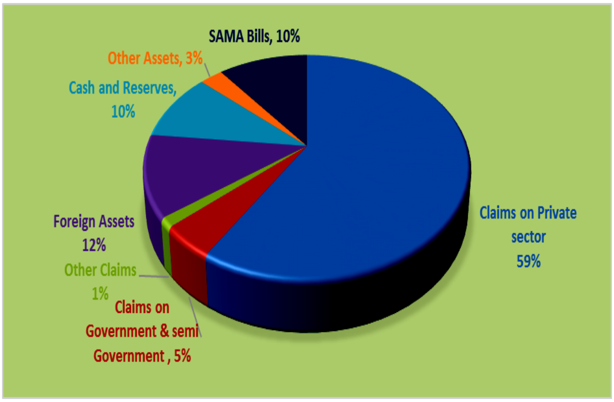


Chart 3.4: Contribution of Bank Assets Components to Total Bank Asset Growth

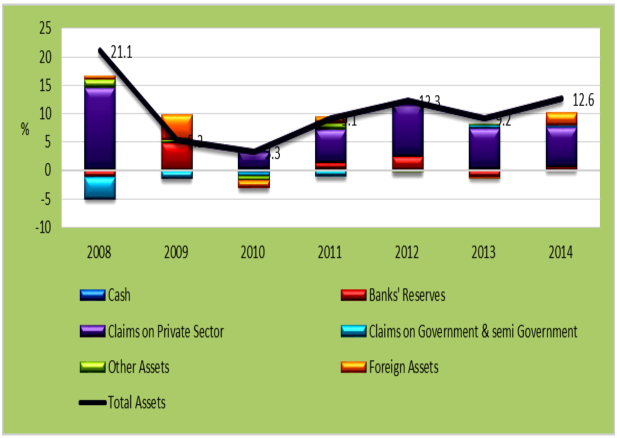
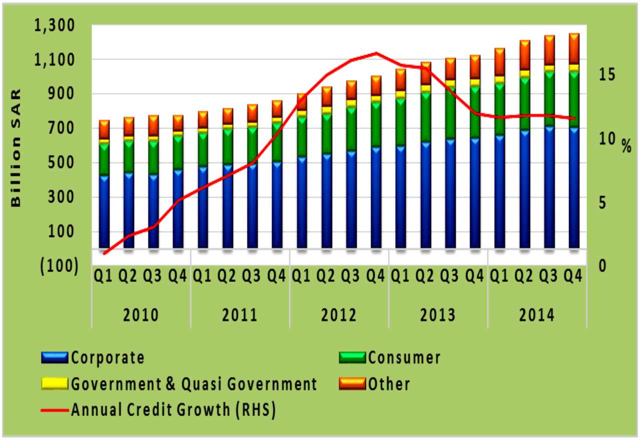


Chart 3.5: Distribution of Bank Credit



Despite the growth in credit, the credit to GDP ratio has been stable throughout the years indicating a healthy growth rate that ensures sufficient credit for economic growth yet with no excessive leveraging[2]. The ratios of bank credit to GDP and Non-Oil GDP posted annual increases of more than 10.0 percent and 3.0 percent in 2014, respectively (**Chart 3.6**). The credit to GDP curve has been flat indicating no excessive leveraging in the sector. In 2014, the ratio settled at around 45percent, lower than most G20 and other regional economies **(Chart 3.7)**.

Bank credit to the private sector constituted the bulk of the lending activity with claims on the private sector continued to serve as the main driver of asset growth in the banking sector in 2014. Bank credit to the private sector, which includes both consumers and corporates, totalled SAR 1.2 trillion in 2014 representing 96.3 percent of the total

[2]A high Credit to GDP ratio is a major early warning indicator for financial instability. Most financial crisis in advanced economies were preceded by high levels of credit to GDP ratio.

Chart 3.6: Bank Credit Relative to GDP, and Non-Oil GDP

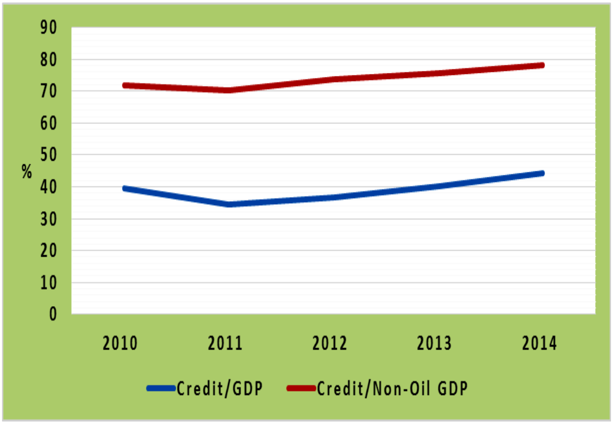
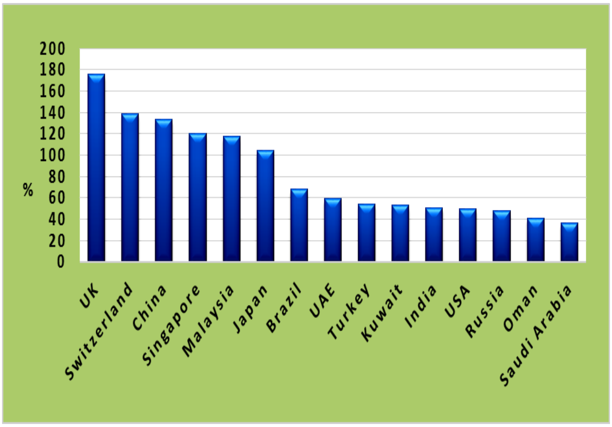


Chart 3.7: Bank Credit-to-GDP Ratios for Selected Countries



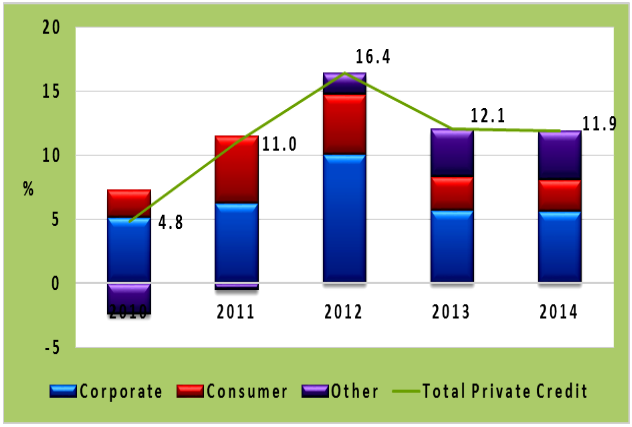
Source: World Bank

bank credit. Bank loans to the corporate sector, which have significantly contributed to private sector credit growth in recent years, constituted 71 percent of the total bank loans and 73 percent of the total private sector loans. In 2014, corporate and consumer loans increased by 13.1 percent and 8.9 percent, respectively (**Chart 3.8**).

3.2.2 Corporate Lending

Overall, Bank lending to the Saudi corporate sector showed a solid growth in recent years, largely driven by strong domestic demand created by the public spending. Total bank credit to corporates recorded a growth of 9.4 percent in 2014, mainly

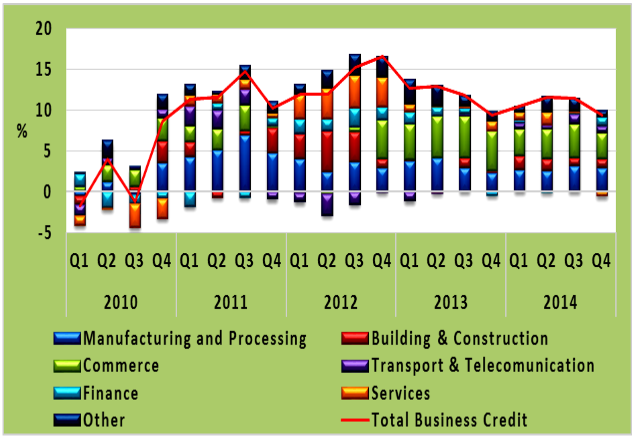
Chart 3.8: Sectoral Contribution to Growth of Bank Credit to Private Sector



attributable to strong credit demand from productive sectors such as Commerce, and Manufacturing and Processing (**Chart 3.9**).

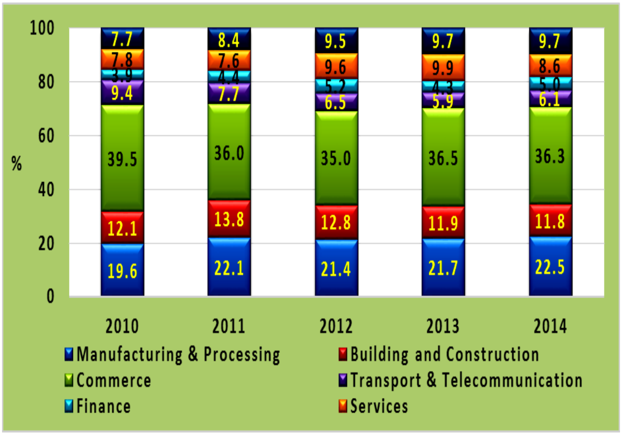
Credit to corporates appears to be more concentrated in some sectors than others. Further diversification in the banks' corporate credit portfolio may help promote sectoral development and diversify credit risk. Looking at the distribution of credit among key corporate sectors, Commerce, Manufacturing and Processing, and Building and Constructions accounted for over 70.6 percent of bank credit to all corporates in 2014. Although, this

Chart 3.9: Sector-Wise Contribution to Growth of *Corporate Loans*



was largely in line with the historical trends (**Chart 3.10**), the concentration of credit in some of these sectors is correlated with certain economic drivers such as government spending on infrastructure, which may in turn transfer vulnerabilities in these sectors to the financial system.

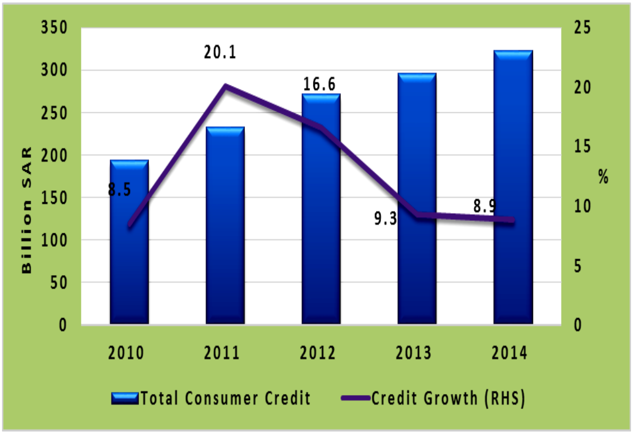
Chart 3.10: Sector-Wise Distribution of Corporate Loans



3.2.3 Consumer Lending

Since 2010, growth in bank lending to consumers outpaced growth in bank lending to corporates. Consumer loans continued to expand substantially over the years as they grew by 12.7 percent annually to stand at SAR 322.8 billion during 2010-14 **(Chart 3.11)**. They eventually constituted 25.8 percent of total bank credit in 2014.The uptrend in consumer loans reflected a number of factors including rising participation of youth population in labor force, low interest rate environment, and increasing competition among domestic banks enabling consumers to obtain better loan deals. Also, the establishment of the national credit registry (The Saudi Credit Bureau, SIMAH) has played a significant role as it allowed for better risk assessment/evaluation of individual borrowers. Lastly, technological advancement has also helped as it allowed for faster and smoother borrowing and debt servicing process through, for example, automatic salary transfers and online credit applications[3].

Chart 3.11: Growth Pattern of Consumer Loans



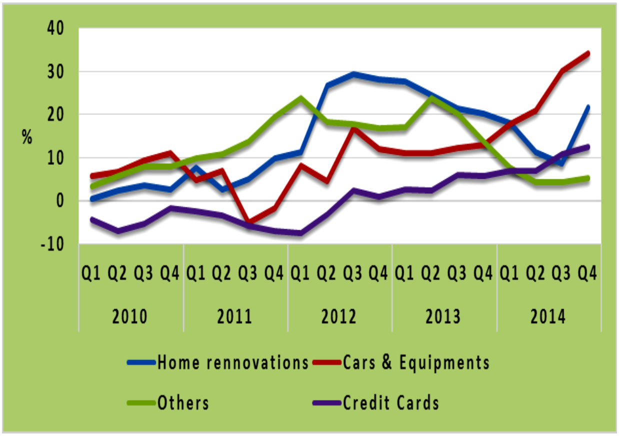
Credit quality of consumer loans remained sound despite robust credit growth over the years. It was the outcome of sound credit risk management and underwriting practices exercised to lessen the prospect of financial instability. For the instance, SAMA has prescribed a Debt Service to Income (DTI) ratio (i.e., a monthly deduction cap) of 33.0 percent of any employed borrower's monthly salary and 25.0 percent of any retired borrower's pension helps in minimize the credit risk. Moreover, all borrowers are to repay their loans within a 5 -year time limit. This policy to date has worked well in supporting the quality of consumer loans, where consumer sector continues to be associated with lower than average NPLs for the past decade. In view of high growth in consumer lending, SAMA continues to review the developments in the sector and deploy additional prudential measures if necessary in order to minimize credit risk.

A significant portion of consumer lending was dominated by consumption-oriented activities. For instance, 7.9 percent of consumer loans were spent on home renovation, improvement and furnishing, while 11.1 percent of loans were used for purchasing cars and equipment. The share of credit card loans, on the other

[3]SIMAH was established in 2002, and began operating in 2004 under the supervisory umbrella of SAMA.

hand, kept falling steadily since 2007 and accounted for 3.0 percent of total consumer loans in 2014. This is mainly due to a couple of factors. First, the establishment of SIMAH has enabled banks to have a better risk assessment of individual borrowers, thus limiting the ratio of credit card eligibility. Second, credit card holders are having more preference toward advanced payments in order to avoid outstanding balance, thus majority of credit transactions are not transforming into the bank's credit portfolio. The remaining components that represented 78.0 percent of consumer loans are classified as “Other”[4] (**Chart 3.12**). The distribution of consumer loans pointed to steady expansion in all types of consumer loans, except credit card loans and loans classified as "others", in recent times. However, the growth of consumer loans acquired for cars and equipment outperformed all other consumer loan categories (**Chart 3.13**).

Chart 3.13: Growth Patterns of Classified Consumer Loans



3.2.4 Real Estate Lending

Real estate lending grew by over 30 percent for two consecutive years, 2013 and 2014. Retail real estate lending remained the major driver of real estate’s annual growth in 2014 as it accounted for 63.3 percent of the total real estate loans **(Charts 3.14)**. The share of real estate lending in the total bank credit reached 12 percent in 2014. On the other hand, its share to national output, real estate lending measured in terms of overall GDP and non-oil GDP remained small at around 5.3 percent and 9.3 percent, respectively.

Chart 3.12: Usage and Growth Pattern of Consumer Loans

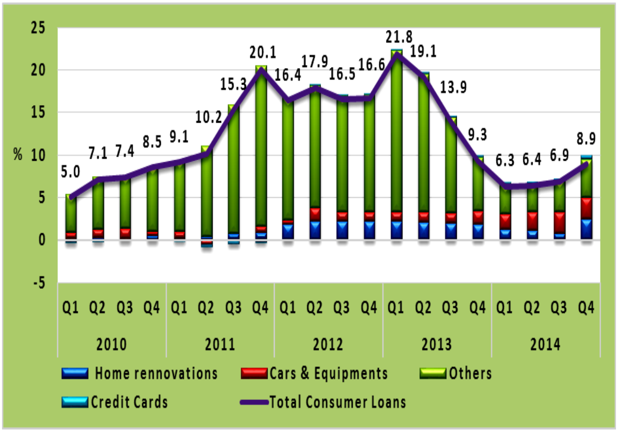
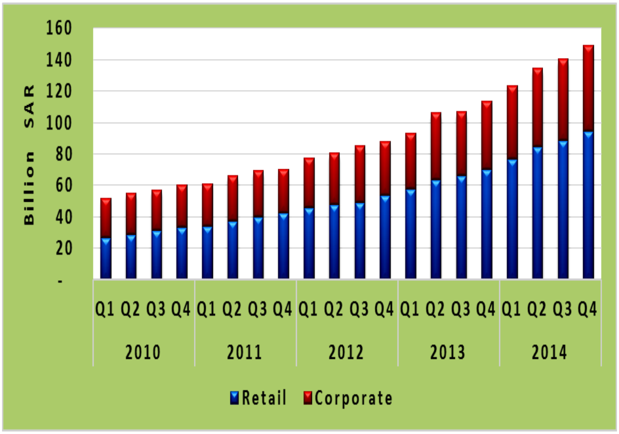


Chart 3.14: Distribution of Bank Loans to Real Estate



[4]In view of the enormity of loans lumped together as *other*, SAMA is currently working with banks to review the classification of loans and improve the low data granularity. The outcome of this exercise will be helpful to find out other significant drivers fuelling the growth of consumer loans. It should be noted, however, that most of consumers' loans classified as others are for general consumption purposes, where borrowers prefer not to reveal the exact purpose.

SAMA continues to actively monitor developments in the real estate market and committed to taking any required actions to mitigate systemic risk in the banking sector arising from the real estate lending portfolio. In view of this, SAMA has deployed macroprudential measures to complement the government's initiatives and ensure a steady and sustainable levels of real estate financing. Consequently, as part of the Real Estate Finance Law and its Implementing Regulations, SAMA has introduced a rule imposing 70 percent loan-to-value (LTV)[5], which took effect in November 2014. The implementation of the LTV ratio is expected to curb excessive leveraging in the real estate sector.

3.2.5 Maturity Distribution of Bank Credit

The maturity distribution of bank credit remained heavily skewed toward short-term lending[6]. Short-term loans still accounted for about 49.7 percent of the total bank loans in 2014, but their share in total bank loans decreased by 14.3 percentage points during 2008-14 (**Chart 3.15**). On the other hand, while the share of medium-term loans rose by about 5.1 percentage points to 19.1 percent during 2008-14, the share of long-term bank loans climbed by about 9.3 percentage points to 31.3 percent during the same period. This clearly shows a gradual shift in the distribution of bank loans towards longer-maturity.

While the maturity distribution of total bank loans remained tilted toward short-term loans, conversely the distribution of consumer loans remained dominated by long-term loans. However, the share of long-term consumer loans decreased by about 19.1 percentage points to 46.4 percent during 2005 -14 (**Chart 3.16**). In contrast, the share of short-term consumer loans increased significantly by about 13.5 percentage points to 26.2 percent during the same period. Short-term consumer loans registered the highest growth in recent years as they increased by more than three-fold during 2005-14, followed by medium-term consumer loans (158.0 percent) and long-term consumer loans (44.8 percent)[7]. This vividly tends to manifest banks' preference toward relatively short-duration loans, thus helping improve the overall quality of consumer credits by lowering the maturity horizon.

Chart 3.15: Maturity Distribution of Total Bank Credit

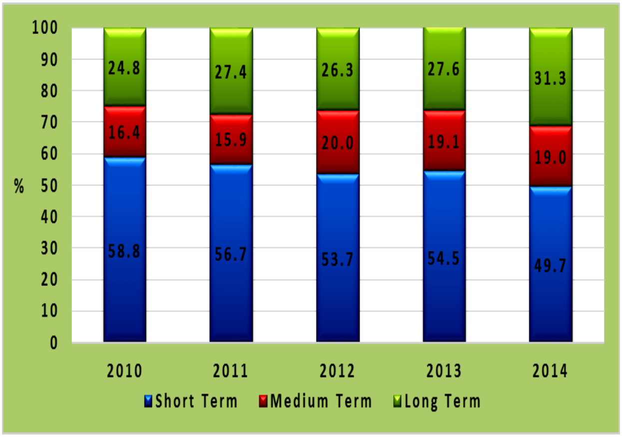
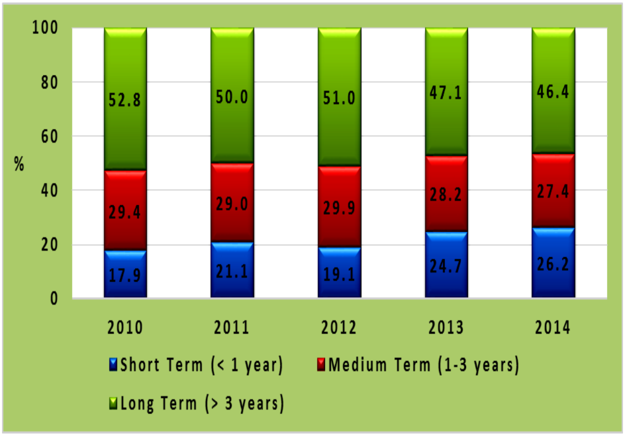


Chart 3.16: Maturity Distribution of Consumer Loans



[5]The LTV ratio is a measure of how much a bank can lend against a residential property, as a percentage of the total value of that property.
[6]Short term is less than 1 year maturity, Medium term is from 1 – 3 years, and Long term is more than 3 years.
[7]Sharp stock market correction in 2006 was a major driver for the recent changes in maturity compositions.

3.3 Balance sheet assessment - Banks Liabilities

Non-interest bearing bank deposits continued to serve as the primary source for funding. Bank deposits continued to steadily grow over the years, and constituted, on average, about 71.0 percent of banks' liabilities during 2008-14. Banks have not relied much on foreign funds and hence their foreign exposure remained limited. In fact, the share of banks' foreign liabilities in their total liabilities continued to decline in recent years averaging 5.8 percent during 2008-14.Hence, the reliance on non-interest bearing deposits (demand deposits) acts as a major mitigation factor against interest rate risk. The low level of foreign liabilities, on the other hand, ensures that the impact of adverse external financial market shocks on Saudi banking sector remains limited (**Charts 3.17 and 3.18**).

Chart 3.18: Component-Wise Contribution to Growth of Bank Liabilities

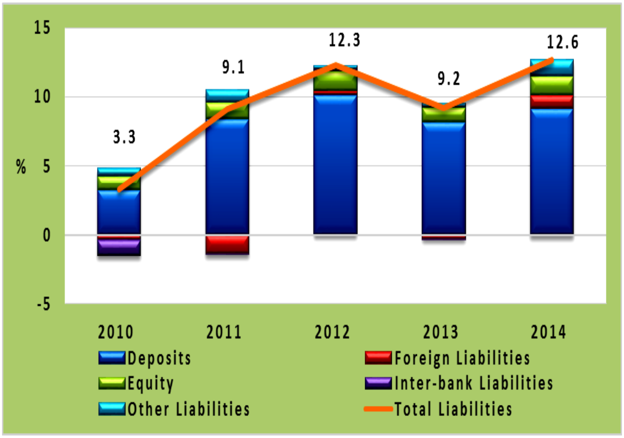
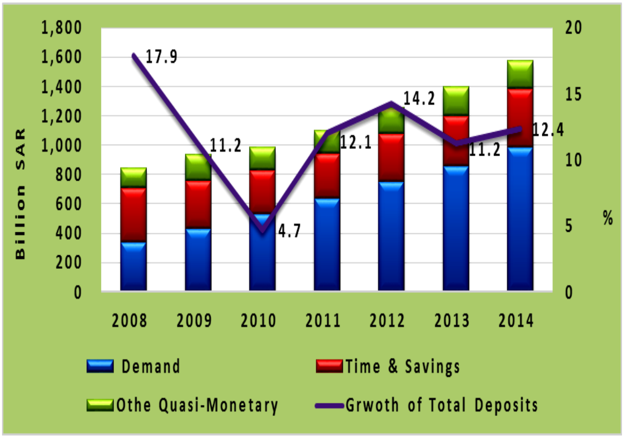


Chart 3.19: Distribution of Bank Deposits

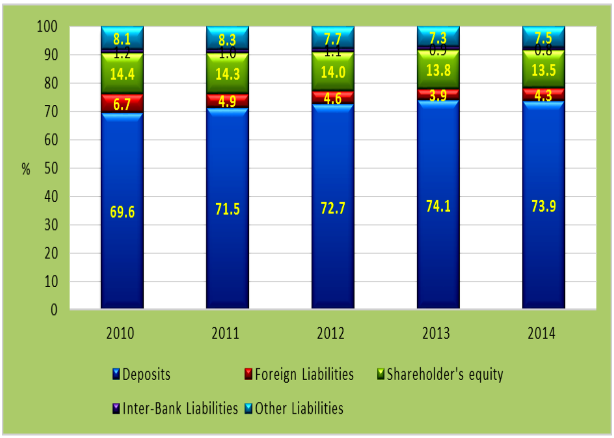


3.3.1 Bank Deposits

High liquidity and continued access to low cost funding are additional factors that contribute to the resilience of the banking sector. Saudi banks continued to enjoy a hefty and stable deposit base, largely aided by strong private sector activity and accelerated public spending in recent years. Total bank deposits showed an average annual growth of 11.0 percent to reach SAR 1.58 trillion during 2009-14 (**Chart 3.19**). In 2014, non-resident deposits amounted to SAR 7.9 billion, equivalent to 0.5 percent of the total bank deposits.

A strong liquidity position is ensured as Saudi banks remained disciplined to the regulatory loan to deposit (LTD) ratio. The LTD remained under the prudential limit of 85.0 percent that SAMA had put in place years ago in order to prevent the prospect of credit overheating. Historically, the LTD ratio averaged below 82.0 percent, but ranged between 77.6 percent and 80.0 percent during 2009-14. Deposits provided a coverage ratio of 125.0 percent of the total bank credit.

Chart 3.17: Distribution of Bank Liabilities



The private sector continued to hold most of the bank deposits with a share of around 75 percent in 2014 with the bulk of these deposits being held as demand, non-interest bearing deposits. The share of demand deposits in total bank deposits stood at 63 percent in 2014, followed by time and savings deposits (25.3 percent), and quasi-money deposits (11.9 percent)[8]. While business and retail deposits made up most of the total demand deposits (94 percent) as well as time and savings deposits (42.5 percent), the foreign currency deposits accounted for 84 percent of quasi-money deposits with government entities' accounts representing a share of 41.4 percent in 2014 .Business and retail accounts represented the bulk of the foreign currency deposits until 2008.

3.3.1.1 Maturity Distribution of Banks deposits

Maturity-mismatch risk is moderate given that the domination of short term deposits is matched with the relative preference towards short term lending. Short-term deposits with a maturity of less than 12 months represent around 97.0 percent of the total deposits base **(Chart 3.20).** There is, however, still some room to mitigate this risk further by encouraging longer-term deposits such as time and saving deposits.

3.4 Off-Balance Sheet Operations

Despite their seemingly large size in absolute terms, the comparative value of off-balance sheet activities in terms of the Basel risk-weighted assets (i.e., the post credit conversion), is small indicating limited impact on the banking sector risk profile. In absolute terms, Banks' off-balance sheet operations grew by 24 percent to reach SAR 2.1 trillion in 2014 reaching a size equivalent to total asset value. The bulk of the off-balance sheet assets, 64 percent, is composed of derivatives (SAR 1.38 trillion). Guarantees, Revocable overdraft and Letter of Credit accounted for 17.0 percent, 12.0 percent, and 6.0 percent of off-balance sheet operations, respectively. The growth trend in off-balance sheet operations is consistent with peer countries such as Australia, South Africa, and Brazil where off-balance sheet activities are still on the rise (**Charts 3.21**). It should be noted, however, that the comparative value of the off-balance sheet in terms of the Basel risk-weighted assets is equivalent to only about 15 percent of total off-balance sheet operations. Derivatives' post credit conversion value, on the other hand, is only equivalent to 1.7 percent.

Chart 3.20: Maturity Structure of Bank Deposits

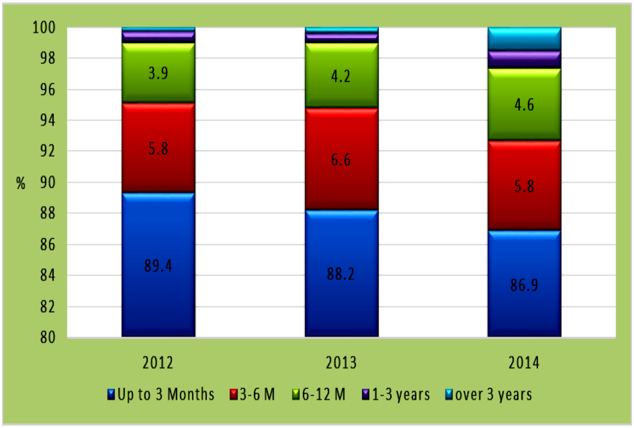
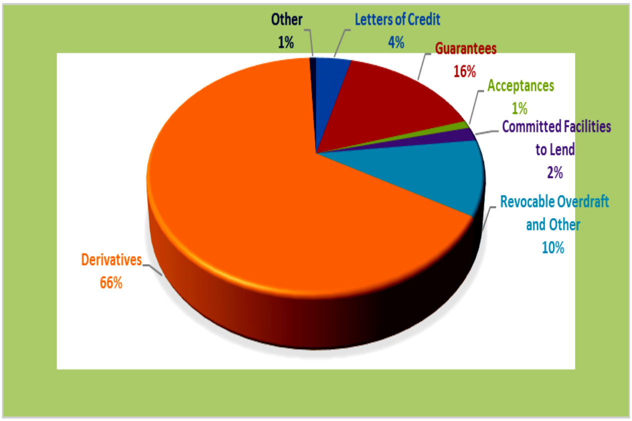


Chart 3.21: Component Off-Balance Sheet items



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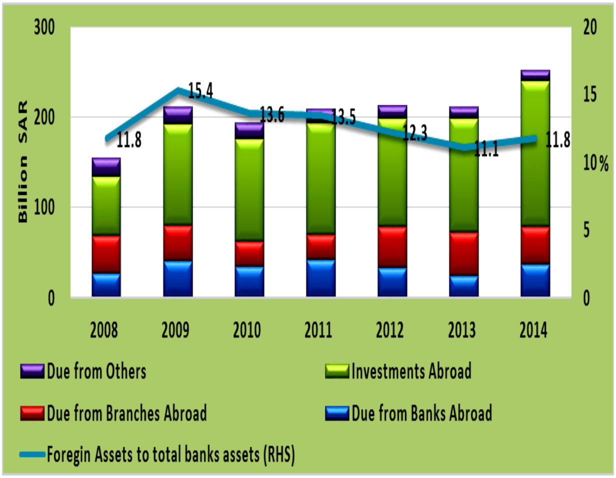
[8]Other quasi-money deposits comprise of residents' foreign currency deposits, marginal deposits for LCs, outstanding remittances, and banks' repo transactions with private parties.

3.5 Foreign Exposure

The limited exposure of Saudi banks to foreign financial markets helped the banking sector remain resilient against recent volatility in the global financial system. While banks' net foreign assets showed an average annual growth of 8.6 percent during 2009-14, their share in the total bank assets remained fluctuating well under 9.0 percent during the same period. In 2014, net foreign assets amounted to SAR 159.3 billion, equivalent to 7.5 percent of banks' total assets (**Chart 3.22**). This tended to protect the Saudi banking sector emanating from spillovers from recent global financial shocks and thereby safeguard the stability of the financial system. Banks' investment abroad[9] constituted the major component of foreign assets. Banks' foreign asset portfolios were largely dominated by their investment abroad with a share of about 64.1 percent in 2014, followed by assets due from branches abroad (16.4 percent) (**Chart 3.23**). However, their growth decelerated since 2011 mainly on account of persistent reduction in assets due from banks abroad.

Chart 3.23: Components of Foreign Assets



On the other hand, Banks' foreign liabilities remained small relative to total liabilities. In 2014, banks' foreign liabilities totalled SAR 92.3 billion, equivalent to less than 4.3 percent of total liabilities. They increased by 24 percent relative to 2013, but are still about 18 percent lower than their peak at SAR 112.5 billion in 2008 (**Chart 3.24**).Liabilities due to foreign banks were the major component of foreign liabilities, which rose by over 163 percent relative to 2013.

3.6 Banking Sector Resilience

Saudi banks have continued to rely on a business model that is largely oriented towards

Chart 3.22: Growth Pattern of Banks' Net Foreign Assets

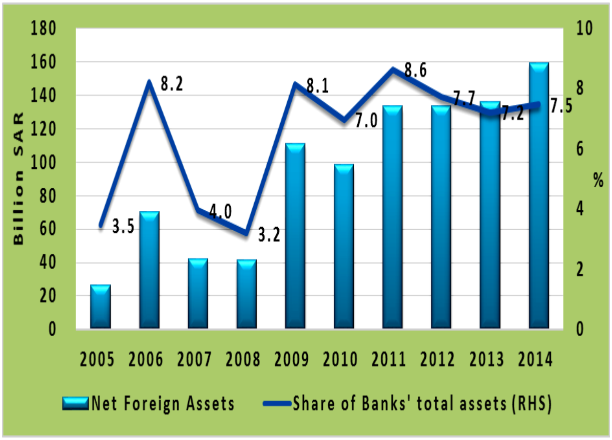
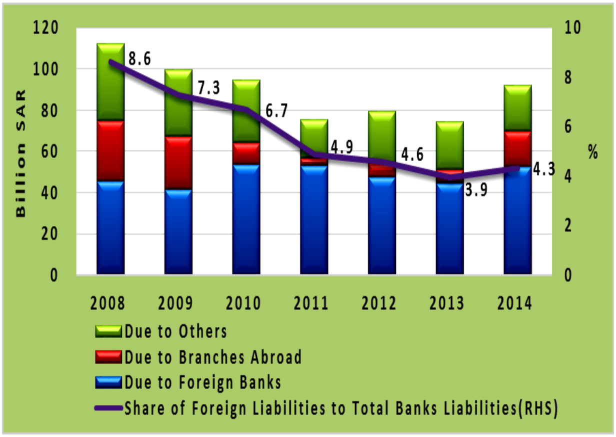


Chart 3.24: Components of Foreign Liabilities



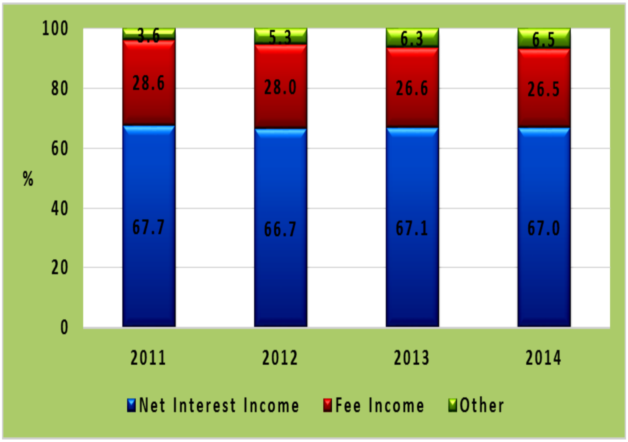
Banks' investment abroad is subject to SAMA's approval, and banks' proposals are evaluated on a case-by-case basis.

domestic savers and investors. For instance, the overriding source of their assets has been domestic deposits from households, businesses and government entities. Similarly, most of their lending is directed to domestic households, corporates and semi-government entities. In other words, Saudi banks' exposure to foreign banks and other entities in terms of lending or borrowing is fairly limited. Moreover, the fixed exchange rate system that has been in place for decades has contributed to the stability of riyal and hence largely reduced banks' foreign exchange transaction risk. It is because of these historical realities that the Saudi banking sector has a of built-in protection against adverse external developments.

3.6.1 Profitability

The banking sector continued to enjoy high profitability in 2014 where Banks' profits rose by 12.5 percent to SAR 40.2 billion in 2014. Net interest income contributed the most as it accounted for more than 67.0 percent of gross income during 2012-14 (**Chart 3.25**). However, its growth decelerated to 8.0 percent in 2014 from a year earlier. In terms of the composition of

Chart 3.25: Components of Gross Income



interest income, interest on loans to the private sector was the major driver of income, accounting for over 74.0 percent of total interest income in 2014. Other key sources of income mainly included the net special commission and fee-based income from capital market products, i.e., brokerage and asset management services.

Banks' profitability remained the highest among G20 economies despite operating in a low interest rate environment. Both Return on Equity (ROE) and Return on Assets (ROA) continued to fluctuate around their respective medium-term averages. The banking sector recorded ROE and ROA at 18.5 percent and 2.5 percent, respectively. These higher profitability levels significantly increase banks' resilience as they represent the high quality buffer against any systemic shocks.

3.6.2 Regulatory Capital and Asset Quality[10]

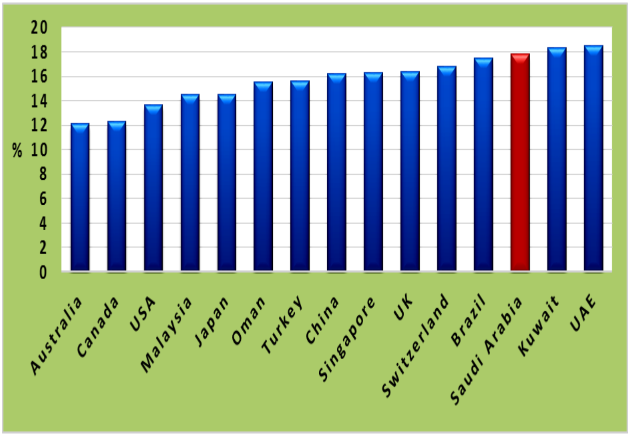
SAMA's prudent regulatory framework requires banks to maintain capital level the (Regulatory Capital to Risk Weighted Assets) well in excess of the Basel Committee's minimum requirements. Furthermore, SAMA has been at the forefront of adopting and implementing the rollout of Basel II Capital Adequacy Regulations incorporating enhanced and expanded risk metrics in 2008. The Saudi banks are not facing challenges in adopting the Basel III standards. They were among the first in the region to fully implement the enhanced capital adequacy ratio (CAR) under Basel III (standardized approach) effective in 2013, with all banks started reporting their Basel III CAR in their March 2013 statements (**Boxes 3.1 and 3.2**).

The Saudi banking sector is also highly capitalized compared to other advanced and emerging market economies. The strong

[10]Capital adequacy ratio is a major indicator reflecting bank's capacity to meet its liabilities and provide a cushion for potential losses and risks such as credit risk, and most importantly protecting bank depositors. It is expressed as a percentage of a bank's risk weighted assets exposures.

capitalization of Saudi banks has been an important contributor to the resilience of the entire Saudi banking sector. The average CAR for the banking sector was maintained at 17.9 percent by the end of 2014, slightly more than the 5-year average of 17.0 percent during 2009-13 (**Chart 3.26**).

Chart 3.26: CARs of Selected Countries



Source: IMF

The quality of capital maintained to meet the required CAR has ensured resilience. Tier 1 capital, which primarily consists of equity capital and freely available disclosed reserves, remained the dominant component of total regulatory capital. In 2014, it accounted for over 90.4 percent of total regulatory capital. Common equity remained the dominant component of the Tier 1 capital. On the other hand, Tier 2 capital which is mainly composed of debt such as commercial bonds and Sukuks that meet the Basel III criteria. The average CAR following the introduction of Basel III has averaged about 18.0 percent of which around 85.0 percent is core common equity.

3.6.3 Liquidity[11]

Liquidity risk in the Saudi banking sector is well managed. SAMA gives high priority to ensuring that banks are fully capable of managing their liquidity mismatch of assets and liabilities, and that they are well positioned to meet cash flow obligations on a timely manner to promote the stability of the banking sector. Consequently, banking sector asset portfolio largely contains high-quality liquid assets such as Saudi government bonds, SAMA bills, and reserves with SAMA. Their ratio of liquid to total assets stood at around 22.3 percent relative to total assets, and 33.6 percent relative to short-term liabilities in 2014 .Furthermore, all banks' have already fulfilled the Basel III liquidity requirements. Both the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR) are already well above the regulatory minimum requirements proposed by Basel III. Saudi banks currently maintain both ratios above the regulatory requirement of 100 percent. The current requirement by Basel for LCR is set at 60 percent.

3.6.4 Leverage

The Saudi banking sector has maintained the leverage ratio around 12 percent which is well above the minimum 3.0 percent set by the Basel Committee on Banking Supervision (BCBS). This is an additional stability factor as it acts as a credible supplementary measure to the risk-based capital requirements. It restricts the build-up of leverage in the banking sector to enable authorities to avoid destabilizing deleveraging processes that can damage the broader financial system and the economy.

To sum up, the Saudi banking sector has strengthened over the years. While its external

[11]The new Basel III liquidity metrics, Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR), are major indicators that aim to improve the liquidity of the banks and reduce their risk of insolvency. The LCR is intended to promote resilience against potential liquidity disruptions over a 30-day horizon with sufficient high quality liquid resources. Similarly, the aim of the NSFR is to promote banks' medium- and long-term resiliency. Therefore banks are required to hold a minimum amount of stable sources of funding relative to the liquidity of the assets to meet contingent liquidity needs from off-balance sheet commitments over a one-year horizon.

exposure is limited, its domestic credit risk appears well managed due to high quality assets and sufficient provisioning. Banking soundness indicators point to a high level of banking sector resilience on account of strong capital and liquidity buffers. The recent improvements in the macro-prudential framework in line with the Basel III regulations have also reinforced the Saudi financial landscape. Therefore, the Saudi financial system is expected to remain resilient to adverse developments and contribute to economic and financial stability.

3.7 Risk Outlook of Banking Sector

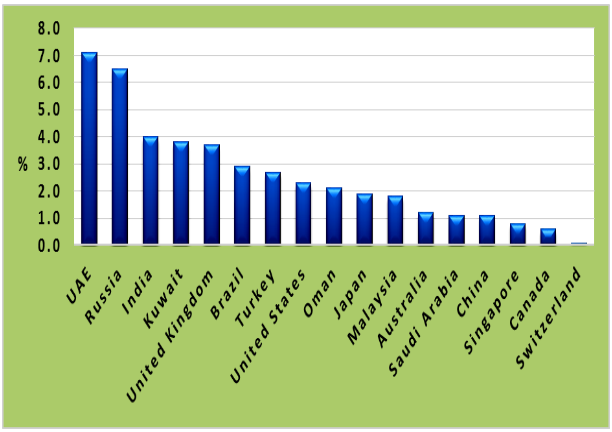
An overall assessment of the Saudi banking indicates high resilience with some key areas for risk management consideration. Credit quality is at its highest levels as indicated by the record low NPL ratios. The sector, however, is highly correlated with macroeconomic changes, particularly with oil prices and government spending. Historically, periods with low oil prices and government spending have coincided with high NPL ratios. Nevertheless, the recent episode of oil price drops, which started during the second half of 2014, is expected to have a much milder impact on the underlying credit quality given the strong fiscal position which allows for continued government spending. The banks' business models are expected to remain focused on current, non-interest bearing deposits as the primary source for funding and on a mix of floating interest rate lending and hedged fixed interest rate investments. Meanwhile, exposure to international markets is likely to remain low.

As for credit risk, an important aspect of the growth in Saudi banks' total credit is that it has not been accompanied by deterioration in asset quality. While the total bank credit grew by 11.6 percent in 2014, the stock of non-performing loans shrank by more than 7.4 percent in the same period. The stock of non-performing loans relative to that of total bank loans (NPL ratio) continued to decline in recent years. The NPL ratio dropped to 1.1 percent in 2014 from its peak of 3.3 percent in mid-2010 and 1.3 percent in 2013 (**Chart 3.27**). The NPL ratio of the Saudi banking sector remained low when compared to a group of selected developed countries and EMEs (**Chart 3.28**).

Although the overall NPL ratio in the banking sector is at historical low levels, it varies from one economic sector to another. Increasing NPLs have been recorded in Commerce, Building and construction and Services sectors, which account for about 21 percent, 6 percent and 5 percent of total banking credit, respectively. In particular, NPLs in the building and construction sector have grown quickly in past few years, while fluctuating highly in the commerce sector.

Chart 3.27: Quarterly Non-Performing Loan (NPL) Ratios

Chart 3.28: NPL Ratios for Selected Countries



Source: World Bank-2013

Although about 20 percent of total non-performing loans were originated within consumer sector, the consumer sector continues to be associated with lower than average NPLs for the past decade. Overall, SAMA continues to monitor the development of NPLs within all economic sectors to ensure resilient and safe lending practices.

SAMA continued to rely on a counter-cyclical provisioning policy to ensure higher resilience of the banking sector to absorb shocks during stress times. NPL ratios are typically a lagging indicator for asset quality, which tend to correlate negatively with periods of high credit growth. In view of this, SAMA requires banks to increase their capital reserves during up-turns (good times) so that they could use them during down-turns (bad times) to minimize the impact of adverse occurrences. Consequently, in 2014, the coverage ratio for total NPLs exceeded 146 percent of total loans.

Saudi banks' asset quality also continued to show sustained improvement as a result of a combination of supportive factors and regulatory initiatives. This includes a favourable economic and business environment, SAMA's hands-on regulatory oversight coupled with risk-based supervision, and the obligation for banks to adopt improved risk assessment and management practices following the implementation of Basel II Capital Adequacy requirements (such as the pillar 2 regulatory requirements). In addition, the setting-up of the *Saudi Credit Bureau* (SIMAH) also facilitated banks to enhance their risk management capabilities, strengthen the credit information system, speed up various processes, and improve lending decisions.

To further reduce concentration risk, SAMA has tightened its single exposure limit further. The cap has been lowered from 25 percent to 15 percent of the bank's capital and reserves. However, to avoid any potential shocks arising from sudden introduction of this measure, the new rule will be implemented in phases where the cap will be reduced by 2 percent each year until it is fully implemented by 2019. This conservative approach, compared to international standards, is adopted to promote further resilience in the already sound banking sector.

Interest rate risk is well managed and banks are highly resilient to potential shocks arising from interest rates hikes. In a study conducted by SAMA, banks showed resilience to potential increase in interest rates. Stress testing, Asset-Liability analysis, and Net interest Income Gap assessments have been performed against three scenarios of interest rate hikes; 25, 50, or 100 bases points. The results showed that the impact is net positive for all banks. This is mainly due to the banks' business model of relying primarily on non-interest bearing deposits for their funding, while focusing more on floating rate investments that will adjust to changes in interest rates **(Box 3.2)**.

In addition, the banking sector has positioned itself to absorb the impact of an even higher interest rate shock with hedging plans and sound risk management tools. Based on a recent SAMA survey, banks do not see any major impact on repayment capacity of the borrowers if interest rates go up by 25 or 50 basis points. In fact, all banks expressed complete confidence in their ability to withstand any potential interest rate shocks of up to 200 basis points[12]. Additionally, all banks have internal models in place to assess the impact of possible changes in interest rates on profitability, liquidity, and capital adequacy.

Moreover, SAMA periodically performs top-down stress testing for the banking sector to evaluate its resilience against hypothetical macroeconomic shocks. The current stress test is based on three different scenarios that range from mild to severe macroeconomic shocks. The 2014 stress test results show that Saudi banks are resilient to adverse macroeconomic shocks (including oil price drop) regardless of the shock severity level. Additionally, they all remain liquid under liquidity stress testing in which they survive a bank run for at least one working week (which is the threshold normally suggested as an international standard). It is also worth mentioning that SAMA also requires individual banks to semi-annually perform and report the outcomes of their own bottom-up stress tests. These outcomes are reviewed regularly and reconciled with SAMA's top-down stress tests to ensure consistency and resilience on both macro- and micro-prudential levels.

To further promote financial stability, reinforce confidence, and minimize contagion and liquidity risk in the banking sector, SAMA has introduced the Saudi Arabian Deposit Production Fund (DPF). Under the DIS, issued in 2015, deposits will be covered by up to SAR 200,000 of the deposit amount. The scheme will be funded by a special fund built particularly for this purpose by banks.

Finally, SAMA adopts a wide range of Macro-prudential measures to ensure financial stability and minimize systemic risk within the banking sector. Over the years, SAMA's macroprudential policy ensured that the banking sector is able to withstand financial and economic shocks and vulnerabilities. Table 3.1 provides a short list of the main macroprudential tools that are currently deployed by SAMA to ensure a sound and resilient banking sector. Additionally, many initiatives have been taken to improve macroprudential regulation including establishing a framework to identify Domestic Systemically Important Banks (DSIBs) and determine their additional capital requirements based on the best international practices. As for credit risk in the real estate sector, the fast growth rate of credit is expected to slow down as a result of the introduced LTV ratio, easing the concerns of excessive leveraging. SAMA has also, pro-actively, taken steps to minimize the shadow banking sector by implementing major reforms to the non-banking credit institutions **(See chapter 6)**.

[12]Some banks indicated a threshold as high as 600 basis points before any negative impacts.

Table 3.1: SAMA's Macroprudential Toolkit for the Banking Sector

Instrument	Regulatory Requirement
Capital Adequacy Ratio	Basel requirement of a Minimum of 10.5%
Provisioning	General: 1% of total loans Specific: Minimum of 100% of NPLs
Leverage Ratio	Deposits/(capital + Reserves) ≤ 15 times
Reserve Requirement	7% for Demand Deposits 4% for Time & Saving Deposits
Loan-To-Value (LTV)	Mortgage loans ≤ 70% of residential real estate value
Debt Service – To – Income (DTI)	Monthly repayments ≤ 33% of employed salary & 25% of retired pension
Loan-to-deposit (LTD) ratio	85 %
Liquidity: Statutory Liquidity Reserve LCR (Basel III) NSFR (Basel III)	Liquid Assets/deposits ≥ 20% 100 % by 2019 (already fulfilled) 100 % by 2019 (already fulfilled)
Counterparty Exposure	Individual Exposure/total capital ≤ 25%
Foreign Exposure	SAMA approval needed before foreign lending (a qualitative measure)

Box 3.1

Saudi Regulatory Framework and Basel Accords

For decades, SAMA has been engaged in discussions and deliberations of the BCBS on its initiatives concerning Risk Based Capital Adequacy regimes. SAMA's involvement goes back to the Basel I Accord of 1988, and subsequently in Basel II in 2004, and Basel III in 2010.

Basel I

The 1988 Capital Accord, which called for a minimum capital ratio (capital to risk-weighted assets) of 8.0 percent, was introduced by SAMA through a Supervisory Regulation Circular in 1992. Throughout 1992–2008, Saudi banks maintained Basel capital ratio averaging around 19.0 percent, well above the minimum requirement.

Basel II

SAMA fully implemented the Basel II Framework incorporating Pillars 1, 2, and 3 in January 2008. During its implementation for Pillar 1 risks, national banks used the Standardized Approach for credit and market risks, and the Standardized or Basic indicator Approach for operational risk.

With regard to Pillar 2, the Supervisory Review Process, SAMA fully implemented the *Internal Capital Adequacy Assessment Process* (ICAAP) whereby banks submit their ICAAP documents on an annual basis. These documents are discussed in bilateral meetings with banks to ensure that they have a robust internal process for assessing their overall capital needs based on their growth projections and risk profiles.

SAMA issued detailed BCBS requirements on Pillar 3, and required banks to make certain disclosures in their financial statements and annual reports to allow market participants to know the capital adequacy of their institutions. Additionally, SAMA also encouraged banks to create a National Data Pool housed in the *Saudi Credit Bureau (SIMAH)* to save information on variables such as Probability of Default (PD), and Loss Given Default (LGD) related to their corporate portfolios.

Basel III

SAMA started to implement and monitor the Basel III Capital Adequacy Ratio (CAR) in January 2013. Tier 1 constituted more than 92.0 percent of the reserved capital.

Box 3.2

SAMA Study on Assessing the Impact of Potential Changes in Interest Rates

During the first quarter of 2015, SAMA has conducted a study to assess the impact of any potential rise in interest rates on Saudi banks. For this purpose, some information and data have been collected from banks whereby all Saudi banks have been involved and responded to the survey questionnaire of SAMA. The data were collected from banks to assess the impact of 0.25, 0.50, and 1 percent rise in interest rates on the banks' profitability and capital adequacy.

The analysis has revealed that a 0.25 percent rise in interest rate will increase the commission income of banks by much more than the associated increase in their funding cost thereby resulting into a net gain to the banking sector.

The key findings of the study are summarized hereunder:

- The potential impact of any rise in interest rates would have a positive impact on the profitability of the banking sector mainly because of the fact that banks' interest rate sensitive assets are much larger compared to the rate sensitive liabilities;
- Banks do not see any major impact on repayment capacity of the borrowers if the interest rates go up by 0.25 or 0.5 percent. However, there may be a nominal impact in case of 1 percent increase. This would be more driven by customer capability/behavior which cannot be predicted. The changes in the probability of default (PDs) as a result of interest rate rise are also expected to be minimal. This is due to the reason that the existing interest rates are very low and hence any increase of up to 1 percent will have minimal impact on repayment capacity of the borrowers;
- Any significant interest rate rise that is higher than 1 percent could be an issue for certain industries, for example, for contracting industry where the contracts are executed and pricing is locked. Similarly, the electronic industry would face the same situation since margins are very slim.
- A major portion of banks' assets is floating rate which includes majority of loans and investment portfolios. Furthermore, the fixed rates assets are hedged through entering into interest rate Swaps deals whereby paying fixed and receiving floating rates.

4. Non-Bank Credit: Recent Trends and Initiatives

The credit creation activity in Saudi Arabia is not limited to banks only, but is also shared by five non-deposit taking specialized credit institutions (SCIs) and several private financing companies. SCIs are state-owned institutions that were formally established few decades ago with the aim to facilitate the development of some domestic sectors by extending interest-free credit to projects falling within these sectors. Recently, the Saudi government has largely increased the scale and variety of these non-bank credit operations to promote financial inclusion and expedite the pace of economic diversification in the Kingdom in order to reduce its dependence on the oil sector (**Box 1**). In addition, non-bank financial companies have been licensed to primarily promote the real estate and leasing operations.

4.1 Credit Performance of SCIs

The five SCIs have played an important role in the Saudi financial system by way of complementing banks' lending operations, and thereby facilitating the expansion of the private sector's role in the national economy. Since their inception, SCIs jointly disbursed loans to the tune of SAR 596.1 billion. However, their combined outstanding loans showed an annual growth of 12.3 percent during 2008-14 to reach SAR 310.9 billion, equivalent to 19.9 percent of the total credit (bank plus non-bank), and 25.8 percent of the bank credit to private sector (**Chart 4.1**).

The significance of SCIs operations can be gauged from the fact that their combined outstanding credit was equivalent to 11.0 percent of total GDP and 19.4 percent of non-oil GDP in 2014. Both ratios were in line with historical trend, which ranged between 8.0 percent and 11.1 percent of overall GDP, and 17.1 percent and 19.8 percent of non-oil GDP (**Chart 4.2**). However, despite this "size" significance, SCIs credit activities have limited implications on the stability of the Saudi financial system. This is due to several reasons. First, the fact that SCIs are non-deposit taking institutions with full government ownership limits the chances for liquidity risk. Second, contagion risk is also limited as SCIs are not linked to the regular banking system given that they are fully financed by the government. Third, SCIs lending is facilitated through the capital allocated by the government rather than leveraging which limits the implications of any deterioration in the SCIs credit quality. As a result, SCIs credit activities do not pose the concerns normally arising from the traditional shadow banking activities.

Chart 4.1: Pattern of SCIs Credit

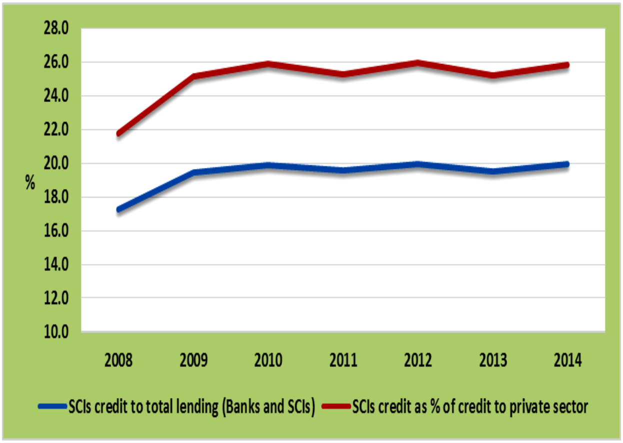
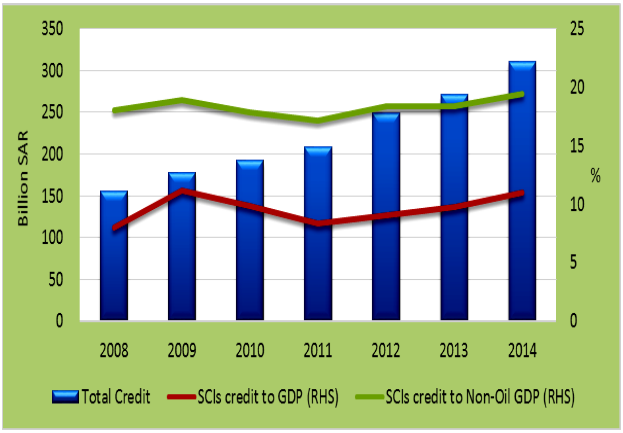


Chart 4.2: SCIs Outstanding Credit Relative to GDP



The distribution of SCIs loans is focused on real estate developments and large-scale projects. The share of the *Real Estate Development Fund credit* in SCIs total outstanding credit stood at 41.6 percent in 2014, followed by the *Public Investment Fund* (29.1 percent), *Saudi Credit and Saving Bank* (11.9 percent), *Saudi Industrial Development Fund* (9.9 percent), and *Agriculture Development Fund* (2.8 percent).

4.2 Non-Bank Finance Sector

The non-bank private financing sector has undergone major restructuring. Three finance laws, namely the Real Estate Finance Law (Box 4.2), Finance Lease Law, and Finance Companies Control Law (Box 4.3) were promulgated in 2012. These laws and their implementing regulations provide the regulatory framework for the real estate finance sector and non-bank finance companies sector, and entrust SAMA with the regulation and supervision of those two sectors.

The Finance Laws and their implementing regulations provide strong prudential measures that aim at ensuring the stability and soundness of the real estate finance sector. Those measures include a maximum Loan-To-Value ratio of 70 percent for residential real estate financing, and a cap on total financing assets of 5[13] and 3 times the value of capital and reserves for real estate companies and non-real estate companies, respectively. More recently, in 2014, SAMA continued developing and enhancing the regulatory framework of the finance sector by issuing The Rules for Practicing Microfinance Activity. These rules will help regulate microfinancing to develop the funding of production activities for the borrowers of small business and handicrafts.

Data reporting and risk management requirements have been introduced as part of the regulatory process to ensure an on-going and timely identification of potential risks. According to Finance Laws and their implementing Regulations, Finance Companies are obliged to provide SAMA with the prudential data at specified times in accordance with the forms, rules, and instructions set forth by SAMA. They are also obliged to prepare a quarterly risk report for discussion by risk management and credit committee and the Board after review by Senior Management and provide SAMA with such reports.

SAMA's market restructuring initiative resulted in a significant development of the non-bank financing sector. Up to March 2015, SAMA has licensed 12 Banks to provide real estate financing activities, 5 real estate finance companies and additional 15 finance companies that would carry out one or more of the following finance activities:

1. Productive asset finance
2. Small and medium enterprise finance
3. Financial lease
4. Credit card finance
5. Consumer finance
6. Microfinance

Furthermore, 11 finance companies are currently under evaluation by SAMA for licensing.

Regulation and supervision of financing companies is undertaken through off-site and on-site supervisory activities. Those activities include, but not limited to, both supervisory and inspection visits to ensure the stability, soundness, and compliance of the finance companies. SAMA's General Department of Finance Companies Control has conducted more than 50 visits so far.

[13] Can be increased up to 7 times for real estate finance companies and 5 times for non-real finance companies subject to SAMA's approval.

Box 4.1
Credit Profile of SCIs

The Saudi government established five SCIs to complement bank lending, and provide medium- to long-term loans to the industry, SMEs, and the real estate and agriculture sectors.

The SCIs accounted for about 14.0 percent of total financial system assets, and their outstanding loan portfolios represented around 26.0 percent of bank credit to the private sector in 2014. The government continued to support SCIs credit operations as it injected SAR 10 billion in one of the SCIs in 2010 and, more recently, announced another hefty injection of SAR 70 billion.

It is important to note that SCIs were quite helpful in easing the credit demand as they had increased their lending activities in the aftermath of the 2007-09 global financial crisis when banks had contracted their credit operations due to heightened risk aversion.

Agriculture Development Fund (ADF): It was established in 1962 to provide short- and medium-term credit to support agricultural investments and related projects. Total loans disbursed by the ADF since its inception amounted to SAR 44.9 billion in 2014. However, its total outstanding loans decreased annually by 1.6 percent to SAR 8.5 billion during 2008-14.

Saudi Credit and Saving Bank (SCSB): It was established in 1971 to provide interest-free loans to low-income Saudi nationals to meet various personal expenses in respect of marriages, and maintenance of houses. Total loans disbursed by the SCSB since its inception amounted to SAR 77.4 billion in 2014. However, its total outstanding loans rose annually by 24.6 percent to SAR 36.9 billion during 2008-14.

Public Investment Fund (PIF): It was established in 1971 to provide medium- and long-term loans to the large-scale, strategically important government and private industrial projects that were unable to obtain funding from the Saudi commercial banks. Total loans disbursed by the PIF since its inception amounted to SAR 171.0 billion in 2014. However, its total outstanding loans climbed annually by 21.1 percent to SAR 90.4 billion during 2008-14.

Saudi Industrial Development Fund (SIDF): It was set up in 1974 to provide loans to Saudi business entities to establish industrial projects. These loans could be used to finance up to 50.0 percent of the total project cost. Total loans disbursed by the SIDF since its inception amounted to SAR 145.6 billion in 2014. However, its total outstanding loans increased annually by 10.3 percent to SAR 30.9 billion during 2008-14.

Real Estate Development Fund (REDF): It was set up in 1974 to finance real estate projects undertaken by individuals for personal housing or for commercial purposes. Total loans disbursed by the REDF since its inception amounted to SAR 225.2 billion in 2014. However, its total outstanding loans grew annually by 9.4 percent to SAR 129.5 billion during 2008-14.

Box 4.2
Real Estate Finance Law

The Real Estate Finance Law and its Implementing Regulations aim to regulate the real estate finance extended by the licensed banks and non-bank finance companies. This Law and its Implementing Regulations also include prudential requirements to maintain soundness, stability and equity of transactions in the sector and promote a level playing field for effective competition among the real estate financiers. These requirements include putting in place contractual standards and the real estate finance ceiling of 70 percent of the value of the asset, besides emphasizing the role of relevant government bodies in the periodic collection and electronic dissemination of data related to the activities of the real estate market. Indeed, these requirements are very important from the perspective of financial stability.

The Real Estate Finance Law and its Implementing Regulations also envisage provisions that regulate the secondary market of real estate finance in the Kingdom, including the establishment of the Saudi Real Estate Refinancing Company (fully owned by the Public Investment Fund) to facilitate trading of real estate contract rights in the secondary market and to ease the inflow of funds in order to achieve growth and stability in the secondary market of real estate finance. Its objectives also include providing better means for real estate financiers to finance beneficiaries for owning houses, enhancing liquidity of real estate finance investments, ensuring a proper distribution of the real state capital allocated for the real estate finance across various regions and society strata and taking over the role of a mediator between the sector and finance sources.

The Implementing Regulations of the Mortgage Law and Enforcement Law issued under the resolution of the Minister of Justice are to be implemented by the Ministry of Justice and courts to regulate the real estate mortgage and enforcement in general. The regulation of mortgage and enforcement are considered key pillars for an effective real estate finance sector.

Box 4.3
Financial Leasing Law

The purpose of the Financial Leasing Law and its Implementing Regulations is to regulate financial leasing contracts provided by banks and non-bank finance companies licensed to perform leasing activity through setting clear controls in respect of the rights of the lessor and the lessee in a stable and sustainable manner, thereby, mitigating risks normally associated with this type of finance and be reflected in pricing and services. The Law and its Implementing Regulations also include provisions that govern the establishment of a joint-stock company by lessors (after approval by SAMA) to register financial leasing contracts prepared in line with the latest methods and best practices, and regulate safe access to them.

Finance Companies Control Law

The Finance Companies Control Law and its Implementing Regulations aim to form a new competitive sector to extend credit while facilitating its soundness and stability. The Law and its Implementing Regulations envisage provisions that regulate the licensing of companies, and set requirements/standards with respect to capital adequacy, finance policies and measures, exposure limits, internal organization, corporate governance, risk management, internal audit, compliance and refinancing. These requirements are intended to contribute to enhancing the stability of the sector, maintaining its soundness, and promoting the level of credit activity with better risk management.

5. Insurance Sector: Performance, Coverage and Resilience

5.1 Overview

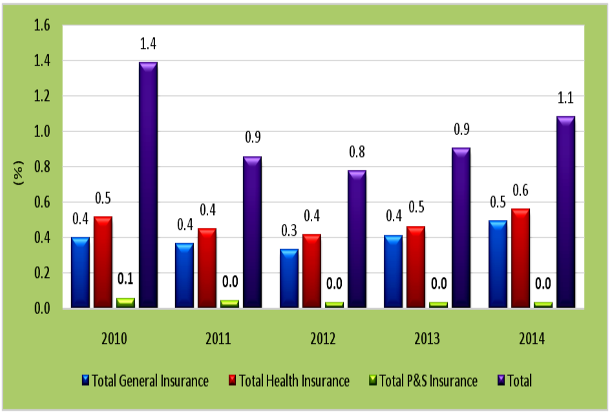
The Saudi insurance sector has a relatively short history as a formally structured, regulated and supervised industry. Prior to the passage of the *Law on Supervision of Cooperative Insurance Companies* (*the Insurance Law*) in 2003 and the *Insurance Implementation Regulations* in the early 2004, the insurance sector consisted of one state-owned company (currently known as Tawuniya), and approximately 130 unregulated insurers, many of which operated as agents for off-shore insurance companies. In 2014, the insurance sector comprised of 35 companies with 16 licensed to provide insurance and reinsurance policies combined while one sole reinsurer. In addition, there were 80 insurance brokers, 82 insurance agents, 2 actuaries, 15 loss assessors and loss adjusters, 10 insurance claims settlements specialists (third-party administration), and 8 insurance advisors facilitating the insurance operations.

SAMA is the principal regulator of the insurance market, but other regulatory authorities are also involved. The *Council of Cooperative Health Insurance* shares the responsibility of supervising the medical insurance line, providing continuous technical and medical follow-up to all those concerned with the system, and supporting the ongoing efforts to preserve the rights of all insured. Similarly, the *Capital Market Authority* (CMA) is mandated to ensure that all insurance companies are compliant with the *Saudi Capital Market Law*.

The Saudi Insurance sector has done well over the years as it has enjoyed a sound and stable credit ratings from major global rating agencies in recent times. Although not all Saudi insurance companies are rated, those rated received a *stable* or *positive* rating. In 2012, eleven companies were rated by *A.M. Best* (a global credit rating agency with a unique focus on the insurance industry) and ten of them received a *stable* rating. Similarly, companies that were rated by *Standard and Poor's* also received either *stable* or *positive* rating.

The insurance sector's contribution to GDP is still moderate, albeit expected to grow rapidly in the near future given major structural changes. The insurance penetration ratio as measured by the ratio of Gross Written Premium (GWP) to non-oil GDP, which indicates the contribution of the insurance market to non-oil output, averaged at 1.0 percent during 2010-14 (**Chart 5.1**). The insurance sector also remained a small component of the financial sector. While banks' total assets in terms of non-oil GDP reached more than 133.2 percent in 2014, insurance sector's total assets relative to non-oil GDP stood at 2.96 percent in the same period.

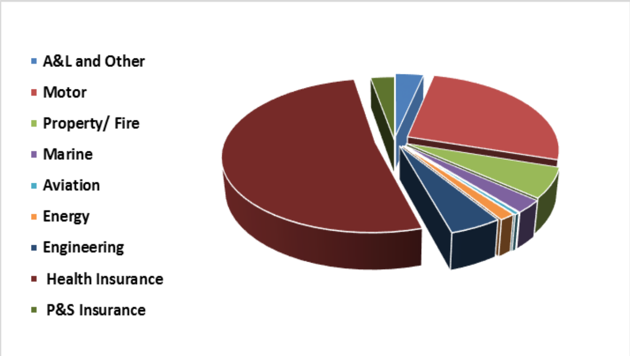
Chart 5.1: Insurance Penetration (GWP as % of Non-Oil GDP)



Insurance products and services are provided through three main insurance classes with each class containing several business lines. The first class is categorized as *General Insurance* which includes business lines such as *Accidents and Liability, Motor, Property/Fire Insurance, Marine, Aviation, Energy, and Engineering*. The second class is *Health Insurance*, and the third class is *Protection and Saving Insurance*. Their respective shares of total insurance activities based on GWP stood at 45.5 percent, 51.6 percent and 3.0 percent in 2014 (**Chart 5.2**).

Health and motor insurance sectors continued to dominate the insurance market share as they together accounted for 77.9 percent of the overall GWP in 2014. This concentration of insurance activities resulted from the provision of health insurance by many businesses to their employees, and the requirement of at least a third-party insurance for all motorists.

Chart 5.2: Market Share of Different Insurance Lines - 2014



The Saudi insurance market has shown a rapid growth in recent years. The share capital of the entire insurance industry increased by 5.6 percent to SAR 10.3 billion in 2014. However, its total equity increased by 7.7 percent to SAR 10.1 billion in 2014. The overall GWP increased by 20.8 percent to SAR 30.5 billion in 2014 (**Chart 5.3**).

Health and motor insurance continued to largely contribute to insurance activities as their respective GWPs grew rapidly by 21.9 percent, and 26.3 percent in 2014 (**Chart 5.4**). Other insurance businesses also showed a rapid growth in their respective GWPs in 2014. The low level of Aviation GWP in recent years could be due to the fact that most airlines have shifted their insurance activities to the international market.

Chart 5.3: Pattern of Gross Written Premiums

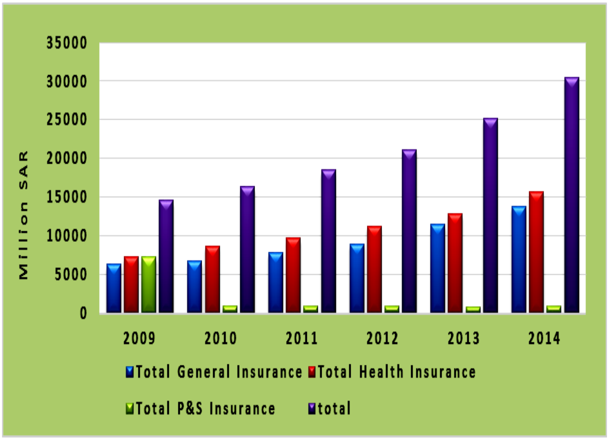
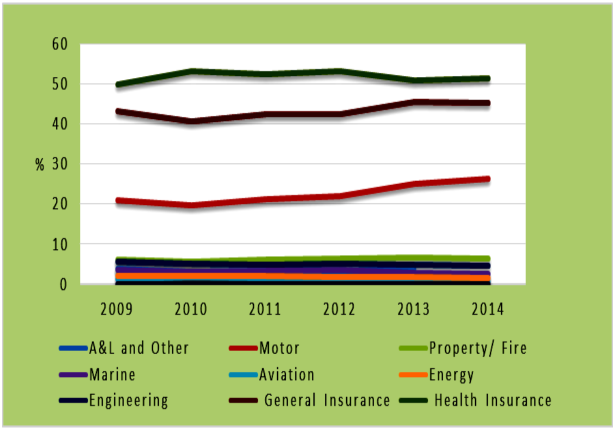


Chart 5.4: Market Share Growth Pattern of Different Insurance Lines



The insurance market continued to show domination by few players. Three top companies in terms of GWP continued to dominate the market since 2011. They collectively generated more than 54.0 percent of total GWP in 2014 (**Chart 5.5**).

The current retention ratio of the Saudi insurance industry reflects less reliance on the reinsurance market. The retention ratio which indicates the percentage of GWP retained by the insurance companies increased to 79.8 percent in 2014 from 76.2 percent in 2013 (**Chart 5.6**). This was

Chart 5.5: Market Share based on GWP of Top Insurance Companies - 2014

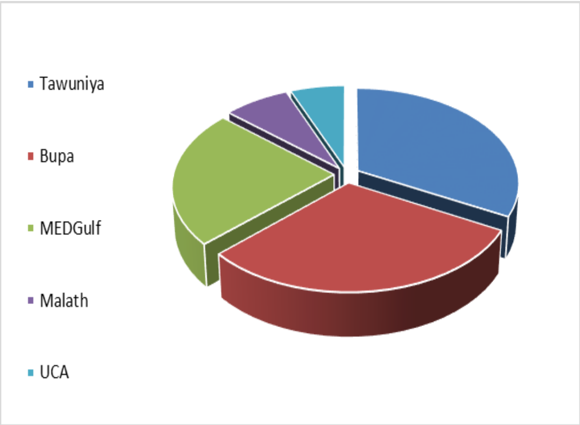
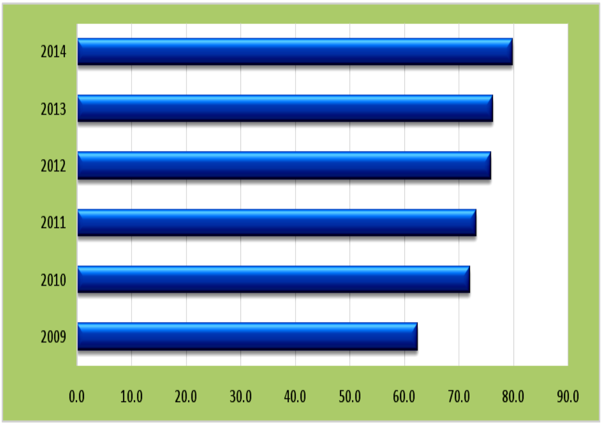


Chart 5.6: Pattern of Retention Ratio (% of GWP

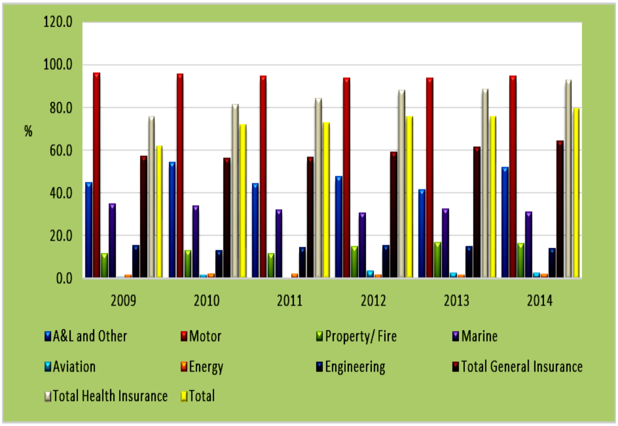


indicative of less integration between the domestic and global insurance markets owing to low percentage of reinsurance contracts signed with international reinsurers. The low reliance on the reinsurance market clearly indicated the fact that most of the market risk is being assumed by the insurance companies.

Retention ratios of different insurance lines showed a wide divergence. While the health and motor insurance businesses that accounted for 77.9 percent of the overall GWP ended up with high retention ratios of 93.2 percent and 94.7 percent, respectively, in 2014, the retention ratios were significantly lower for the rest of insurance lines reaching a level as low as 2.0 percent for Energy insurance (**Chart 5.7**). The retention ratios of health and motor insurances were expected to be higher given the demand for these business lines.

Saudi insurance industry as a whole comfortably met the requirement of a minimum of

Chart 5.7: Retention Ratio Patterns of Different



30.0 percent retention ratio laid down for the entire insurance sector by Article 40 of the Insurance implementing Regulations. However, these Regulations do not specify such a limit for each business line within the insurance sector. As a result, a high level of risk may be concentrated in certain business lines.

5.2. Profitability Pattern

The insurance market showed stable profitability growth pattern during the period from 2009 until 2014, with the exception of the year of 2013. Insurance underwriting results, an indicator of absolute profits generated from core insurance activities, increased by more than twice in 2014, recovering from the negative levels in 2013 and coming back to its normal levels. This corresponded to an increase in the Net Results, the difference between insurance operations revenues and expenses, by 151.5 percent in the same period. Investment results (income from investment activities minus expenses of investment activities) showed a slight decrease of 3.3 percent in 2014 (**Chart 5.8**). The overall sector recorded net profits close to 0.9 billion in 2014 compared to total losses of around SAR 1.5 billion in the year before. Both, Return on Equity (ROE) and Return on Assets (ROA) recovered from last year to reach 7.3 percent and 1.6 percent, respectively in 2014 compared to -15.4 percent and -3.4 percent in 2013 (**Chart 5.9**), which was due to inadequate pricing, and high market competition that also played its part as it led to reduction in premiums below the levels recommended by insurance actuaries.

The reduction in the net loss ratio (net claims incurred/net earned premium) in 2014 shows improvement in the operational performance of the insurance sector that was a concern in the previous years. The spread between the Net Earned Premium (NEP) and the Net Claims Incurred (NCI) narrowed. This was reflected by the reduction in the loss ratio which decreased from 92.9 percent in 2013 to 80.0 percent in 2014 (**Chart 5.10**). This occurred due to two main factors: increase in the required level of provisioning in view of increase in expected claims, and inadequate pricing. Motor and health insurances which represented the bulk of activities experienced the highest loss ratios. Their respective net loss ratios decreased to 92.0 percent and 79.0 percent in 2014 from 97 percent and 94 percent in 2013.

Chart 5.8: Patterns of Insurance Underwriting, Investment, and Net Results

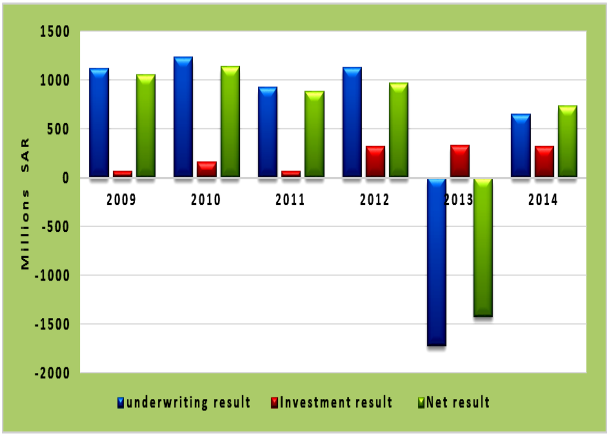
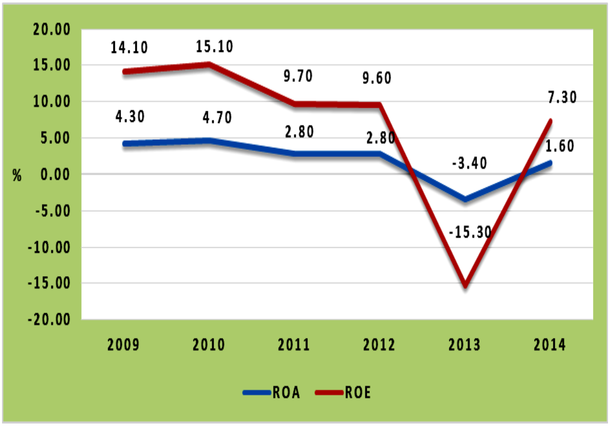
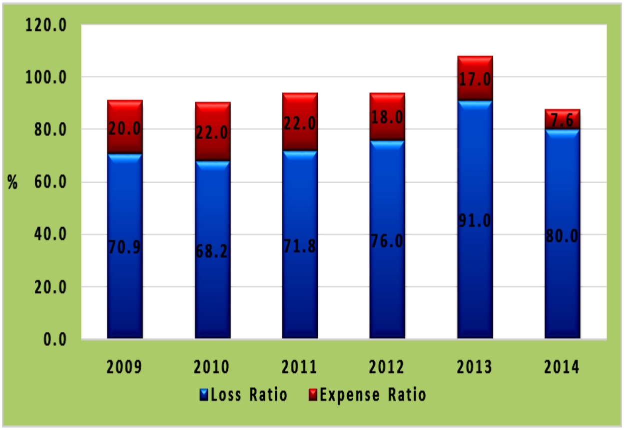


Chart 5.9: Patterns of Returns on Assets and Equity



Given the domination of few large companies, there is a need for small companies to undergo restructuring. It is clear that most insurers are unable to compete against the top three market players due to their smaller size. Therefore, it seems highly desirable for these underperforming companies to get larger either through merger and acquisitions (M&A) or through recapitalization. However, no insurance company to date has formally approached SAMA to seek approval for any form of M&A. This is largely due to their preference in taking the route of recapitalization, opting for additional stock issuances largely facilitated by supportive liquidity conditions. It is natural for large

Chart 5.10: Patterns of Loss and Expense Ratios



Saudi companies to leverage the market and hold substantial shares of the motor and medical insurance. Hence, small insurance companies may distinguish themselves by offering specialized insurance products.

5.3. Measures to Reinforce Resilience

SAMA has put in place a number of measures to reinforce the resilience of the Saudi insurance sector to a high level to make it withstand potential market turbulences. For instance, SAMA requires each insurance company to deposit to SAMA an amount equivalent to 10.0 percent of its paid-up capital as a statutory reserve to meet any unexpected obligations towards policy holders. Total statutory reserves for the insurance sector amounted to 58.4 percent of total shareholders' liability in 2014. This indicates a good level of prudence from a shareholder perspective as sufficient provisioning against losses is ensured. Similarly, SAMA prohibits Saudi insurance firms from extending reinsurance to non-Saudi companies that have received a rating below BBB from S&P, or its equivalent from another internationally recognized credit rating agency. This tends to add to the resilience of the market and enhance its ability to withstand shocks resulting from interconnectedness with global markets.

The health of the Saudi insurance sector is recovering and almost meeting the solvency margin requirement set by the insurance law and the implementing regulations. Its reported solvency margin rose by 29.5 percentage points to 99.0 percent of the 100 percent benchmark in 2014 (**Chart 5.11**). Recognizing the need for insurance companies to raise their solvency margins and return to the required levels, SAMA advised them to submit plans as to how they would bring the solvency margins up to the required level. In addition, SAMA also took various steps to enhance profitability in the market such as actuarial pricing, and required companies to take into consideration the loss

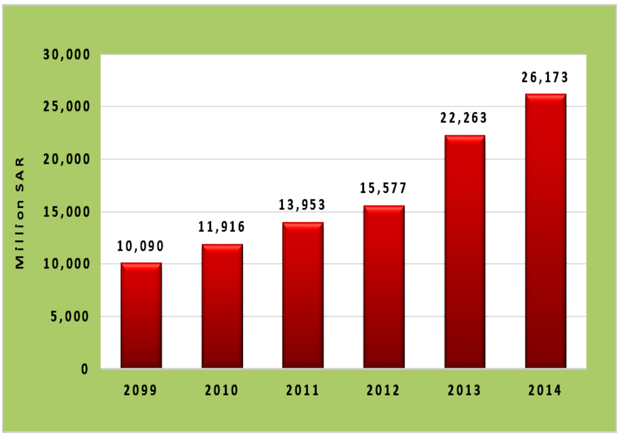
Chart 5.11: Trend of Solvency Margins

experience during the underwriting process.

SAMA also reinforced provisioning policies to ensure adequate provisioning and solvency of the insurance sector, following a significant under-reserving in 2012. In 2014, *Technical* reserves (funds set aside from profits to cover claims) increased by 17.6 percent to SAR 26.2 billion from around SAR 22.3 billion in 2013 (**Chart 5.12**).

Market risk in the Saudi insurance industry is under close monitoring by SAMA. Total Market Net Claims Incurred (NCI) increased by 9.1 percent to SAR

Chart 5.12: Pattern of Technical Reserves



17.6 billion in 2014 from SAR 16.1 billion in 2013. As for business lines, gross claims paid showed a growth of 75.1 percent with respect to A&L and other insurance, 52.6 percent with respect to Property/ Fire insurance, 28.6 percent with respect to Motor insurance, and 11.2 percent with respect to Health Insurance in the same period. Therefore, this called for further enforcement of safety measures and fraud control procedures especially with respect to motor and health insurance to help reduce the insurance market risk. This will also be instrumental in addressing the overall market perception that the insurance market risk is above average and that there is a need for measures to mitigate it.

The Saudi authorities have realized that further efforts to promote development and stability in the Saudi insurance industry are needed. Two key efforts among others are; First, regulatory authorities need to coordinate more strongly to ensure more synchronization between different insurance laws to enhance operational efficiency and promote insurance market stability. Particularly, further coordination between SAMA and the *Council of Cooperative Health Insurance* will reduce regulatory arbitrage and eliminate conflicts in the law implementation; Second, human capital and underwriting skills need to be built in a systematic fashion to speed up development of the Saudi insurance industry. Insurance programs are not common in Saudi universities and therefore there is a shortage of qualified and skilled Saudi professionals especially in the underwriting and pricing process. The shortage is particularly acute in the mid-level management of insurance companies. As the insurance industry is highly skills and knowledge-oriented, it is necessary to develop programs to improve insurance-related skill sets, and ensure healthy work environment to encourage Saudis to enter the insurance industry.

6. Stock Market Trends

6.1. Overview

The Saudi stock market has shown steady and stable growth over the years with considerable trading since 1970. Market regulators have continued to make the regulatory framework flexible and innovative to promote capital formation, diversify investor base, and introduce new investment instruments. They have also taken steps as part of a long-term strategic plan to deepen the market by expanding the number of listed companies and deepen investors base by gradually opening up the market to foreign investors. All these ongoing efforts have brought not only soundness and stability to the market but also a broader international recognition.

The Saudi stock market is by far the largest among the Gulf Cooperation Council (GCC) countries. As of 31 December 2014, *Tadawul All Share Index* (TASI) consisted of 169 listed companies that are classified into fifteen sectors (**Table 6.1**).

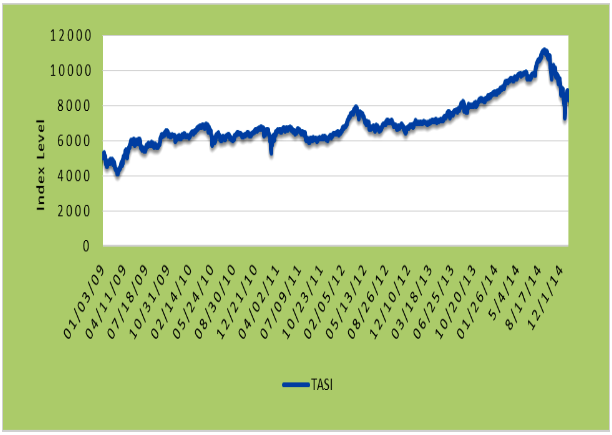
Despite the recent drop in TASI due to the fall in oil prices which was followed by a quick partial recovery, TASI has been, in general, trending upward in the share prices since 2009 (Chart 6.1). In 2014, TASI closed at 8,333.30 points compared to 8,535.6 points a year earlier, showing a decrease of 2.4 percent in the total market capitalization. Retail recorded

Table 6.1: Stock Market Capitalization (Billion SAR

Sector	Number of Firms	2013	2014	Y-to-Y Change (%)
Banks & Financial Services	12	380.04	513.82	35.20
Petrochemical Industries	14	554.65	423.28	-23.68
Cement	14	90.93	90.81	-0.13
Retail	14	50.10	75.99	51.68
Energy & Utilities	2	62.62	64.52	3.04
Agriculture & Food Indust.	16	93.97	122.68	30.55
Telecom. & Information Tech	5	187.58	175.73	-6.31
Insurance	35	36.85	39.77	7.91
Multi-Investment	7	97.48	73.58	-24.52
Industrial Investment	14	55.45	57.52	3.73
Building & Construction	17	27.59	27.89	1.10
Real Estate Development	8	78.60	99.22	26.24
Transport	4	15.09	19.83	31.44
Media & Publishing	3	4.79	3.81	-20.53
Hotel & Tourism	4	17.12	24.43	42.72
Total	**169**	**1,752.86**	**1,812.89**	**3.43**

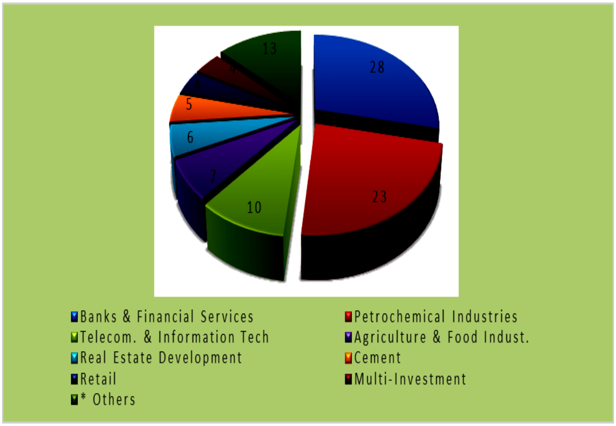
Source: Tadawul

Chart: 6.1 Tadawul All Share Price Index



Source: Tadawul

Chart 6.2: Sector-Wise Distribution of Market Capitalization- 2014



Source: Tadawul

* Others include Energy and Utility, Industrial Investment, Insurance, Building and Construction, Hotel, Transport, and Media.

the highest capitalization gain of 51.6 percent over the previous year followed by Hotel & Tourism (42.7 percent Y-to-Y change) and Banking & Financial Services (35.2 percent Y-to-Y change).

6.1.1. Market Concentration

The Saudi stock market witnessed a rapid expansion in recent years in terms of both the number of listed companies and the coverage of various economic sectors. While the number of companies more than doubled to 169 in December 2014 from 70 in February 2004, the classification of sectors increased from 8 to 15. This was the outcome of efforts by the market regulator to deepen, diversify, and more accurately represent the market in an attempt to reduce its volatility and promote stability.

The market, however, remains concentrated and largely dependent on the two largest sectors: Banking & Financial Services and Petrochemical. These two sectors collectively accounted for 51.6 percent of total market capitalization in 2014 (**Chart 6.2**). Hence, there is a case for reinforcing initiatives aimed at promoting public capital formation, and improving/ expanding corporate ownership structures to reduce market concentration and improve market index representation. Market regulators also need to implement initiatives intended to enhance the scale of institutional investment as individual investors remained the key players in the Saudi stock market with a trade share of 86.9 percent in 2014, followed by institutional investors (11.8 percent), and foreigners (1.2 percent)[14].

6.1.2. Market Openness

The gradual opening of the market to foreign investors has been helping in limiting the volatility that would result from a sudden large scale entrance of foreign investors to the market. In an attempt to deepen the market, regulators have implemented a number of supportive measures in the past to gradually open it up to foreign investors. Indirect foreign investment was allowed through mutual funds in 1999, and foreign resident investors were granted direct access

CMA is working on a new and more accurate classification of the type of investors.

to the Saudi capital market in 2006. A year later, the GCC residents were also granted direct access to the Saudi capital market. In 2008, Non-resident foreign investors were also allowed to indirectly access the Saudi market through Saudi Equity Swap (SES) agreements. In 2010, Exchange-Traded Funds (ETF) were launched to allow non-resident foreign investors to directly invest in them. The Saudi government has recently taken another policy decision that will allow certain qualified foreign institutional investors (QFIs) to directly invest in the Saudi stock market in 2015. This expected further opening of the market to QFIs in the second half of 2015 will further promote stability as these are qualified investors that can add to the level of maturity and sophistication in the market.

6.2. Market Regulations and Surveillance

The capital market regulator has continued issuing and amending rules and regulations to create investment-conductive environment that supports investor confidence and protection. Recently, the Qualified Foreign Investor (QFIs) regulation has been issued, and Credit Rating Agencies Regulations will be effective on September 2015. On the other hand, Special Purpose Entities Regulations is under drafting, and Investment Funds and Authorized Persons Regulations are under revision.

The Capital market regulator continues strengthening its supervisory and surveillance efforts by enhancing its close monitoring of all trading transactions and actions to ensure compliance of market participants with the Capital Market Law (CML) and it's implementing Regulations. The market in general witnessed contraction in the number of violations related to manipulation and misleading of information, as well as violation related to insider trading and conducting of securities business without a license. **Risks of market manipulations have been decreasing since 2008.** In 2014, the number of filed investigation cases into violations of manipulations and misleading information was 14 cases compared to 48 cases in 2008. This is a result of the continued improvements in market regulations and surveillance. Although the year of 2014 recorded a noticeable increase in the total number of filed violations, most of these filed cases were mainly due to the rise in violations related to disclosure requirements (46.0 percent) that most listed companies are not familiar with, followed by violation related to investment/ real estate funds regulations (13.6 percent), and authorized Persons regulations (11.7 percent). It is worth mentioning, however, that this increase in violations can be justified by two key factors: improved violations-detecting surveillance system, and growing market size.

6.2.1 Prudential Rules

Given their strong and robust performance, Authorized Persons (APs) continue to grow in size. Their total paid-up capital increased to SAR 15.9 billion in 2014 from SAR 15.6 billion in the previous year representing a 1.6 percent growth. They generated a net profit of SAR 3.0 billion in 2014, growing by 29.4 percent from the previous year.

APs maintain adequate financial resources as their prudential measures exceed the Basel requirements. Their average Capital Adequacy Ratio (CAR) in 2014 was 29.1 percent. In addition, their average capital base for the same year was SAR 18,197 million, which is 2.4 times its minimum capital requirement.

6.3. Market Resilience

6.3.1. Profitability

Although the overall profitability of the Saudi stock market slightly decreased in 2014 relative to the previous year (Table 6.2), the market continued to perform well. On a sector-wise basis, the health of the Insurance sector continues to improve. The sector recorded the largest increase in both return on assets (ROA) and return on equity (ROE). On the other hand, Telecommunication and Information Technology sector recorded the largest decline. Banks & financial services,

Table 6.2: Sector-Wise Profitability Indicator

	ROE		ROA	
Sector	**2013**	**2014**	**2013**	**2014**
Banks & Financial Services	14.04	14.70	2.08	2.05
Petrochemical Industries	13.13	12.60	4.97	4.80
Cement	19.36	19.77	14.91	15.02
Retail	25.36	27.10	14.24	14.35
Energy & Utilities	5.89	6.77	1.31	1.38
Agriculture & Food Industries	17.36	16.92	7.48	7.63
Telecom. & Information Tech	16.51	4.55	8.13	2.09
Insurance	-13.76	5.03	-11.94	3.99
Multi-Investment	2.44	3.82	1.52	2.36
Industrial Investment	9.28	9.20	3.98	3.67
Building & Construction	10.12	5.34	3.24	1.83
Real Estate Development	4.19	6.22	2.91	4.21
Transport	13.09	9.48	6.87	4.95
Media & Publishing	-1.52	-3.82	-0.58	-1.41
Hotel & Tourism	20.46	31.16	14.45	17.04
Overall	**12.73**	**12.37**	**3.32**	**3.07**

Source: Tadawul, Bloomberg, and SAMA staff calculations

Petrochemical, as Leading sectors continued to perform well. The market Price-Earnings (P/E) ratio remained within the normal range of 15-25 percent over the years with the exception of the period before the 2006 crash (**Chart 6.3**).

6.3.2. Corporate Leverage

Most corporate sector entities listed on the stock exchange remained less reliant on borrowing. Although the overall debt-to-assets ratio slightly increased by 1.16 percent to become 28.53 percent in 2014, the ratio remained well below the 50.0 percent mark. Banks continued to rely more on deposits and hence ended up with the lowest debt-to-asset ratio of

Chart 6.3 :Price-Earnings Ratio

Source: Tadawul

4.54 percent. Conversely, Energy & Utilities sector showed the highest level of leveraging as its debt was equivalent to 43.91 percent of its total assets (**Table 6.3**).

Most of the sectors preferred to borrow long-term. Their respective short-term debt-to-total debt ratios remained well below the 50.0 percent mark in 2014 (**Table 6.4**). Their combined short-term debt relative to total debt stood at 12.37 percent. They also preferred to maintain cash balances at levels high enough to effectively meet short-term financial obligations. Most sectors have cash-to-short-term debt ratios well above the 100 percent mark. Even sectors with relatively high short-term debt (e.g., Hotel and Tourism) covered their positions by large cash holdings. All sectors' combined cash holdings relative to their combined short-term debt stood at a significantly high level of 192.65 percent.

In short, most corporate sector entities have shown a great deal of risk aversion as indicated by their current levels of leveraging and liquidity holdings. They seem well-placed against adverse economic developments on account of relatively small holdings of short-term debt along with liquidity holdings large enough to clear their short-term debt obligations.

Table 6.3: Sector-Wise Leverage indicators

	Total Debt/Total assets (%)		Y-O-Y Change (%)	Short-Term Debt/ Total Debt (%)		Y-O-Y Change (%)
Sector	**2013**	**2014**		**2013**	**2014**	
Banks & Financial Services	5.03	4.54	-9.74	86.37	81.11	-6.09
Petrochemical Industries	34.24	32.13	-6.16	15.50	10.19	-34.27
Cement	13.89	12.29	-11.52	39.40	50.12	27.20
Retail	17.04	18.22	6.92	30.81	52.19	69.37
Energy & Utilities	42.15	43.91	4.18	1.26	6.29	398.15
Agriculture & Food Industries	29.99	29.67	-1.07	41.45	38.24	-7.74
Telecom. & Information Tech.	19.45	18.29	-5.96	19.35	11.35	-41.34
Insurance	0.00	0.00	0.00	0.00	0.00	0.00
Multi-Investment	20.12	20.78	3.28	12.84	6.15	-52.08
Industrial Investment	30.37	31.75	4.54	4.38	4.70	7.25
Building & Construction	36.42	34.74	-4.61	78.31	80.88	3.28
Real Estate Development	24.1	26.39	9.50	4.02	6.78	68.78
Transport	33.7	34.28	1.72	14.36	18.79	30.87
Media & Publishing	25.87	28.1	8.62	45.70	52.36	14.58
Hotel & Tourism	1.85	9.48	412.43	48.94	95.93	96.03
Overall	**28.21**	**28.53**	**1.16**	**12.04**	**12.37**	**2.73**

Source: Tadawul, Bloomberg, and SAMA's staff calculations

Table 6.4: Sector-Wise, Short-Term Liquidity Coverag

	Cash to Total Assets (%)		Y-O-Y Change (%)	Cash to Short-Term Debt (%)		Y-O-Y Change (%)
Sector	**2013**	**2014**		**2013**	**2014**	
Banks & Financial Services	11.85	10.56	-10.89	295.45	290.39	-1.71
Petrochemical Industries	12.97	11.53	-11.10	231.91	399.21	72.14
Cement	8.9	5.35	-39.89	143.42	74.10	-48.33
Retail	7.83	4.38	-44.06	94.22	330.13	250.40
Energy & Utilities	1.21	1.49	23.14	207.87	45.29	-78.21
Agriculture & Food Industries	8.95	10	11.73	25.60	47.08	83.91
Telecom. & Information Tech.	3.17	2.4	-24.29	79.17	112.84	42.54
Insurance	34.4	38.82	12.85	0.00	0.00	0.00
Multi-Investment	4.87	3.84	-21.15	64.69	144.49	123.35
Industrial Investment	8.98	6.11	-31.96	533.27	285.77	-46.41
Building & Construction	5.31	5.28	-0.56	12.18	119.66	882.69
Real Estate Development	10.54	7.28	-30.93	877.75	331.23	-62.26
Transport	3.23	7.51	132.51	26.76	28.21	5.43
Media & Publishing	2.65	3.02	13.96	216.57	195.83	-9.58
Hotel & Tourism	19.92	34.39	72.64	5562.84	415.46	-92.53
Overall	**7.24**	**6.80**	**-6.12**	**213.25**	**192.65**	**-9.66**

Source: Tadawul, Bloomberg, and SAMA's staff calculations

7. Payment Systems: Recent Initiatives

SAMA is one of the key institutions that have continued to contribute to the efficiency and safety of the financial market infrastructure to strengthen the Saudi financial system. SAMA with the cooperation and support of the commercial banks and other government agencies has developed a number of payment and settlement systems such as Saudi Arabian Riyal Interbank Express (SARIE) system, and SADAD Payment System (SADAD) to facilitate economic development and promote financial stability in Saudi Arabia.

7.1. Profile of SARIE System

The SARIE system is the mainstay of the Saudi payments infrastructure. It is fully owned and operated by SAMA since May 1997. There are now 23 participants in the SARIE system including SAMA and 22 commercial banks. SARIE essentially provides a platform that links all Saudi commercial banks enabling them to settle payments in Saudi Riyals. In doing so, SARIE provides a platform for new, interbank payment streams, supporting new (financial) product development and supporting the goal of broadening financial inclusion.

The SARIE system has contributed to the minimization of interbank settlement risk for all SARIE payments in addition to facilitating the development of a wide range of electronic banking systems. SARIE is integrated with other payment systems operating in Saudi Arabia to facilitate payment settlements. It is also used to settle equity and bond transactions traded on the *TADAWUL Stock Exchange*. Transactions through SARIE have shown exponential growth over the years as they rose to over 64 Million transactions with a total value of SAR 54 trillion in 2014 from 5.2 million transactions with a total value of SAR 5.2 trillion in 2000.

The SARIE *Operating Rules and Regulations* (ORR) govern the use and operation of the central system. SARIE is a fully integrated *Real-Time Gross Settlement System* (RTGS) that permits all banks within Saudi Arabia to make immediate interbank money transfers through accounts held at SAMA. Commercial banks are connected to the central system through proprietary gateways over a private network. Most banks have automated payment processing systems linked to these gateways. The system is available 24/7 and ensures payment finality and irrevocability. Payments are settled in real time provided that senders hold sufficient liquidity in their accounts. If required, payments are queued until sufficient liquidity is available. Participants have real-time direct access to their accounts with SAMA, with the ability to monitor their financial positions. The tight linkages to other SAMA head office operating systems permit banks to manage their liquidity and SARIE accounts via sale and repurchase facilities against their government bond and SAMA bill holdings, as well as sales and purchases of foreign currency through SAMA.

SARIE currently combines the functionality of both a high-value and a high-volume system and handles both credit transfers and direct debits. The message types are based on the *Society for Worldwide Interbank Financial Telecommunication* (SWIFT) standards and were upgraded to MT103 format in 2008. SARIE supports both single and bulk transfers, which may be effected on the same-day or up to 14 days forward value basis. The system facilitates interbank and customer payments as well as direct debits, and facilitates the execution of domestic transfers arising from the receipt of international funds transfer instructions.

SARIE utilizes a number of security features to ensure that it operates smoothly, and in a fully

controlled environment. These security features include the use of digital signatures, encrypted communication lines, secure access protocols with contingency provided through dual configuration, and contingency sites. SARIE also provides a rigorous and comprehensive mechanism for controlling risks. Intraday overdraft limits are prescribed to restrict the system's exposure to any one participant. All limits are fully secured by collateral being decided by SAMA. In line with a series of ongoing upgrades to the system and in response to the market feedback, a number of technical and platform enhancements were recently introduced General system performance was also enhanced and a number of workstation improvements were also made.

The *Collateral Policy and Covering Procedures* govern the provision of intra-day debit limits, overnight covering and collateral requirements. This new policy apparatus has replaced the old SARIE Collateral Policy and Limits put in place in 1997 and the Debit Balances on Participant's Account policy statement (issued in 1988). SAMA has also combined the policy for overnight covering (not previously documented in any policy) with the more comprehensive and updated Intra-day Limits policy. The major changes from the old policy are: introduction of a Minimum Limit of SAR 50 million; and changes in the list of Eligible Collaterals.

SAMA is responsible for maintaining information secrecy and security, and for providing protection against various IT risks. To this end, SAMA has also adopted a number of international standards for IT Security (e.g., *ISO 27001 standard*). SAMA has also developed security rules for banking transactions as well as instituting E-Banking Rules in April 2011, and updating rules to ensure effective operational risk management. These rules and regulations are guiding principles for audit and follow-up in information security of the Saudi banking sector. Moreover, all banks that provide Internet banking services have taken a number of measures to combat phishing and block publishing sites. These measures include building an IT early warning system, a 24/7 monitoring of suspicious sites, adhering to identity verification standards (*Two-Factor Authentication (TFA) standards*), and promoting employees and clients awareness of phishing risks.

7.2. Development of Low-Value ACH

In 2009, SAMA undertook a comprehensive review of the national payments environment and developed the Integrated Payments Systems Strategy (IPSS) in Saudi Arabia, that articulated the vision of the payment ecosystem in 2020. One of the key strategic pillars envisioned was the development of an *Automated Clearing House* (ACH) to complement SARIE as a low-value payment system for Saudi Arabia and also support other initiatives such as Mobile Payments. Significant progress has been made on a number of pillars intended to focus on various initiatives around SARIE, SPAN, and SADAD. SAMA is currently in the design phase of the ACH project with implementation scheduled over the next few years.

Despite the significant and swift progress made in moving payments into the financial sphere through four existing electronic payment channels, a recent survey conducted by SAMA indicated that only 41 percent of payment values were conducted electronically. While Saudi Arabia has been successful in making high-value payments migrate to electronic channels, low-value transactions that constitute the majority of payments volume remain largely cash-based with cash payments constituting 84 percent of payments volume.

The introduction of a future-ready ACH will facilitate low-value/high volume payments to be made electronically and hence increase the scope of the electronic (less-cash) payment ecosystem in the years to come. The ACH will provide direct access to corporates, and enable users to have multi-currency handling capability and process international transfers. It will support real-time processing and offer two settlement windows per day. The system will operate for extended hours, adopt the *ISO 20022 message standard* and enable *Straight-Through-Processing* (STP) for businesses. Value-added service features will include a central Profile database, beneficiary verification and account validation, fraud management and *Counter Terrorism Financing* (CTF) *screening*, an information delivery service, and end-to-end payment tracking among others. In short, once ACH becomes operational, it will enable SARIE to operate as an independent RTGS, increase the overall resilience of the cash-less payment system, reduce reliance on cash, improve efficiency of financial ecosystem and foster economic development.

7.3. Compliance with International Standards

SAMA is currently undertaking an assessment of Observance of the CPMI-IOSCO Principles for Financial Market Infrastructures to ensure compliance with international standards (Box 7.1) and reduce risk. The objective of the assessment is to improve the overall transparency of the *Financial Market Infrastructure* (FMI) and its governance, operations and risk management framework for a broad base of audience that includes current and prospective participants in the FMI and the public. Greater market transparency will enhance the safety and efficiency of arrangements related to payments, clearing, settlements and transaction tracking and hence foster financial stability.

7.4. Refinement of Existing Clearing and Settlement Process

SAMA, CMA and the Capital Market Authority (CMA) and the Stock Exchange (Tadawul) are working jointly to undertake a strategic review of the current Saudi Clearing and Settlement Process (CSP) along with an evaluation of the associated risks. The aim is to increase the safety, soundness and efficiency of the CSP to ensure that it is in line with best practices, and that it lays a solid foundation for the Saudi Arabian Capital Market to grow and expand in accordance with its strategic vision and regional ambitions. The objectives of the CSP review are to:

- **Minimize risks for all stakeholders and participants;**
- **Improve the regulatory framework, as well as regulatory supervision and oversight:** the project assesses the clarity and homogeneity of standards; aims to improve supervisory methods, and empowers the relevant supervisory functions through alignment of clear responsibilities. It also assesses the effectiveness of legal foundations, settlement arrangements, and supervisory gaps;
- **Define market methods and products with respect to future needs:** The CSP must be flexible enough to support innovation in new product development, market methods, technology use and to direct the market towards best practice. The objective, therefore, is to allow participants to develop new financial services and products in line with the strategic vision of the Saudi Capital Market, and improve the responsiveness to local and global trends in product and service innovation;
- **Identify gaps within the current CSP and define an implementation plan that will be in line with international standards and will help achieve the desired results.**

7.5. Promotion of Prepaid Debit Cards

SAMA has established a series of vehicles designed to support simple entry-level account structures with payment capabilities at low cost in order to expand the scope of banking services to the currently unbanked segment of the population. This new approach will generate more payment transactions electronically, and hence facilitate SAMA's pursuit of its key objective of reducing cash in circulation in the Kingdom.

SAMA has developed the regulatory requirements and governance structure necessary for the introduction of pre-paid card based bank accounts, including the *Know Your Customer* (KYC) rules and account opening processes. SAMA has also reviewed the entire value chain of bank accounts and associated payments to ensure that the product offering is secure and reliable and that these services meet the needs of all stakeholders. The prepaid rules were issued in Q2 2012. The associated prepaid pricing scheme was issued in Q4 2013. Virtually all banks in Kingdom are now issuing Prepaid Cards as part of their core banking portfolio. At present, there are over one million prepaid cards in circulation, the majority of which are prepaid payroll cards. The prepaid debit cards work through the SPAN payments infrastructure and serve various groups such as expat workers, tourists, youth, and underserved nationals. These major groups in the Saudi society that were previously under-served or excluded from the banked/financial community. The Prepaid payments suite facilitates better access to banking services for these communities and supports the broader ambitions of less cash and broader financial inclusion, given their large size and contribution to the economy[15].

[15]More than 40.0 percent of population consists of youth under 18, and around 8 million are expatriates. Additionally, more than 2 million pilgrims visit KSA every year. The majority of these groups are unbanked and use cash to carry out transactions.

Box 7.1: Implementation and Monitoring of PFMIs

In April 2012, the Committee on Payment and Market Infrastructures (CPMI) and the International Organization of Securities Commissions (IOSCO) issued the Principles for financial market infrastructures (PFMIs). In line with the G20's expectations, CPMI and IOSCO members committed themselves to adopting 24 principles and 5 responsibilities included in the PFMIs.

The CPMI and IOSCO began the process of monitoring the implementation of the PFMIs as the CPMI-IOSCO Steering Group and established a standing working-level Task Force (TF) to design, organize and carry out the implementation monitoring assessments. The implementation monitoring involved three phases. The first phase was concerned with the assessment of whether jurisdictions have completed the required policy ground work to implement the Principles and Responsibilities. The second phase was intended to assess whether the policy ground work is consistent with the Principles and the Responsibilities. The third phase was intended to assess whether there is consistency in the outcomes of implementation of the Principles and Responsibilities.

The initial Phase 1 assessments (covering 27 jurisdictions) were conducted in mid-2013. The results of the assessments published in August 2013, showed that most jurisdictions had begun the process of implementation, although few had completed the process for all categories of Financial Market Infrastructures (FMIs). This represented substantial progress given the complexity and broad scope of the PFMIs, and the fact that the PFMIs were issued as recently as April 2012.

The first update to the above-mentioned initial Phase 1 assessments was conducted early last year. The results of the assessments were published in May 2014. They reflected the status of jurisdictions' legal, regulatory or policy frameworks as of 11 January 2014. SAMA obtained a rating of 4 (4 being the highest) for its Level 1 assessment as it fully implemented the PFMIs for its FMIs. The second phase assessments started in November 2014. This phase focuses on an assessment and review of the application of the Responsibilities to assess whether relevant authorities' activities in a jurisdiction are consistent with the relevant Responsibilities and whether such authorities observe the Responsibilities in a complete and consistent manner. A report on the results of the assessment covering all jurisdictions is planned for publication in the second half of 2015.