

# KSA BANKING SECTOR

## Time to bank on economic recovery!

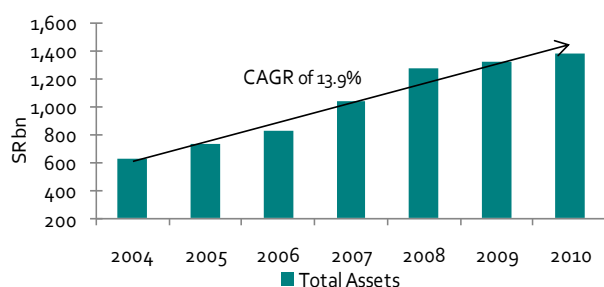
### 1. Poised for growth in short to medium term

Rising oil prices and the concurrent economic boom in Saudi Arabia during 2002–2008 benefitted the Kingdom's banking sector. Consequently, bank assets and credits increased at a compounded annual growth rate (CAGR) of about 17% and 23%, respectively, during this period.

The financial turmoil of 2008, however, hurt regional confidence and raised doubts about the strength and quality of Saudi banks. Uncertainty increased after two of the country's largest family holdings, the Saad and Al Gosaibi Groups, defaulted on debt repayments estimated at around USD 22 billion. This decelerated the pace of growth in assets, credits and deposits by 2009. Nevertheless, KSA's banking sector managed to emerge from the financial crisis relatively unscathed compared to its western counterparts due to its limited exposure to global financial markets and stringent credit regulations.

The overall economic recovery since 2010 and rising oil prices increased confidence. Consequently, the total assets of commercial banks in KSA increased 4.3% year-on-year (yoy). Bank deposits expanded 4.0% yoy in 2010 due to strong liquidity and translated into a loans-to-deposits ratio of 73.9%, while capital and reserves held by commercial banks increased 8.8% yoy during the same period. The graphs below show increase in total assets and growth in total deposits of KSA banks during 2004-2010.

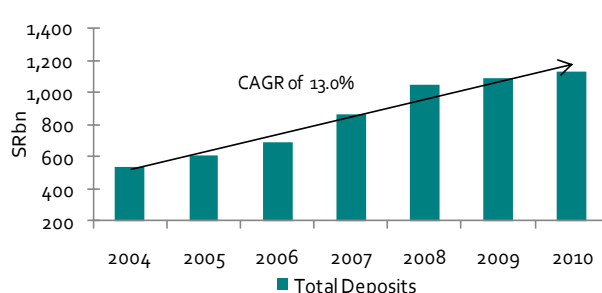
Figure 1. Total assets of Saudi banks



Source: Zawya, SAMA

Note: Total assets include assets of all the 12 banks in KSA.

Figure 2. Total deposits of Saudi banks



Source: Zawya, SAMA

Note: Total deposits include deposits of all the 12 banks in KSA.

Saudi banks sustained the growth momentum in the first quarter (Q1) 2011, as reflected in the increase in assets and deposits. Total bank assets grew 8.5% yoy to SAR1436.9 billion in Q1 2011 from SAR1324.1 billion in Q1 2010 due to increased expenditure by both public and private entities. Rising consumer disposable income and growth in the number of bank branches and ATMs bolstered customer deposits to SAR1083.6 billion in Q1 2011 (11.8% yoy) from SAR969.5 billion in Q1 2010.

We expect the overall increase in demand for credit to support growth in the Saudi banking sector's assets. The rising number of communication, utility and water projects being undertaken across the Kingdom is expected to increase demand for bank credit and support growth in deposits. Bank assets and deposits are also expected to benefit from abundant liquidity as well as the government's progressive monetary policies.

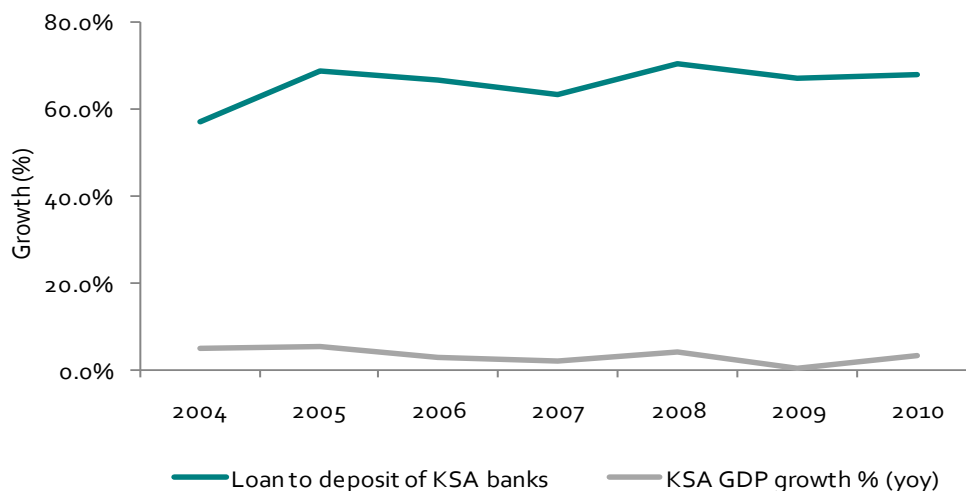
## 2. KSA economy & banks

### Saudi banking sector growth mirrors economy

The banking sector's growth is tied to the economy. Consider this case in point: During 2004-2008, demand for loans from both the private and public sectors increased in tandem with the Saudi economy, which expanded at a CAGR of 4.9% due to rising oil prices. In fact, the loan to deposit ratio for banks peaked at 80.5% in 2008.

The global economic crisis hit banks across the world in the latter part of 2008. Yet, the impact on Saudi banks was relatively muted due to the fiscal support provided by the government and the Kingdom's efforts to diversify into non-oil sectors. Total bank assets and deposits continued to grow, albeit at a much slower pace compared to pre-crisis levels. Non-performing loans (NPLs) increased 125% in 2009 due to the rising number of credit defaults. The consequent higher provisioning by banks led to an overall decline in profitability in 2009. However, the Saudi banking sector's growth has been on track since the beginning of 2010, supported by stable economic growth due to rising oil prices. Although, the government is diversifying away from oil sector to reduce its dependence on oil revenues, oil sector continues to remain a major contributor to KSA's economic growth. In 2010, the oil sector contributed approximately 27% to Saudi Arabia's GDP and generated around 80% of total revenues. Net loans disbursed by banks increased 4.9% in 2010 compared to 1.7% in 2009. The graph below shows that banking sector growth, as reflected in the loan-to-deposit ratio, is tied to GDP growth.

Figure 3. Correlation of KSA's GDP growth and the loan-to-deposit ratio of Saudi banks



Source: Zawya

The Saudi economy is on the recovery track supported by the positive outlook for the oil sector in the near to medium term. KSA's GDP is expected to increase at a CAGR of 4.5% during 2010-2015. This is likely to provide huge opportunities for banks operating in the Kingdom.

### 3. KSA Banking: Key growth factors

**Current economic growth to support sector:** Saudi Arabia's GDP grew 3.4% in 2010. With the economy recovering aided by rising oil prices, growth in the Saudi banking sector is likely to accelerate in the near term. The government's expansionary fiscal measures, including huge capital investments in strategic sectors and infrastructure, are also expected to boost the banking sector. Furthermore, disposable income per household is likely to increase in tandem with the economy. The consequent increase in consumer spending power would support growth in the banking sector.

**Favorable demographic pattern will increase credit appetite:** Around 68% of the total population is between 15 to 64 years; therefore, people in this group are either close to the working age or already working. This implies high consumer expenditure and increased demand for retail banking products and services. The rising banking population is expected to boost growth in the sector.

**Growth in private sector activities to spur growth in bank assets and deposits:** The private sector accounts for around 90% of total bank assets. The ongoing expansion in business activities in this sector stimulated by a thriving economy, rising oil prices and continued support of the government is expected to increase the asset base of banks.

**Increasing project finance expenditure to reinforce growth of banking sector:** The government's fiscal policy, mainly expenditure, is driving economic growth. This is reflected in the expansion of the banking sector. Allocation to water, agriculture and infrastructure projects has been raised by 10% (or SAR50.8 billion) for 2011 over that in the previous budget. Also, funds earmarked for transport and telecommunications have been increased by SAR25.2 billion for the year. The Saudi government's commitment to economic growth and diversification through expansionary fiscal measures is expected to strengthen growth in the sector.

**Growth in Islamic banking to amplify overall growth:** The rising popularity of Islamic banking as an ethical alternative to traditional banks is a key factor driving growth in the Saudi banking sector. Islamic loans accounted for around 40% of total loans in Saudi Arabia in 2010. Moreover, as Islamic banks adhere to Shariah principles and have low leverage, risks to their profitability are low. For example, low leverage helped Islamic banks to contain the impact of the financial crisis. This segment is likely to continue growing backed by increasing popularity, the sector's resilience in the face of the crisis, and rising number of players offering Shariah-compliant products and services.

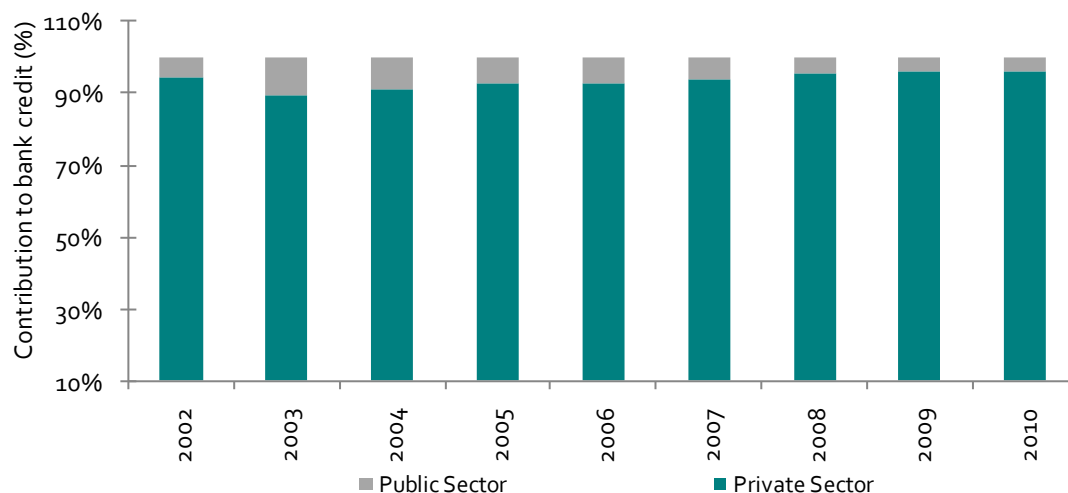
### 4. KSA banking sector trends

- **Bank loans analysis**

**Loans by sectors:** Saudi banking sector loans are primarily dominated by private sector players that used up over 90% of total credit disbursed in the last five years. In 2010, loans offered to the private sector increased 4.8% yoy and accounted for about 96% of total loans credit disbursed. On the other hand, the public sector accounted for about 4% of total bank loans in 2010. Private sector lending enjoys the backing of the Saudi government, which is keen to reduce dependence on the oil sector by diversifying and supporting growth in other sectors. Lending to the public sector is low compared to the private sector as the government

has funded several projects using its own finances. The Saudi government's initiative to modernize and diversify the economy is likely to support growth in the private sector. Therefore, demand for bank credit is expected to increase as activities in this sector gather momentum. The graph below shows the contribution of public and private sector to total bank credit in KSA.

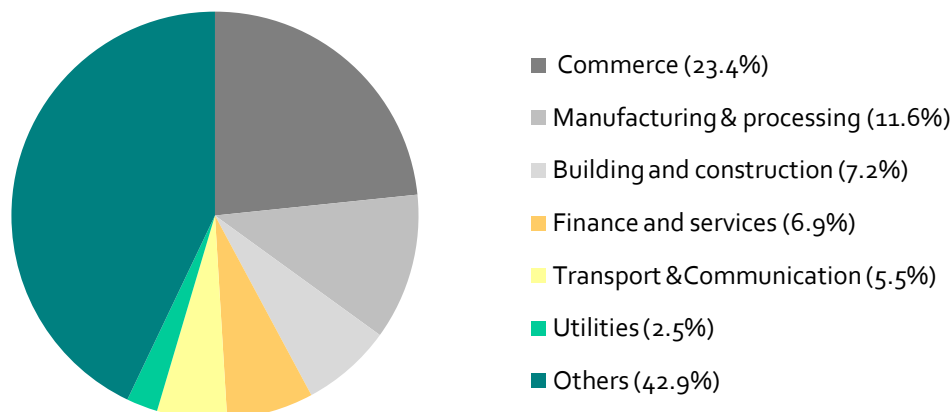
Figure 4. Contribution of sectors to total bank credit



Source: Zawya

**Loans by economic activities:** The Saudi government's efforts to diversify economic growth increased bank credit to other important sectors such as finance, services, water and utility. However, lending to the finance and services sectors was constrained over the past two years due to the credit crunch. In 2010, bank lending to the finance and services sectors declined 16.5% yoy and 22.7% yoy, respectively. In contrast, all other sectors reported growth in bank credit, with electricity, water and other utility sectors reporting 44.0% yoy growth. Total bank credit to different economic activities increased 5.2% yoy in 2010, after declining 1.1% yoy in 2009. Increased activity in the transport and communication sector is expected to boost demand for credit. Also, higher budgeted expenditure on water, agriculture, and infrastructure projects is likely to result in more credit being disbursed to these sectors. Moreover, lending by banks to the finance and services sectors is expected to be back on track in line with economic recovery.

Figure 5. Percent contribution by economic activities (2010)



Source: Zawya, SAMA

## • Bank deposit analysis

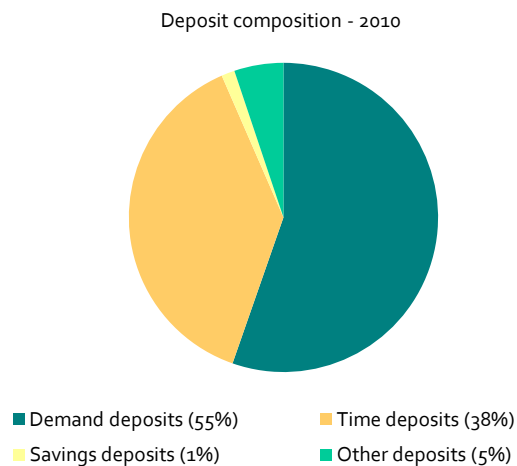
As shown in Exhibit 5, total bank deposits increased 4.0% yoy from SAR108.6 billion in 2009 to SAR112.9 billion during 2010. Total bank deposits increased at a CAGR of 20.1% during 2005–2008 benefiting from the strong economic growth. During this period, higher oil prices facilitated increased government expenditure and, consequently, growth in non-oil GDP. Higher government spending increased business confidence, local and regional private sector activities and investments significantly. This increased both demand and supply of credit. However, the growth in deposits was negatively impacted by the global turmoil during 2008–10. Nonetheless, deposits have been increasing in tandem with economic recovery since the beginning of 2010. The graphs below highlight the growth in deposits and deposit composition of Saudi banks.

Figure 6. Growth in total deposits of Saudi banks



Source: Zawya

Figure 7. Total deposit composition of Saudi banks



Source: Zawya

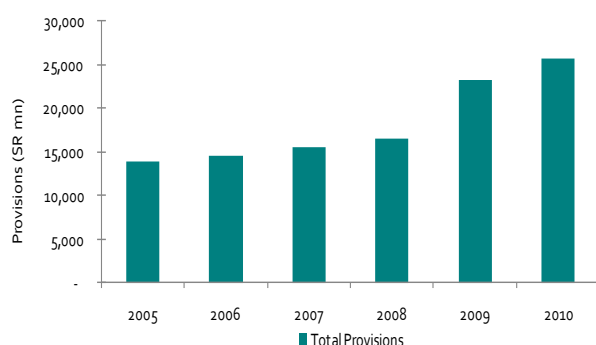
## Deposit composition

Deposits comprise demand, time, savings and other deposits—other deposits contribute around 7% to the total. Demand and time deposits accounted for 55% and 38%, respectively, of total deposits with Saudi banks. Time and savings deposits also increased as businesses and public sector entities used them to generate income. Due to robust government expenditure, Saudi banks witnessed a 20% growth in demand deposits in 2010 compared to the previous year. We expect deposits to continue growing at a faster rate in line with loans, considering the positive macroeconomic outlook and increased government expenditure.

## • Provisions

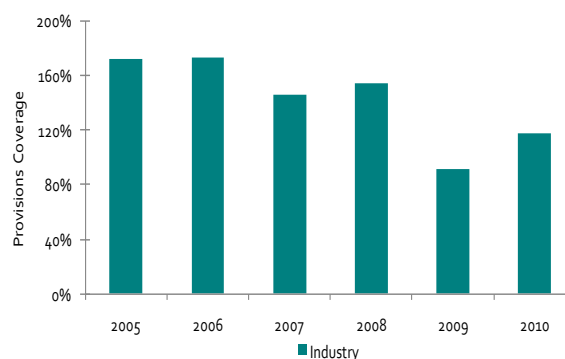
Banking sector provisions increased 11.1% yoy to SAR25.7 billion during 2010, despite a 15% yoy decrease in NPLs. The higher provisioning reflects caution due to deteriorating credit quality and defaults by two major conglomerates. In 2009, banks recorded a surge in NPLs that led to higher booked provisions and restricted the growth in bottom lines. Banks continued to increase provisions aggressively in 2010 in order to expand NPL coverage. Provisions coverage expanded from 91% in 2009 to 117.8% in 2010.

Figure 8. Total provisions by Saudi banks



Source: Zawya

Figure 9. Provisions coverage by Saudi banks



Source: Zawya

Having already peaked, the NPLs of Saudi banks are expected to decline further in the near term. Saudi banks are expected to reduce provisions from current historic highs due to the drop in NPLs. This is likely to expand bottom lines.

## • Liquidity

Saudi Arabian Monetary Agency (SAMA), the central bank of Saudi Arabia, controls bank liquidity mainly through repo and reverse repo rates and direct deposit facilities. Repo rate is the interest rate at which banks borrow from the central bank (SAMA) whereas reverse repo rate is the rate at which central bank (SAMA) borrows money from banks. To improve liquidity and plug the decline in deposits and credit, SAMA lowered repo and reverse repo rates during 2008-2009. SAMA reduced the repo rate four times in 2008 and by 50 basis points to 2% in 2009; the reverse repo rate was slashed five times in 2008 and thrice during 2009 to 0.25%. SAMA also lowered the cash reserve requirement on demand deposits to 7% as a part of measures to ensure ample liquidity was available to meet steady domestic demand. Saudi banks are expected to be fairly liquid considering their capital adequacy ratio is above the regulatory requirement and that the loan to deposit ratio is lower relative to pre-crisis levels.

## • Compliance to Basel II and Basel III norms

Saudi Arabian Monetary Agency (SAMA) made it mandatory for banks to maintain a minimum capital adequacy ratio (CAR) of 8%, as prescribed by Basel II. However, banks in the Kingdom have been maintaining almost twice that. For instance, larger banks such as National Commercial Bank, The Saudi Investment Bank, and Riyadh Bank have Tier I capital ratios of 17.10%, 17.17% and 16.03%, respectively. In 2009, the capital to risk-weighted assets (Basel Standard) of KSA banks stood at 16.5%, much more than the internationally prescribed Basel standard of 8.0%. This reflects the strong capital position of the Saudi banking sector. As per Basel III norms, banks will now have to maintain a Tier I capital ratio of 6% and also hold a capital conservation buffer of 2.5% to withstand future periods of stress. This brings the minimum CAR level to 8.5%; that is 50 basis points higher than the CAR per Basel II norms. Despite the increase in capital to risk weighted asset requirement, Saudi banks are expected to undergo a smooth transition to Basel III as these banks are already well-capitalized.

## • Banking sector regulations and their impact on growth

Saudi Arabian Monetary Agency (SAMA), the regulatory and supervisory authority, is responsible for maintaining financial stability by enforcing the Banking Control Law. SAMA has implemented several prudential regulations since its creation in 1952.

SAMA facilitated the sustained long-term growth and development of Saudi banks through its strong and comprehensive system. The regulator awards licenses, approves banking activities and takes prompt corrective action when required. It has power to promulgate rules, regulations and guidelines in areas such as capital adequacy, liquidity, lending limits, and credit and market risk. These regulations curb credit growth risks by requiring banks to obtain approval for foreign lending and by imposing statutory caps on individual indebtedness. Over the years, these supervisory powers have been used effectively to ensure that the Saudi banking system continues to enjoy a reputation for soundness and stability in international financial markets.

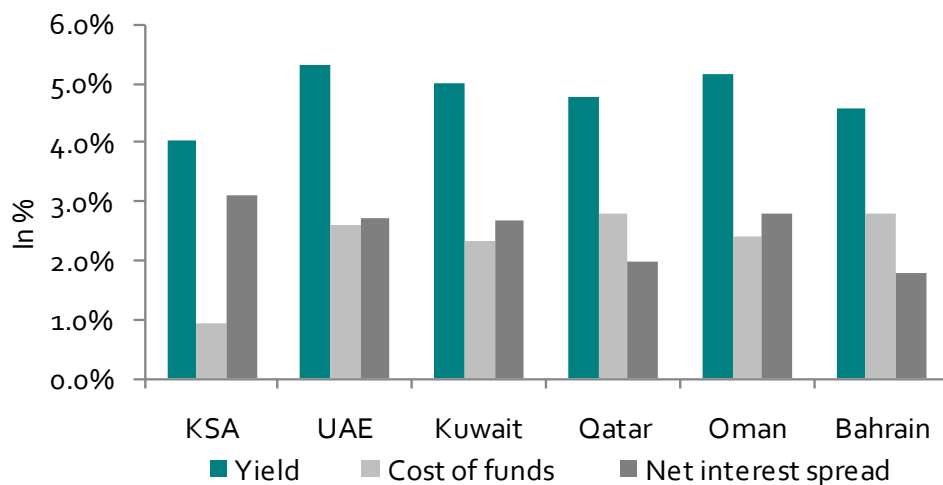
The Saudi banking sector is suitably regulated. This enabled it to weather the global financial crisis that dealt a severe blow to developed economies. Saudi banks remain well capitalized, with capital adequacy ratios comfortably above minimum standards (14–22%) and low leverage ratios (equity to total assets ratio ranging from 11–18%). The Saudi banking sector's resilience amid the financial turmoil indicates adequate risk management and strong regulation and supervision.

## 5. KSA Banks – Competitively placed against GCC peers

### Saudi banks ahead of GCC counterparts in terms of yield, costs and spreads

KSA banks are competitively placed relative to banks in GCC countries in terms of yield, cost of funds and interest spreads. The graph below compares the yield, cost of funds, and net interest spreads of KSA banks with those of banks in other GCC countries.

Figure 10. Yield, cost of funds, and net interest spread of banks in GCC countries



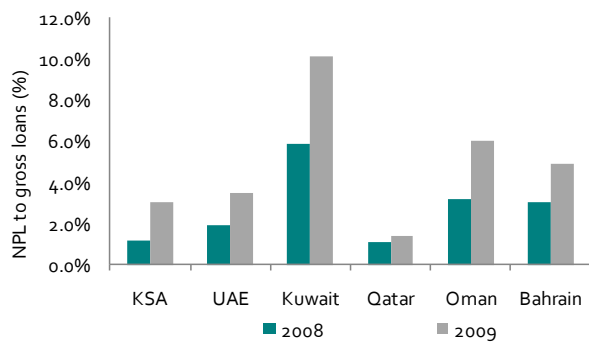
Source: Zawya, banks' Annual Reports

As evident in the graph above, the spreads of banks in the Kingdom during 2010 as a whole remained strong and contributed to the improvement in NII. The cost of funds of Saudi banks was the lowest relative to banks in other GCC countries and resulted in maximum net interest spread despite the financial crisis.

## KSA banks' NPLs lower than GCC peers

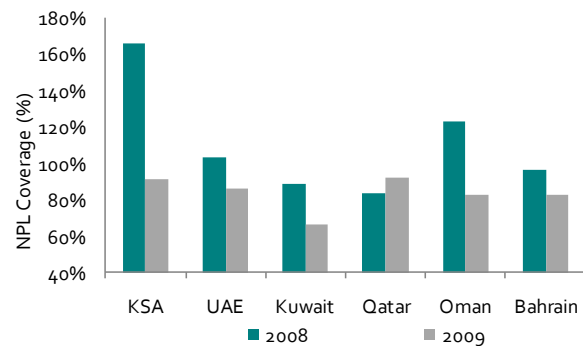
NPL to Gross loans of Saudi banks remained significantly low compared to other GCC countries, except Qatar, which had the lowest NPL ratio (NPL over total loans disbursed by the banks) of all GCC countries. Even though the NPL coverage ratio of Saudi banks declined from 166.2% in 2009 to 91.0% in the 2010, the coverage ratio was at par with those of banks in other GCC countries.

Figure 11. NPL to gross loans of banks in GCC



Source: Zawya

Figure 12. NPL coverage of banks in GCC

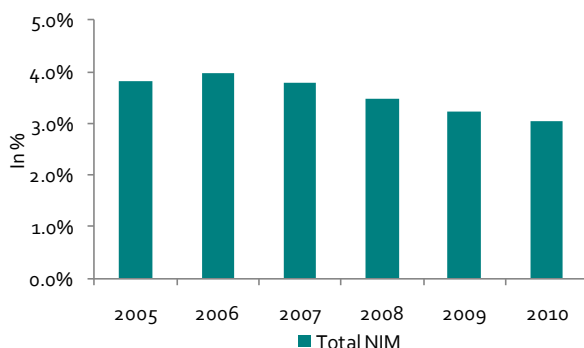


Source: Zawya

## Net Interest Margin regaining luster

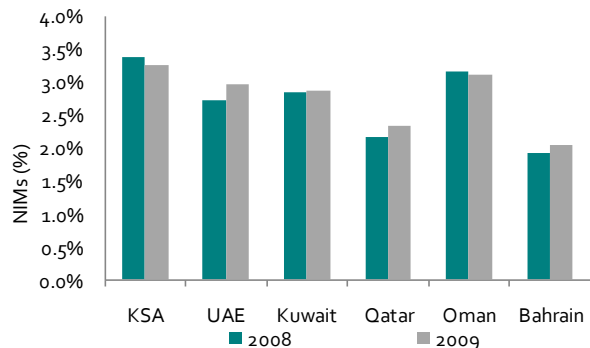
Interest expenses are the main cost incurred by banks, while interest income is the primary source of revenue. The net interest margin (NIM) of Saudi banks was quite high during the economic boom of 2005–2007. Banks reported a humongous increase in assets, deposits and credit due to heightened economic activity, particularly in the private sector. However, the global financial meltdown decelerated the overall growth, albeit to a much lesser extent compared to other developed economies. Consequently, net interest margin contracted during 2008-2010. Nevertheless, the Saudi banking sector reported the highest net interest margin among GCC nations. The graphs below show total NIM of Saudi banks vis-à-vis banks in other GCC nations.

Figure 13. Total NIM of Saudi banks



Source: Zawya

Figure 14. NIM of banks in GCC nations

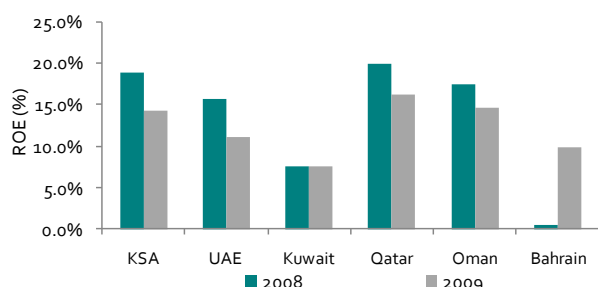


Source: Zawya

## KSA banks report higher profitability

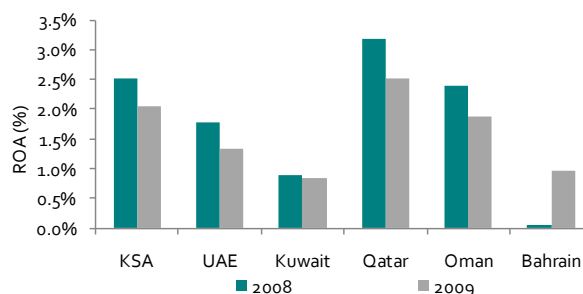
Saudi banks posted significant Return on Equity (ROE) due to high net interest spreads. This can be ascribed to the high percentage of non-interest bearing deposits and the low cost to income ratio. Saudi banks also registered high returns on asset (ROA) compared to their GCC peers. The graphs below show ROE and ROA of Saudi banks vis-à-vis banks in other GCC nations.

Figure 15. ROE of banks in GCC nations



Source: Zawya

Figure 16. ROA of banks in GCC nations



Source: Zawya

Saudi banks are among the top performers in the GCC region in terms of ROE and ROA—Qatar leads the peer group in both aspects. The ROE of all GCC banks, excluding KSA banks, averaged 11.8% in 2009. The ROE of Saudi banks averaged 14.2% during the period, well above the average for banks in other GCC nations (excluding KSA). Saudi banks reported an average ROA of 2.0% compared to the 1.5% average by banks in other GCC nations (excluding KSA).

## 6. KSA banks – Financial performance

The Saudi banking sector comprises 12 domestic commercial banks and 11 licensed branches of foreign banks. The 12 are National Commercial Bank (NCB), Samba Financial Group (SAMBA), Al Rajhi Bank, Riyad Bank (RIBL), Saudi Investment Bank (SIBC), Bank Aljazira (BJAZ), Bank Albilad, Alinma Bank, SABB, Banque Saudi Fransi, Arab National Bank, and Saudi Hollandi Bank; all, except NCB, are listed on the Saudi stock exchange. SABB, Banque Saudi Fransi, Arab National Bank, and Saudi Hollandi Bank are joint ventures with foreign banks. The sector is moderately concentrated, with the top four banks (NCB, SAMBA, Al Rajhi, and RIBL) accounting for around 60% of total bank assets.

As discussed earlier, the asset and deposit base of the Saudi banking sector continued to expand in Q1 2011 due to the sound economic environment. Total loans disbursed by banks increased 5.7% yoy (2.3% quarter on quarter) to SAR783.5 billion in Q1 2011 as activity in several sectors, including manufacturing, processing, mining and quarrying, building and construction, commerce, transport & communications and services, gained momentum.

Furthermore, the total estimated provisions of 11 banks (excluding NCB) declined to SAR1.3 billion in Q1 2011 from SAR1.5 billion in Q1 2010, reflecting an improvement in the overall asset quality and return of business confidence. Total non-interest income of the 11 banks increased 6.9% to SAR3.6 billion in Q1 2011 compared to SAR3.4 billion in Q1 2010. Consequently, the net income of these 11 banks increased to SAR7.8 billion (7.7%) in Q1 2011 from SAR7.2 billion in Q1 2010.

## Asset quality on recovery track

Gross NPL decreased significantly to 2.7% during 2010 from 3.3% the previous fiscal. Saudi banks were able to reduce gross NPL, thereby exacerbating the risk-averse lending behavior of banks, and strengthened their ability to increase interest income. Saudi banks were mainly able to reduce gross NPL due to reduced NPLs, increased provisions and loans disbursed in 2010.

Table 1: KSA Banks asset quality

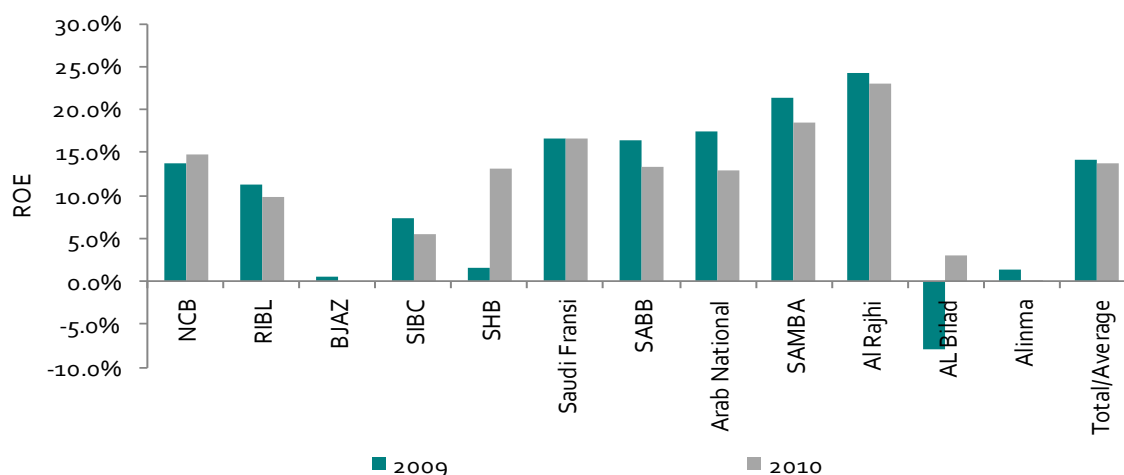
Banks	Gross NPL		NPL coverage	
	2009	2010	2009	2010
NCB	4.6%	3.9%	85.4%	116.9%
RIBL	1.2%	1.7%	140.9%	126.2%
BJAZ	7.5%	0.0%	65.2%	NA
SIBC	5.8%	5.4%	70.1%	110.4%
Saudi Hollandi	5.9%	2.6%	100.2%	124.4%
Saudi Fransi	1.3%	1.2%	126.6%	147.0%
SABB	4.5%	3.4%	50.3%	100.0%
Arab National	2.8%	3.0%	75.9%	108.1%
SAMBA	3.3%	3.7%	116.1%	118.1%
Al Rajhi	2.7%	2.1%	108.4%	135.8%
AL Bilad	5.5%	5.5%	62.1%	89.4%
<b>Total</b>	<b>3.3%</b>	<b>2.7%</b>	<b>89.8%</b>	<b>117.6%</b>

Source: Zawya

## Profitability of Saudi banks

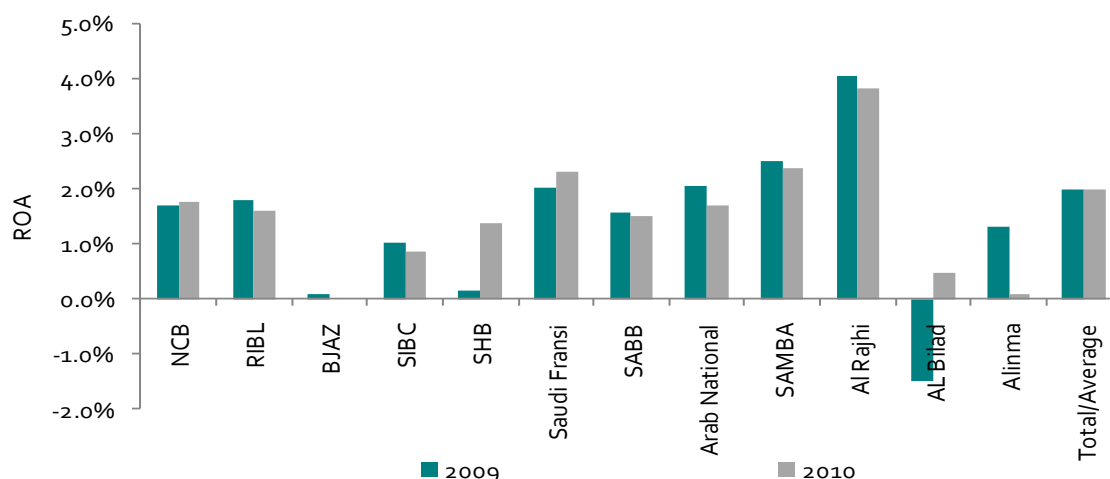
The banking sector's profitability took a hit in 2010 mainly due to the increase in provisioning requirements prompted by the exposure of these banks to the two Saudi family affiliated conglomerates that defaulted. Decline in the corporate loan portfolio and defaults in the personal loan and credit card portfolios also dented profits. Despite the drop in NPLs in 2010, banks continued to book high provisions in order to maintain a high provisions coverage ratio. We expect profitability to improve slightly aided by higher yields and the low cost of funds. The graphs below show ROE and ROA of Saudi banks for the last two years.

Figure 17: ROE of Saudi banks



Source: Zawya

Figure 18. ROA of Saudi banks



Source: Zawya

As evident from the graphs above, Al Rajhi Bank was the top performer in terms of both ROE and ROA (22.9% and 3.81%, respectively) in 2010. This robust performance is ascribed to the bank's ability to continuously grow its low-cost customer deposits base—non-interest bearing demand deposits represented around 88% of total deposits in 2010. Also, as Al Rajhi has the largest number of branches and ATMs, it enjoys the highest penetration in the market vis-à-vis other banks in Saudi Arabia.

## Yield and spread

The yield on earning assets (i.e., yield generated from earning assets such as bonds and interest bearing accounts) declined from 4.06% in 2009 to 3.46% in 2010. However, cost of funds reduced to 0.48% from 0.98% in 2009. Costs of funds declined due to the low interest rate environment. Therefore, although the yield on assets dropped, cost of funds declined at an even faster rate. Due to this, spreads were relatively stable at 3.0% during 2010 compared to 3.08% the previous year. The Saudi banking system enjoys the advantage of lower funding costs as demand deposits account for around 55% of the total funding base paying no interest to the depositors.

Table 2: KSA Banks – Yield, cost of fund and net interest spreads

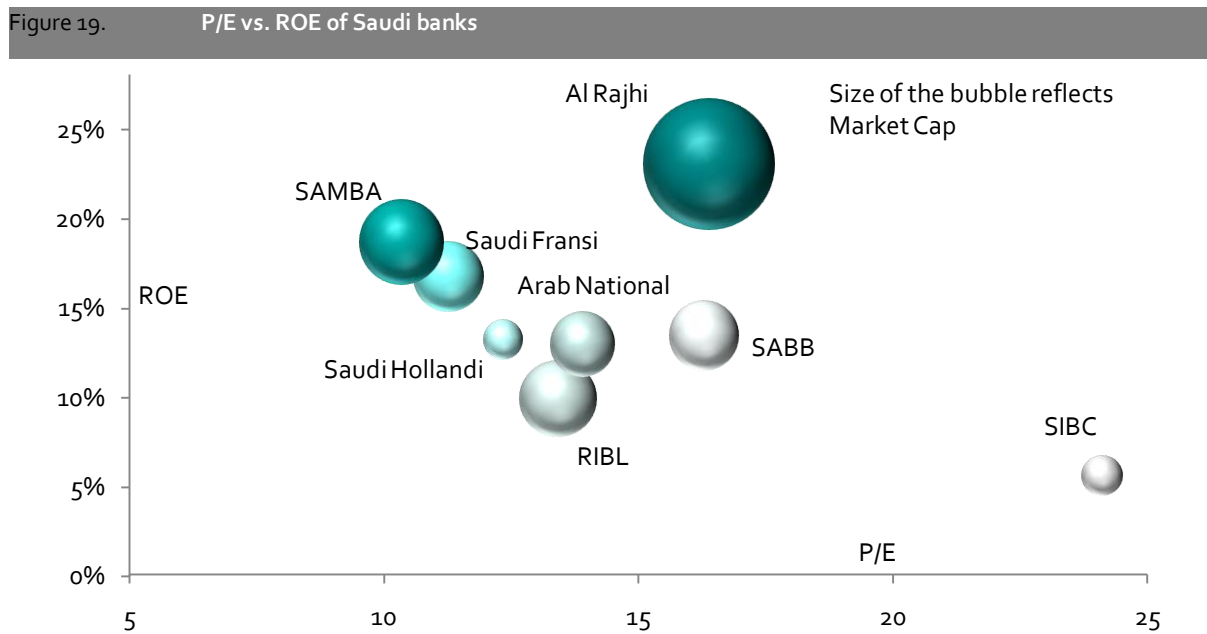
Banks	Yield on earning assets	Cost of funds	Spreads
NCB	3.7%	0.7%	3.0%
RIBL	2.9%	0.5%	2.4%
BJAZ	2.9%	0.6%	2.3%
SIBC	3.5%	0.8%	2.6%
Saudi Hollandi	3.0%	0.7%	2.3%
Saudi Fransi	3.0%	0.5%	2.6%
SABB	3.1%	0.5%	2.6%
Arab National	3.2%	0.3%	2.8%
SAMBA	2.9%	0.4%	2.5%
Al Rajhi	5.3%	0.2%	5.1%
AL Bilad	3.5%	0.1%	3.3%
Alinma	3.0%	0.0%	3.0%
<b>Total</b>	<b>3.5%</b>	<b>0.5%</b>	<b>3.0%</b>

Source: Zawya

Despite subdued growth in net income, assets and credit during the period of recovery in 2010, Saudi banks were able to maintain high capital buffers, adequate provisions and ample liquidity. This is expected to facilitate their expansion in the near to medium term.

## Valuation

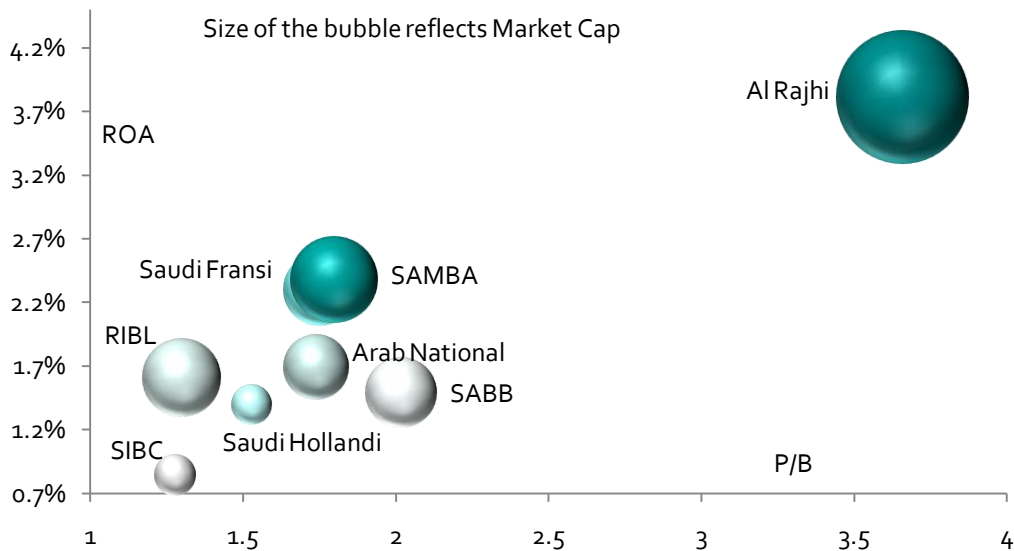
As evident in the graph below, SIBC had the highest P/E in 2010 compared to the industry average of 19.3x. With a P/E of 16.7x, Al Rajhi Bank appears attractively priced due to its industry leading ROE of 22.9% compared to the industry average ROE of 10.5%. The industry average is based on the P/E and ROE of 11 listed Saudi banks.



Source: Bloomberg

On P/B and ROA basis, Al Rajhi Bank looks attractively placed compared to its peers due to its industry leading P/B of 3.9x (compared to the industry average of 1.8x), rightly justified by its industry leading ROA of 3.8% (compared to the industry average of 1.46%). The industry average is based on the P/B and ROA of 11 listed Saudi banks.

Figure 20. P/B vs. ROA of Saudi banks

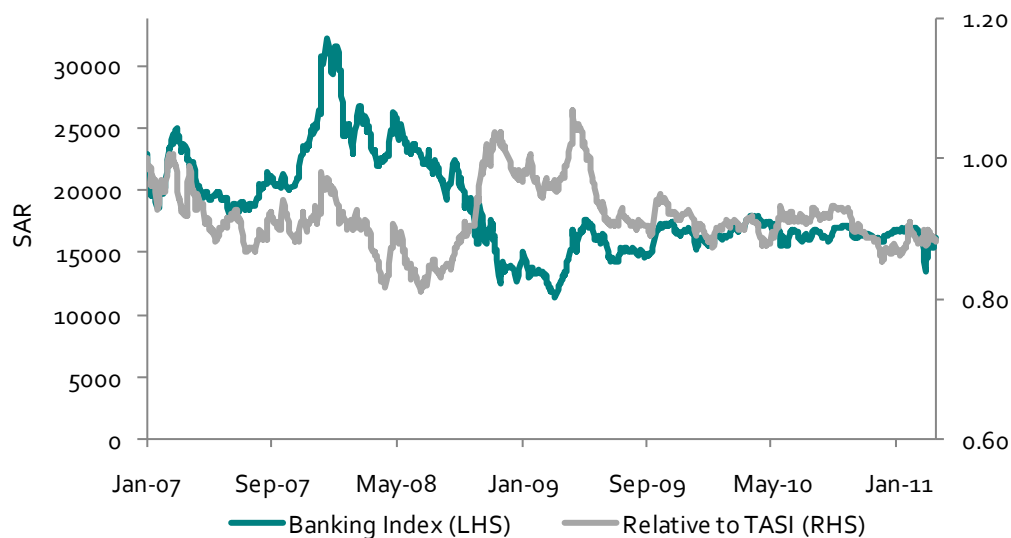


Source: Bloomberg

## KSA banking sector index performance vis-à-vis TASI

The Tadawul All Share Bank Index (TASBI) generally moves in tandem with the Tadawul All Share Index (TASI). The graph below shows this trend between 2007 and mid-2008. However, in 2008, the TASBI underperformed the TASI due to the financial crisis. Yet, TASBI has moved in line with the market index since 2009 when the recovery began.

Figure 21. Tadawul All Share Bank vis-à-vis Tadawul All Share Index (TASI)



Source: Zawya

Going forward, TASI is expected to benefit from Saudi Arabia's economic stability. Improvements in the regulatory structure are also expected to increase foreign investment and support the overall growth in stock markets. The TASBI is likely to reflect this trend as well.

## 7. KSA banking sector – Key issues & challenges

**High concentration of corporate loans raise fear of further credit defaults:** The private sector accounts for most of the credit (around 90%) disbursed by banks. Lending to high leverage borrowers in the corporate sector makes banks more vulnerable during economic downturns. Amid uncertain economic recovery, further exposure to these borrowers may impact banks to a great extent.

**Slower pace of growth in loans:** The loan to deposit ratio of banks has decreased from the pre-crisis level as they have become more cautious and risk averse in lending. The Saudi banking sector, one of the largest in the GCC region in terms of total banking assets, reported a loan to deposit ratio of just 67.8% in 2010. The challenge for banks lies in increasing the loans disbursed while keeping NPLs under control.

**Overall low banking penetration:** The penetration of the Saudi banking sector is low in terms of branches. At 57 bank branches per million, it is significantly below that of its GCC peers UAE and Kuwait (181 and 92 branches per million, respectively). Also, the Kingdom's loan to GDP ratio (42.8% in 2008) was among the lowest in the GCC region. Its deposit to GDP ratio of 46.8% during the year too was well below the GCC average of 60.4%. Retail lending constitutes a small portion of lending by Saudi banks. However, with consumer confidence returning and the recent passing of mortgage laws, this sector offers opportunities as well. The current low level of loan penetration reflects the long-term growth potential for Saudi banks.

**Political, economic uncertainty may impede growth:** The current unrest in the Middle East could impede overall growth in the Saudi Arabia economy.

## 8. Outlook

The global financial crises did not significantly impede the Saudi banking sector's growth as the government adopted prudent financial, monetary and fiscal policies. Saudi banks continue to figure among top banks in the GCC based on capital adequacy, liquidity and profitability.

The positive macroeconomic outlook for Saudi Arabia, its favorable demographics, increased investment in infrastructure in the country and ongoing sectoral reforms support business prospects in the Kingdom. The expected growth in GDP and higher economic activity are likely to provide banks opportunities to expand their credit portfolios. Moreover, the current low loan to deposits ratio of 73.9% (compared to 80.5% in 2008) and abundant liquidity in the system indicate there is scope for credit expansion by Saudi banks. Heightened economic activity would increase the appetite for finance, and thereby, the asset, credit and deposit base of banks based in the Kingdom. The prospects of the Saudi banking sector appear upbeat considering the growing oil revenues and the government's continued focus on increasing the non-oil sector's contribution to economic growth and development. Saudi banks are well-poised to benefit from the prevailing positive economic conditions in the country.

## Glossary & Abbreviations

**Compounded Annual Growth Rate (CAGR):** This refers to the year-on-year growth rate over a period of time and is applied to arrive at the growth rate of business and economic parameters such as revenues, net income and GPD, among others.

**Demand deposit:** This refers to deposits with banks that can be withdrawn at any time without intimation.

**Time deposit:** This refers to deposits that are deposited for a fixed duration and can only be withdrawn with prior notice.

**Provisions:** Provisions refer to the expense earmarked by banks as allowance for anticipated questionable loans. It is considered supplementary capital under the Basel Accord.

**Provisions coverage ratio:** This ratio assists in analyzing a bank's asset quality. It is the ratio between the cumulative provision balances of a bank as on a particular date to gross NPAs. It is also a measure that indicates the extent to which a bank has made provisions against bad loans.

**Basel Accords:** Basel Accords refer to supervisory recommendations on banking laws and regulations against the risks faced by banks. The accords aim to ascertain that financial establishments have sufficient capital to meet obligations and absorb unexpected losses.

**Saudi Arabian Monetary Agency (SAMA):** SAMA, the central bank of Saudi Arabia, bears responsibility for the promotion and growth of the financial system in the Kingdom. SAMA acts as a banker to the government and supervises commercial banks. SAMA also manages foreign exchange reserves and oversees the monetary policy to promote price and exchange rate stability.

**Repo rate:** Repo rate is the interest rate at which banks borrow from the central bank (SAMA in this case) in order to bridge the gap between demand and supply of funds. Repo rate, the truncation of the repurchase rate, is also considered the official bank rate.

**Reverse repo rate:** Reverse repo rate is the rate at which the central bank (SAMA) borrows from banks.

**Capital adequacy ratios (CAR):** A bank's capital ratio is the ratio of qualifying capital to risk adjusted (or weighted) assets computed in accordance with the risk-based capital adequacy framework. Saudi banks are required to keep the ratio above the regulatory prescribed minimum CAR set by SAMA. The ratio measures the capital reserves of the banks and is a measure of financial strength and stability. A ratio below the minimum indicates that the bank is not adequately capitalized to expand operations. The ratio ensures that the bank do not expand their business without having adequate capital.

**Non-performing loans (NPL):** NPL refers to defaulted loans or those that are close to default. Banks across the globe are working to minimize such loans and improve overall asset quality.

**Yield:** Yield refers to the interest on investment; it is expressed as percentage of cost of investment.

**Cost of funds:** Cost of funds denotes the cost of borrowing money that is incurred by banks in order to lend money.

**Spreads:** Spreads, or net interest spreads (as used in this report), represents the difference between the yield on earning assets and the cost of funds.

**NPL ratio:** The ratio represents NPL over total loans disbursed by banks.

**NPL coverage ratio:** This is the ratio of allowance for probable losses on non-performing loans (NPL) to total NPL.

**Net Interest Margin (NIM):** Interest expenses are the main cost incurred by banks and interest income is the primary source of revenue. The difference between interest income and expense is known as net interest income (NII). NII is the income that the bank earns from its core business of lending. Net interest margin is the net interest income earned by the bank on its average earning assets (advances, investments, balance with the SAMA, money at call, and others).

**Net Interest Income (NII):** NII is the difference between interest income and expense.

**Cost-to-income ratio:** This refers to the ratio of operating expenses to operating income, including non-interest income (fee-based income).

**Return on Equity (ROE):** The ratio is expressed as net income over average equity. It measures how well a company uses shareholders' funds to generate profits.

**Return on Assets (ROA):** Returns on asset ratio is the net income on total assets.

**Non-interest bearing deposits:** These are deposits in checking accounts.

**Earning assets:** Assets that earn income, such as bonds and interest bearing accounts, are called earning assets.

**Yield on earning assets:** Yield on earning assets refers to the yield generated from average earning assets. It is one of the parameters to measure the solvency of financial institutions.

**Price to Earnings ratio (P/E):** This is the ratio of a company's stock to earnings per share. Generally, a high P/E multiple suggests that investors expect high earnings growth in future and vice versa.

**Price to Book Value (P/B):** This is the ratio of the market price of a share to its book value. The ratio gains importance vis-à-vis P/E as the market valuation of a bank cannot be measured only by its price to earnings ratio (P/E ratio) as net earnings are influenced by the provision for non-performing assets, which is subject to internal policies and can be manipulated. (A bank could make low provisions to show a better profitability.)

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