FINANCIAL SERVICES

17.1 INTRODUCTION

During the Eighth Development Plan, performance of the financial services sector was positive, in spite of the repercussions of the global financial crisis, which emerged at the beginning of the fourth quarter of 2008. Intensity of the impact of the crisis varied from country to country. As a result of the efficiency and flexibility of the "pre-emptive and preventive" measures taken, Saudi Arabia was one of the least affected.

The Ninth Development Plan aims at enhancing effectiveness of policies for developing financial services; preventive measures for dealing with repercussions of the global financial crisis; and reinvigorating the developmental role of investment banks, specialized lending institutions, insurance activities, and venture-capital companies.

This chapter addresses the current conditions of the financial services sector; explains relevant developments under the Eighth Development Plan; reviews key issues and challenges that must be addressed under the Ninth Development Plan; and highlights the future vision, objectives, policies and targets for the sector in the Ninth Development Plan.

17.2 CURRENT CONDITIONS

17.2.1 Performance of Commercial Banks

The banking sector performed well over the first four years of the Eighth Development Plan. Its performance indicators over the 2004-2008 period can be summarized as follows (Table17.1):

- The value of investments abroad and foreign assets of commercial banks rose by 65.8% and 66.8%, respectively.
- The capital account achieved significant growth, estimated at about 135.2%, with capital and reserves of banks growing by approximately 152.7% and their cumulative earnings by about 80.1%.

- Claims on the private sector grew by 134%, due to an increase of bank credit to this sector by 135.2%, while investment in private securities grew by 100%. In contrast, receivables from the government sector increased by 37.7%, due to an increase of bank credits to the government sector by 10.3%. In addition, investments in government securities by banks increased by 43.1%.
- The average annual growth rate of the money supply (in its broad definition, M3), decreased slightly, from 18.8% in 2004 to 17.7% in 2008, while the relative contribution of time deposits and savings deposits in the money supply increased from 27.6% to 39.6%, which is a positive saving and investment indicator.

Table 17.1
Monetary and Banking Indicators
Eighth Development Plan(*)

(SR billion)(**)

Indicator	2004	2008
1. Total foreign assets and investments abroad:	**131.7**	**218.8**
- Foreign assets of commercial banks	92.8	153.9
- Investments abroad by commercial banks	38.9	64.9
2. Capital account:	**68.8**	**161.8**
- Capital and reserves of banks	52.2	131.9
- Cumulative profits	16.6	29.9
3.Banks claims on private sector:	**313.9**	**734.6**
- Credit to private sector	303.0	712.8
- Investment in private securities	10.9	21.8
4. Banks claims on government sector:	**175.8**	**242.0**
- Credit to government sector	29.1	32.0
- Investment in government securities	146.7	210.0
* Treasury Bills	0.3	119.2
* Development Bonds	146.4	90.7
5. Consumer loans	**115.3**	**174.0**
6. Credit-card loans	**3.3**	**9.5**
7. Growth rate of money supply (M3) (%)	**18.8**	**17.7**
8. Relative contributions of M3 (%):	**100**	**100**
- Currency in circulation outside banks	12.1	8.9
- Demand deposits	42.6	36.9
- Time deposits and savings deposits	27.6	39.6
- Cash-equivalent deposits,	17.7	14.6

(*) Up to the end of the fourth year of the Eighth Development Plan.
(**) Values are rounded to nearest decimal.
Source: Saudi Arabian Monetary Agency.

17.2.2 Banking Sector and the Global Financial Crisis

The global financial crisis was triggered by the American banking sector, specifically the bankruptcy of Lehman Brothers. Collapse of some banks in the United States and Europe followed. Aware of the seriousness of the crisis, for the banking sector in particular, the Saudi Arabian Monetary Agency (SAMA) initiated a comprehensive set of preemptive measures, aimed at enhancing domestic liquidity, easing pressure on commercial banks and increasing their ability to lend, and calming all those, who deal with the banking sector. The most significant of these measures were:

a. Introducing more than one cut of the interest rate on lending by SAMA to banks (repo), reducing it from 5.5% in mid-2008 to 2% in April 2009.
b. Introducing a similar reduction of the reverse repurchase rate (reverse repo), which is the rate paid by SAMA for deposits from commercial banks, decreasing it from 2% to 0.5% over the same period.
c. Reducing the reserve requirement ratio on demand deposits from 13% to 7% over the same period, in an effort to increase domestic liquidity and improve the lending ability of banks.
d. Providing foreign-currency liquidity to the banks by injecting the equivalent of about SR11.5 billion; which boosted domestic liquidity and supported the lending ability of banks.
e. Conducting a comprehensive review of the credit risk departments of branches of foreign banks operating in the Kingdom, to ensure compliance with Basel 2, in addition to intensifying control and supervision of Saudi banks.

Generally, available indicators confirm the solidity of the financial position of Saudi banks, even in the worst stages of the global financial crisis. The most important of such indicators are:

- Rise of capital adequacy ratio of Saudi banks to 21.9% in 2008 using the Basel 2 standard, which specifies a minimum of 12%.
- Increase of total assets of banks from 2004 to 2008 by 98.7%; from SR655.4 billion to about SR1,302.3 billion.

- Increase of the capital account balance (reserves + capital + accumulated profits) from 2004 to 2008 by about 135.2%; from SR68.8 billion to about SR161.8 billion.

17.2.3 Development of Stock Market Performance

As shown in Table 17.2, the Saudi stock market experienced unusual developments over the 2004–2008 period. These may be summarized in the following:

- The general share price index experienced sharp fluctuations, resulting in unjustified rises in the prices of numerous stocks, which ultimately led to strong correction through a wave of sharp declines that took the index down by about 52.5% during 2006.
- In 2007, there was relative improvement in stock market indices. The general share price index rose by about 39.1% and the market value of shares increased by approximately 58.8%. The market then remained stable until the last quarter of 2008; specifically, until the outbreak of the global financial crisis in October 2008, when the share price index fell sharply by about 56.5% by the end of 2008.

Table 17.2
Saudi Stock Market Indicators
Eighth Development Plan(*)

Year	Number of Companies	Number of Traded Shares (million)	Value of Traded Shares (SR billion)	Market Value of Shares (SR billion)	General Share Price Index 1999 = 100	Share Turnover Ratio of Shares
2004	73	10298	1773.9	1149	8206.2	154.4
2005	77	12281	4138.7	2438	16712.6	169.8
2006	86	68515(**)	5261.9	1226	7933.3	429.2
2007	111	57829	2557.7	1946	11038.7	131.4
2008	127	58727	1962.9	924	4802.9	212.3

(*) Up to the end of the fourth year of the Eighth Development Plan.
(**) Data modified to exclude impact of splitting the nominal value of shares of listed companies to become 10 Riyals per share instead of 50.
Source: Saudi Arabian Monetary Agency.

The most important factors that contributed to the decline of the Saudi stock market since the crisis are the following:

- Decline of most global financial market indicators after the crisis; spread of rumours and concerns among traders, due to lack of clarity over possible developments; and doubts about the extent of effectiveness of government intervention around the world in mitigating the negative impacts of the crisis; i.e., the crisis created an overwhelming state of doubt and uncertainty.
- Decline of international oil prices following the crisis, due to the expected decline in the global demand for commodities and the possibility of a global recession.
- Lack of commitment to transparency by some international companies and financial institutions in disclosing their financial and credit positions following the crisis, and the worsening situation following successive bankruptcies of several such companies and institutions.
- Many banks liquidated portfolios of clients, especially after devaluation of their shares in the stock market, provoking a state of uncertainty for dealers in the stock market.

The Saudi Capital Market Authority took a number of important measures to address the repercussions of the global crisis, including:

- Disclosing the largest shareholders, in order to establish the principle of transparency.
- Changing the unit price of shares, in order to improve market performance.
- Opening the market to foreign investors, on condition that their transactions be carried out through licensed brokerage firms.
- Allowing exchange agreements to transfer economic benefits of the shares of companies listed in the stock market to brokerage firms, in accordance with specific controls.

17.2.4 Investment Funds

As shown in Table 17.3, investment funds performed well during the period 2004–2008, with an increase in the number of funds, the value of local investments, total assets, and number of subscribers. However, due to the uncertainty created by the global financial crisis and its negative impact on the stock market, there was a significant decline in the performance indicators of the funds during the last quarter of 2008, compared with the previous year, as follows:

- Total assets declined by the end of 2008 by 28.7%.
- The values of both domestic and foreign investments declined by the end of 2008 by 23.3% and 46%, respectively.
- The number of subscribers to the funds declined by the end of 2008 by 12%.

Table 17.3
Main Indicators for Investment Funds
Eighth Development Plan(*)

(SR billion) (**)

Year	Number of Operating Funds	Value of Domestic Investment	Value of Foreign Investments	Total Funds' Assets	Number of Subscribers (Thousand)
2004	188	44.5	15.8	60.3	198.4
2005	199	115.7	21.3	137.0	568.3
2006	214	61.3	22.8	84.1	500.0
2007	252	79.9	25.2	105.1	426.1
2008	262	61.3	13.6	74.9	375.0

(*) Up to the end of the fourth year of the Eighth Development Plan.
(**) Values are rounded to nearest decimal.
Source: Saudi Arabian Monetary Agency.

17.2.5 Development of Activity of Specialized Lending Institutions

The data in Table 17.4 show the development of funding provided by specialized lending institutions and credit funds over the period 2004–2008. The following facts are noteworthy:

- The total value of loans actually disbursed increased to SR30.6 billion in 2008; an increase of about 456.4% compared with 2004, which reflects the growing demand for loans from these institutions.

- The volume of outstanding loans owed to specialized lending institutions rose from SR119.1 billion to about SR155.2 billion during the period; a total increase of 30.3%. These indicators reflect a slowdown in collection of outstanding loans and the fact that repaid loans are inadequate for covering new loans, with total collection declining by about 34.4% in 2008, compared with 2004.

- Performance of specialized lending institutions is no longer tied to success in being self-financing, i.e., balancing as far as possible the volume of actual disbursements of new loans with the volume of collected past loans. This is attributable to the growing demand for loans by individuals and the private sector, which led actual loan disbursements to grow by 456.4% in 2008, compared with 2004.

Table 17.4
Performance of Specialized Lending Institutions
Eighth Development Plan*

(SR billion)**

	2004	2008	Change %
Total outstanding loans	119.1	155.2	30.3
Total collected	16.3	10.7	(34.4)
Actual outgoings	5.5	30.6	456.4

* Up to the end of the fourth year of the Eighth Development Plan

** Values are rounded to nearest decimal. Percentages in parentheses indicate negative values.

Source: Saudi Arabian Monetary Agency

The "expansionary fiscal policy" played a crucial role in enabling the specialized lending institutions to double their funding abilities by increasing their capital as follows:

a. Increasing the capital of the Industrial Development Fund by SR13 billion, bringing it to about SR20 billion in 2006, which led to actual disbursements increasing in 2006 by 36.9%, compared with 2005.

b. Increasing the capital of the Real Estate Development Fund by SR43 billion, which led to actual disbursements increasing in 2006 by 57.6%, compared with 2005.

c. Increasing the capital of the Public Investment Fund by SR20 billion in 2006, which led to actual disbursements increasing by 288.9% in 2007, compared with 2006.

d. Increasing the capital of Saudi Credit and Saving Bank by SR5 billion in 2008, in addition to supporting it by a deposit of SR10 billion, in order to help it continue providing several types of soft loans to low-income individuals including: social loans, vocational loans, car-purchase loans, as well as enabling the Bank to support SMEs.

17.2.6 Insurance Market

The Kingdom is the largest insurance market in the GCC. The insurance industry covers several areas, including vehicles, health, fire, engineering, and aviation.

The system established by the Cooperative Insurance Companies Control Act in 2004 was an important step towards strengthening the insurance network and insurance services. This system covered three key elements: the legal framework, including the governing (executive) body that undertakes application of the system; control and supervision of the sector; and the dispute resolution mechanism.

Over the 2004–2008 period, there was substantial activity in the insurance market, evidenced by the rapid expansion, intensification and deepening of the market. In 2004, there was only one insurance company, but by the first half of 2008, the Council of Ministers had approved the licensing of 22 insurance companies. By the end of 2008, other positive indicators emerged, as follows:

- The insurance market grew significantly in 2008; by about 27%, while total insurance premiums paid were about SR10.9 billion, compared with about SR8.6 billion in the previous year.
- Total health insurance premiums increased by 55% to approximately SR4.8 billion, compared with SR3.1 billion a

year earlier.

- Demand for general and health insurance rose in 2008 by 6% and 75%, respectively, compared with the previous year.
- The depth of the insurance market rose to 0.62% in 2008, compared with 0.53% in the previous year. The depth of an insurance market is the ratio of total subscribed insurance premiums to GDP.
- Density of the insurance market (per capita spending on insurance) rose to SR440, compared with SR358 in the previous year.

It is worth noting that by the end of the first quarter of 2009, the Council of Ministers approved the establishment of 29 insurance and reinsurance companies. These companies were provided licenses to begin their operation.

17.2.7 Islamic Banking and Sukuk (Bonds)

Islamic Banking and sukuk are promising for financial services development in the Kingdom. Available data indicate that until 2007, Sukuk issued in Saudi Arabia totalled SR11.6 billion in value. In addition to the Islamic windows in conventional banks, there are 4 Islamic banks in the Kingdom. According to a report issued by the World Islamic Banking Conference on competitiveness of Islamic banks, the Kingdom ranks first, as measured by the earnings of Islamic banks over the period 2000–2006. In addition, Islamic banks developed their investment policies to cover several areas of production and services, and they adopted innovative banking methods, such as "lease-purchase."

Notably, due to the controls adhered to by Islamic banks in their investment policies, Islamic banking and securities did not suffer from the repercussions of the global financial crisis and were not affected by the bottlenecks caused by the subprime mortgage crisis in the United States of America. This reinforces the importance of Islamic banking and instruments in the development of finance in the coming period.

It is also worth noting that the Saudi Capital Market Authority approved in 2009 establishing a capital market for trading Islamic securities in the Kingdom, and the Saudi stock Market Company (Tadawul) started taking measures and adopting implementation mechanisms, in order to activate the Islamic sukuk market.

17.3 ISSUES AND CHALLENGES

17.3.1 Global Financial Crisis

The impact of the global financial crisis on the economies of developing countries varied depending on several criteria, including the degree of economic openness, the level of integration of national financial institutions with global financial institutions, and the degree of linkage of the national financial market with global financial markets. The regulatory and control role of the state in addressing distortions of market mechanisms as they arise, before they develop into a crisis, is certainly important. Nonetheless, undertaking this role requires identification of financial health indicators that reflect the ability of the national economy to absorb and address financial crises. Such indicators fall into two main groups, namely:

- Banking sector risk indicators, such as: capital adequacy, asset quality, profitability and yield, and vulnerability to market risks.
- Risk indicators for financial institutions, the household sector, market liquidity, and real estate markets.

17.3.2 Developmental Role of Investment Banks

Council of Ministers Resolution No. 72 of 2007 stipulated reinforcement of the developmental role of the banking sector, by developing policies and mechanisms to provide the financing requirements of the production sectors that are capable of diversifying the economic base. Implementation of this resolution requires analysis of the current conditions and trends of bank credit. Such an analysis points to diminution of the relative importance of medium and long-term bank credit, compared with a steady increase in the relative importance of short-term bank credit, not to mention expansion of consumer loans and credit-card loans; all of which may limit ability of the banks to meet the growing demand for long-term business loans.

Hence, expansion of investment banks is a more effective solution to the problem of medium-and long-term credit. Investment banks are financial institutions specialized in granting medium-and long-term financing, relying on their relatively stable resources derived from their capital and medium-and long-term deposits, in addition to issuing bonds and long-term borrowing, i.e., the primary goal of such banks is to finance medium-and long-term investments.

17.3.3 Developmental Role of Islamic Sukuk

Within the context of the current conditions of the financial services sector, the indicators related to Islamic sukuk are positive. However, these securities still face some regulatory and technical obstacles that need to be addressed, by focusing on three major areas:

- Developing new regulations to offer Islamic securities and list them in the financial market, with emphasis on facilitating procedures and benefiting from international experiences in this area.
- Establishing a secondary market for trading in Islamic sukuk in the Kingdom.
- Developing legislation to control offering, listing and trading Islamic sukuk.

17.3.4 Scarcity of Venture-Capital Companies

Activities of venture capital companies vary. However, their dominant common characteristics are high-risk component, terms of financing and pursuit of high rates of profit. This is usually done either through financing projects that face difficulties in borrowing from banks, due to their inability to provide sufficient guarantees, or through purchasing troubled projects or projects suffering accumulated debts and weakened repayment capacity, for which the venture capital company would undertake to develop and implement effective rescue programmes. Thus, venture capital companies contribute effectively to financing and managing high-risk investments. Other non-traditional examples of financing carried out by venture capital companies are lease financing and future sales financing.

The Ninth Development Plan aims to incentivise partnerships between private national and foreign-direct investors to establish venture capital companies and remove the regulatory obstacles that limit their contribution to the development of financial services in the Kingdom. Technological business incubators provide the optimal environment for formation and success of venture capital companies, where capital is invested in converting ideas and new industrial innovations to goods and products that serve both domestic and foreign markets.

17.3.5 Specialized Lending Institutions

As a result of steady increases, demand for loans from the specialized lending institutions far exceeded the volume of collected loans. This, as explained previously, led the State to increase the capital of these institutions during 2006–2007. Based on the following considerations, forecasts indicate future demand for loans beyond the current capabilities of these institutions:

- Growing demand for loans from the Industrial Development Fund by national and foreign investors, due to the significant improvement of the investment environment in the Kingdom.
- The initiative announced by the Industrial Development Fund in March 2009 to raise guarantees (Kafalah Programme) for loans extended by domestic banks to SMEs from 50% to 75% of the value of the loan, and raise the upper limit of the value of the guarantee from SR1.0 million to SR1.5 million.
- Initiation of implementing the national strategy for industry, which will result in increased demand for the financial services of the Industrial Development Fund.
- Increased demand for loans from the Real Estate Development Fund, as a result of population increase and in the light of the

trend, encouraged by the State, towards increasing house ownership rates.

- Increased demand for the social and vocational loans offered by the Saudi Credit and Saving Bank.
- The need to increase the resources of the Public Investment Fund to enhance its contribution to major development projects.

17.4 DEVELOPMENT STRATEGY

17.4.1 Future Vision

Enhancing the capabilities and own resources of the financial services sector, to achieve the greatest possible degree of horizontal and vertical expansion of these services, with emphasis on improving their quality and competitiveness, increasing their relative contribution to GDP, and reinforcing their developmental role. This is to be achieved through the mobilization of savings, providing the necessary funding to advance various economic activities, and ensuring the presence of an efficient banking system, well-developed financial markets and comprehensive competitive insurance services, thereby contributing effectively to improving the performance of the private sector and the national economy as a whole.

17.4.2 Objectives

- Achieving financial and economic stability and enhancing the investment climate, which would reflect positively on the performance of the national economy and its various sectors.
- Providing funding for various economic activities, especially small and medium enterprises (SMEs).
- Improving performance of the private sector, increasing and diversifying sources of income, providing more job opportunities for nationals, raising living standards and improving the quality of life.

- Enhancing the efficiency and effectiveness of the banking system, developing the financial markets, reinforcing the developmental role of the specialized lending institutions and insurance services, and improving their quality and ability to compete.

17.4.3 Policies

- Promoting "preventive measures" to deal with the repercussions of the global financial crisis, through fiscal and monetary policy tools that would support domestic liquidity and stimulate the ability of banks to lend, with emphasis on the commitment to transparency; and establishing an early warning system for financial crises.
- Persisting with the regulatory and control role of the state, while enhancing the measures for promoting the stock market and improving performance of the investment funds and raising investment awareness among citizens.
- Enhancing the developmental role of banks, through establishing more investment banks, and increasing the relative weight of long-term loans, in order to meet the needs of the activities that would contribute most to diversification of the economic base.
- Increasing the developmental role of Islamic sukuk and insurance activities, and stimulating national and foreign private investment to establish more venture capital companies.
- Continuing to support the capital of specialized lending institutions, in line with the steady increase in demand for their loans, to expand their contribution to the developmental role of the private sector, and to raising living standards and improving the quality of life for citizens.
- Expanding the technical assistance and advice provided by the Industrial Development Fund, especially to SMEs.

- Continuing the efforts to coordinate monetary and fiscal policies in the GCC countries to promote integration of financial services, and intensifying efforts by the Kingdom to contribute to the development of a new global financial system, through its membership of the Global Financial Stability Council.
- Continuing the efforts of the Saudi Arabian Monetary Agency to develop the financial system of the Kingdom, strengthen the banking system, while emphasising supervision and control over the activities of commercial banks.

17.4.4 Targets

- Achieving an average annual growth rate of about 7.6% in the financial services sector over the period of the Plan.
- Increasing the total value of loans provided by specialized lending institutions (excluding the Public Investment Fund) to about SR142.7 billion over the period of the Plan.
- Developing an early warning system for financial crises, supported by specific indicators, to monitor the financial security of the Saudi economy and its financial institutions.