The National Commercial Bank

Saudi Banking Sector Review

December 2009

Saudi Banks Pause for Breath

- In this report, we provide insights on the nine months (9M) 2009 financial performance of the eleven locally-incorporated commercial banks, hereinafter our coverage universe. As of September 2009, our coverage universe accounted for 96% of total system-wide assets.
- In 2009 year-to-date, our coverage universe remained profitable, liquid and sound even though growth in net profit decelerated to –7.3% Y/Y, which was mainly driven by historically high provisioning (SAR6.7 billion), and to a lesser degree, by the negative contribution of non-asset-based fee income.
- In contrast to 9M 2008, whereby investment provisions drove the scene, the provisions till date are primarily attributed to the spike in credit provisions by 281% Y/Y.
- Non-asset based fee income, comprised of banking fees and exchange income continued the downtrend, falling by double-digits, -12.2% and –10.2% Y/Y, respectively. Thus, weighing heavily on core operating revenue by eroding the moderate growth in net special commission income (NSCI).
- Amid a protracted liquidity glut, the ratio of cash in vaults and at SAMA to total assets rose to 9.9% and capital adequacy ratio (CAR) went up slightly to 16.7%.
- The strong contribution of non-core income, mainly from trading and fair value through income statement investments explain the rise in CAR. These two items had registered a substantial income of SAR1.36 billion by the end of 3Q compared to a loss of SAR0.82 billion in 2008.
- Assessing the yearly performance and the historically low records so far, we believe that the steep upward credit cycle had run its course and that banks are reassessing their current credit portfolios in terms of composition and volumes to adapt to a moderate credit cycle, a “New Normal” to be exact .

Key Parameters of our Coverage Universe*

	Assets	L/D	NI	G	ROAA	MC	P/B
National Commercial Bank	253.1	58.7%	3.34	-27.0%	1.9%	N/A	N/A
SAMBA Financial Group	184.1	60.5%	3.71	2.6%	2.7%	53.6	2.7
Al Rajhi Bank	165.4	113.7%	5.30	3.9%	4.3%	112.1	4.1
Riyad Bank	175.7	88.8%	2.12	0.4%	1.7%	44.9	1.7
Banque Saudi Fransi	121.7	90.1%	2.14	-4.1%	2.3%	32.5	2.2
Arab National Bank	111.9	85.5%	2.07	1.1%	2.4%	31.7	2.4
Saudi British Bank	123.9	88.3%	2.01	-11.3%	2.1%	39.8	3.0
Saudi Hollandi Bank	63.2	82.3%	0.53	-42.6%	1.1%	11.5	2.0
Saudi Investment Bank	50.6	79.5%	0.64	4.5%	1.6%	8.4	1.2
Bank Al Jazira	29.2	70.3%	0.29	-6.5%	1.4%	6.0	1.3
Bank Al Bilad	17.0	87.1%	0.05	-66.5%	0.4%	6.7	2.0

Notes: Assets: Total assets in SAR bn in 3Q09, L/D: Loan to deposit ratio in 3Q09, NI: Net income in SAR bn in 3Q09, G: Growth in NI in 3Q09, ROAA: Return on average assets in 3Q09, MC: Market Capitalization as of 30 September 2009, P/B: Price/Book as of 30 September 2009

Sources: Financial statements, Tadawul and NCB

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I. Abbreviations

Short Name	Commercial Name
NCB	National Commercial Bank
SAMBA	SAMBA Financial Group
RAJHI	Al Rajhi Bank
RIBL	Riyad Bank
BSF	Banque Saudi Fransi
ANB	Arab National Bank
SABB	Saudi British Bank
SHB	Saudi Hollandi Bank
SAIB	Saudi Investment Bank
BJAZ	Bank Al Jazira
BILAD	Bank Al Bilad

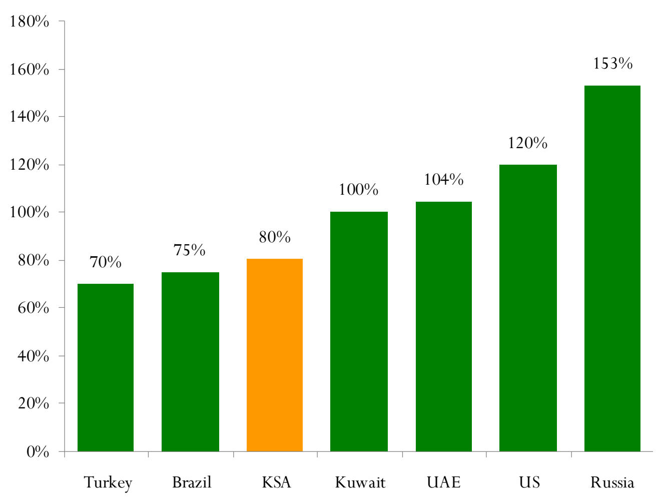
II. Saudi Banking Overview

Not Immune, But Resilient

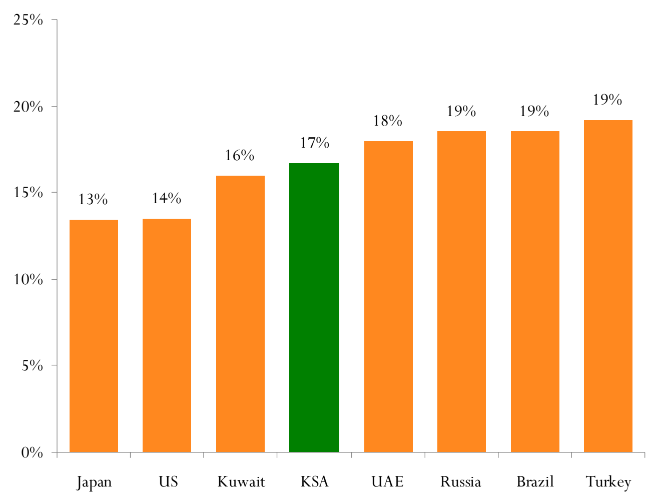
Even though Saudi banks are, currently, far away from the stellar performance that have seen their profits grow annually by 60% and 31%, respectively, in 2005 and 2006, the 11 locally-incorporated commercial banks, hereinafter our coverage universe, had remained in the black during the ensuing financial crisis. Indeed, profitability is what sets the domestic banking system apart from global peers, developed or developing, with obvious strengths emanating from greater reliance on core banking activities, lower non-performing loans (NPLs) ratio, little recourse to wholesale funding and ample liquidity that muted any concerns about solvency. Unlike its global counterparts, SAMA in its capacity as a central bank did not have to rescue or nationalize any bank, however, the resilience of the domestic banking system can partially be credited to its prudent and flexible policy-making regime that provided much needed liquidity in 2H 2008.

The soundness of the Kingdom's banks relative to many of its peers after the crisis, will help speed up the country's return to a higher growth trajectory once the global economy settles down and non-oil private consumption and investment regains momentum. In comparison to other countries, the banking system had maintained a comfortable loan to deposit ratio (L/D) of 80.4% by the end of 3Q 2009, a level that reflects excess capacity to lend and a lower systemic risk. Meanwhile, the capital adequacy ratio (CAR), which went slightly up to 16.7% in 3Q, is another signal of an ample cushion to match the embedded risk in assets, especially if we take into consideration the lower capacity utilization compared to regional and international counterparts, with the UAE and Russia at 100% and 153% L/D ratio.

Loan to Deposit Ratio[1], 3Q09



Capital Adequacy Ratio[2], 3Q09



Sources: SAMA, IMF, and IIF

The abovementioned relative strengths of the local banking sector, however, should not capture attention away from the challenging themes that had emerged in 9M 2009. First, the shrinking growth in loan and investment books that we believe will lead to a slower balance sheet growth by the end of 2009 and 2010. Second, the deterioration in asset quality due to an expected increase in NPLs partly attributed to the undisclosed exposure to a few family groups in distress and largely to the ongoing moderate business cycle. Third, a squeeze in net interest margins due to the higher competition and a low interest rate environment, largely on floating investments. Finally, the decline in fees from banking services with the deceleration in business volumes from lending and brokerage, and the marked deterioration in the international trade-finance segment, as evident from the downfall in the values of letters of credit (LCs) opened and settled.

III. Sector Structure

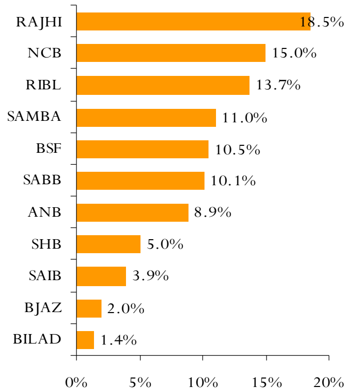
No Expected Change in the Offing

The 11 locally incorporated banks accounted for 96% of the system-wide total assets by 3Q 2009, as reported by SAMA, reflecting the early mover advantages that had accrued to them during the 1990s, with SAMA freezing the extension of new licenses infront of foreign banks. Intuitively, international banks are more focused on niche market segments, namely, private and investment banking that do not require a strong backbone of branch network, and, given the huge capital expenditure needed, will not mount any future challenge on the retail and corporate segments saturated by local banks. Unsurprisingly, we see almost no change in the domestic market structure compared with the same period three years ago, with the four major players, namely, NCB, SAMBA, Al Rajhi and Riyad, commanding around 58% of the market share for loans, deposits and assets, a meager reduction compared with around 60% by the end of 3Q 2006. Based on international averages for the four-firm concentration ratio, the Saudi banking sector can be tagged as an oligopolistic sector, whereby few players are well entrenched and dominant.

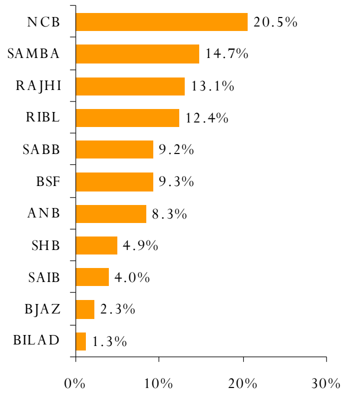
The National Commercial Bank (NCB) maintained its status as the largest bank by asset size, which stood at SAR253 billion, a 19.5% market share, while Al Rajhi had solidified its status as the top funding source, with a loan book exceeding SAR144 billion, an 18.5% market share. Although there are ample opportunities for organic expansion, the stagnancy in market shares, moderate credit cycle and the excess liquidity will likely, in our opinion, act as catalysts for banks to look for cross border acquisitions and expansion. Our expectations do view the MENA/South Asia regions as prime areas of investment in the medium-term, especially after the key players NCB and Al Rajhi made strategic moves in Turkey and Malaysia. In addition, the current global conditions, on the contrary to mainstream views do point to lucrative opportunities, especially that banks' valuations worldwide had plummeted tremendously, and the price-tag post crisis will be much less. In line with the popular mantra for stocks "buy low sell high", Saudi banks can take advantage of the current downward cycle in their outward investment, with the global economy bottoming-out and the upside potential over the medium-term is most likely.

Sector Structure Indicators

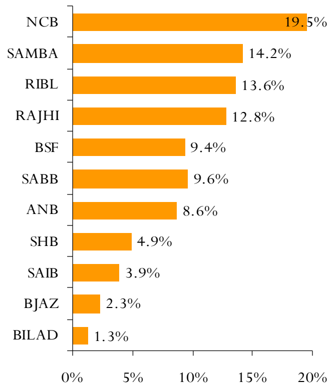
Share in Net Loans[3], 3Q09



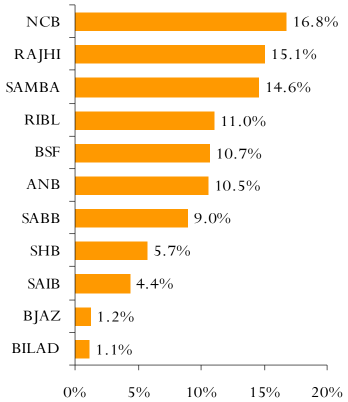
Share in Deposits[4], 3Q09



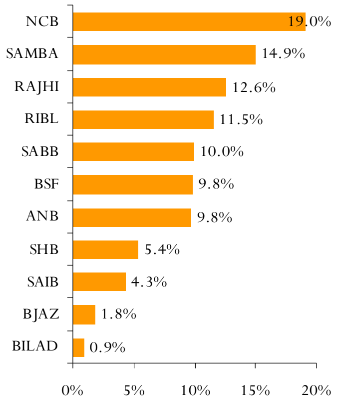
Share in Total Assets, 3Q09



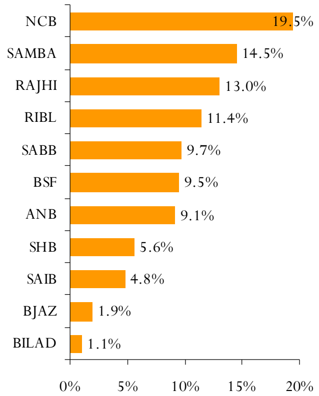
Share in Net Loans, 3Q06



Share in Deposits, 3Q06



Share in Total Assets, 3Q06



IV. Balance Sheet

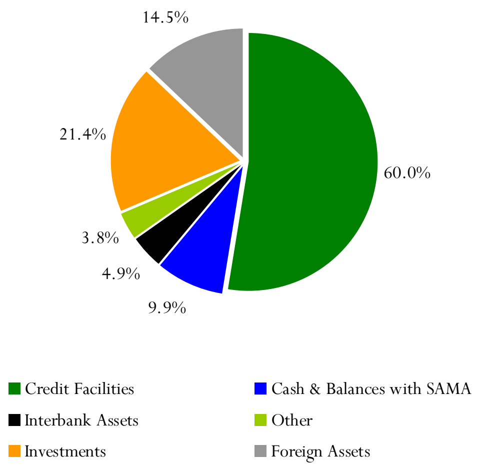
Why the Medium-Term Asset-Liability Mix Will Show Minor Changes?

The asset-liability mix of Saudi banks in 3Q 2009 did not show a marked shift in form from a year ago, and, in our opinion, the composition will show minor structural adjustments over the medium-term. In contrast to the period from 2002-2008, there are little prospects for sizable stimuli that can act as catalysts for a dramatic change from this quarter onwards. Growth from consumer and corporate credit during the last six years had propelled the credit facilities' share in total assets from around 40% to a significant 60%, at the expense of investment that had slid substantially from 43.2% to 21.4%, and foreign assets that fell from 19.2% to 14.5%. Indeed, the vibrancy of the domestic market and the non-oil private sector growth prospects lured local banks into actively managing their portfolios through loan granting rather than passively managing them through fixed-income investment, whether domestically or internationally.

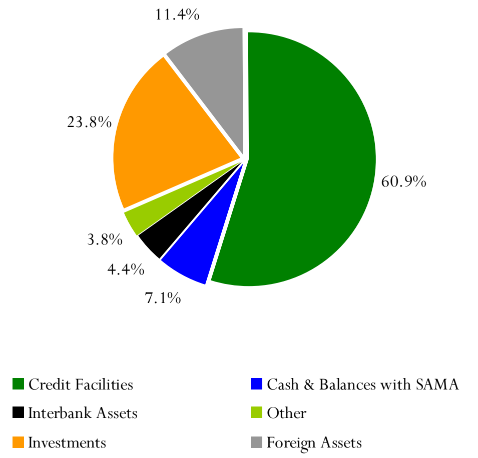
As for 3Q 2009, the asset and liability structure attained same shares for most of the items compared to 3Q 2008, especially heavyweights like the credit facilities and deposits that hovered around 60% and 70%, respectively. The main theme that was deduced is the role of excess liquidity in changing the composition for cash and balances with SAMA as well as the interbank items. The fact that the growth in net loans & advances, in our coverage universe, have receded dramatically to just 2.2% Y/Y, while deposits with SAMA have soared by 66.1% Y/Y by the end of September, reflects the reduced capacity utilization on the part of banks that opted to hold more excess reserves with SAMA. This explains the increased share for the cash & balances with SAMA item to around 10% from 7%, and the diminished share of interbank liabilities to 7.5%, with the lesser need to tap into the interbank market. To sum up, excess liquidity, driven by banks' wait-and-see approach, will be the critical factor in impacting the shares of cash, interbank, and investments in the medium-term, albeit with no dramatic moves.

Investment-Funding Mix

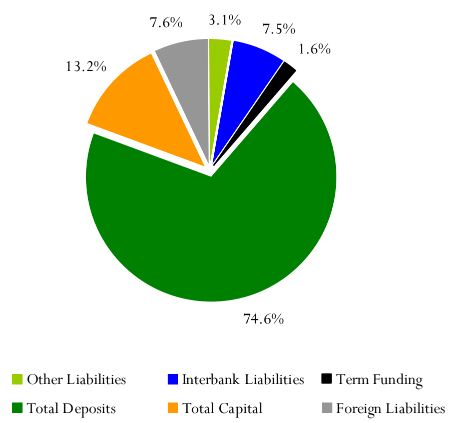
Asset/Investment Mix, 3Q 2009



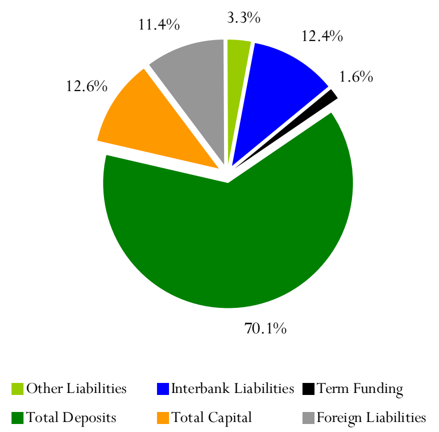
Asset/Investment Mix, 3Q 2008



Liability/Funding Mix, 3Q 2009



Liability/Funding Mix, 3Q 2008



The Lowest Growth Rate on Record Signal a "New Normal"

Over the 9M period ending September 2009, the total stock of assets of our coverage universe increased by a mere 3.8% Y/Y, the lowest growth rate on record. As expected, Saudi banks' consolidated balance sheet in 3Q continued to post a single-digit annual growth rate for the second consecutive quarter. When compared to the all-time high 32.3% and the staggering 30.7% Y/Y growth rates recorded by the end of 2Q 2008 and 3Q 2008, respectively, the performance in 3Q is a reminder of the moderation theme that will contain any tendency towards an upside trajectory that resembles the consumer and corporate-led credit cycles.

The all-time low emanates from the sudden stall in the corporate-driven private credit growth during the past 9M, from the high of 34.9% in August 2008 to a relatively meager 2% by the end of September 2009. Indeed, the moderate credit cycle in large part is driven by a slow down in the non-oil private GDP growth rates for 2009 and 2010, projected at 2.2% and 2.8%, respectively, which is below the historical average of 5.2% posted during 2003-2008. Since consumer loans had ceased to be a driver for credit growth after 2005, due to SAMA's tighter regulations concerning tenor and maximum exposure, corporate credit, currently, is the dominant force in dragging the loan book growth rate lower. The main downside drivers include: (1) the infeasibility of a list of projects due to the external demand factors that do not justify increasing capacity and granting credit facilities, (2) receding domestic demand that had knock-on-effects on investment demand, and (3) cautious lending, which is a natural outcome after last year's investment provisioning and 9M 2009 rise in credit provisions. Provisions, in particular, are a signal for the emergence of a new credit cycle, whereby conservatism will be the name of the game in Saudi Banking.

Micro-level dynamics within the banking industry in 9M09 exhibited this new norm, with a marked deceleration in the growth of net loans & advances perpetuating the drag on assets growth. Although the general trend was a downward one across most banks, it is important, for two major reasons, to classify banks according to the degree of impact on their balance sheets. First, to assess their credit strategy, and in particular, whether they are adopting a pro-cyclical or counter-cyclical stance. Second, and most importantly, to conduct a cross-section analysis between banks, and ascertain, the laggards and leaders albeit the benign environment. Banks can be divided into three groups, namely: (1) below-average, (2) average, and (3) above average.

On the lending side, after assessing the three quarters on a Y/Y growth basis, heavy weights like SAMBA, SABB, and ANB had below-average performance, posting negative lending growth rates of 11%, 5.7%, and 7.7%, respectively, by the end of 3Q compared to an industry aggregate of 2.2%, on the back of reduced business activity and huge growth in credit provisions that hovered around 200% Y/Y for the three banks.

Average performers included, medium and small-sized banks, BSF, SHB and SAIB. To start with, BSF did not exhibit stellar performance, as it maintained a measured increase in its lending activities that interestingly was just a minor 0.2-0.6% above the industry level for the past three quarters. Meanwhile, SHB and SAIB had plunged the last quarter to record meager growth rates of 0.1% and 2.2% Y/Y, respectively, despite their relatively vibrant activity in 6M 2009. In particular, SHB's performance in 3Q was extremely impacted by the withdrawal of a whopping SAR4.3 bn in customer deposits, effectively shrinking its balance sheet by 9.3% Q/Q.

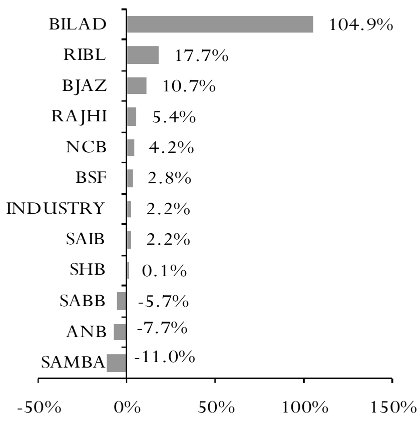
Despite the fact that Al Rajhi's loan book growth had registered a steep decline from 20.2% Y/Y in 1Q to 5.4% Y/Y by 3Q, it had remained above industry for the long haul, reflecting Al Rajhi's commitment to cement its grip, being the largest lender. The top-tier NCB had, also, vaulted past the industry aggregate at 4.2% Y/Y in 3Q in spite of lagging behind in 1Q and 2Q. RIBL and BJAZ had maintained a stable growth in comparison to peers, with 17.7% and 10.7% Y/Y by the end of September. Clearly, this performance had enabled RIBL to surpass SAMBA as the third-largest lender in just three years, and will eventually help BJAZ to minimize its traditional dependence on the brokerage segment and its gyrations. Last, but not least among the above-average performers and the most notable case during the last three quarters is the stellar performance of Al Bilad bank, the smallest Saudi bank in every dimension, which had been the most proactive, especially in 2Q and 3Q, expanding its loan book by a hefty 45% and 105%, respectively.

On the funding side, although customer deposits had expanded at a faster pace than loans, it had recorded the lowest growth rate since 4Q 2003 at 10.5% Y/Y. This factor might have constrained inflows to the balance sheet of banks, but we believe that largely it did not weigh on banks' decisions or ability to lend, as a result of the excess capacity mentioned earlier. The apparent trend in 9M09, however, was that all banks with the exception of SABB, ANB, and SAIB grew their deposit base despite the more conservative attitude towards lending, an indicator of two aspects: (1) the fact that Saudi banks do still believe in the vibrancy of the Saudi economy in general and the non-oil private sector in specific, and (2) the almost no cost environment of accumulating deposits, with demand deposits expanding at a substantial 21.1% Y/Y by the end of 3Q, the highest in 13 months.

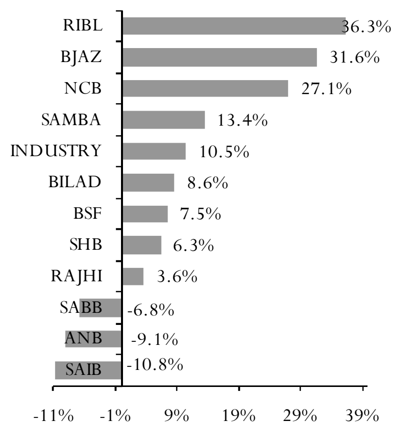
Growth in the balance sheet was mainly driven by growth in cash and balances with SAMA. As shown in the total assets contribution chart, cash and balances with SAMA had contributed a hefty 3.2% to the overall growth in assets of 3.8%, the highest contribution for the most liquid item since 2Q 2008. In the meantime, net investments and net loans contributed a negative 1.7% and a meager 1.3%, respectively. Interestingly, the contribution of net loans & advances had been the smallest on record, signaling the reduced role played by the major-yielding asset in 3Q, and most likely in the next couple of quarters. Suffice it to say that such record figures, reaffirms our believe that the steep upward credit cycle had run its course and that banks are reassessing their current credit portfolios in terms of composition and volumes. Are we heading towards a " new normal", whereby a balanced approach for the credit cycle will be the norm?, the answer is definitely a yes because domestic banks will have to strike a balance so to avoid over expansion on the upside or over contraction on the downside, the premises behind taking uncalculated risk or losing market share. However, this critical success factor will take time to be entrenched in banks' strategies, especially after a massive credit "up-cycle".

Micro-Level Balance Sheet Indicators

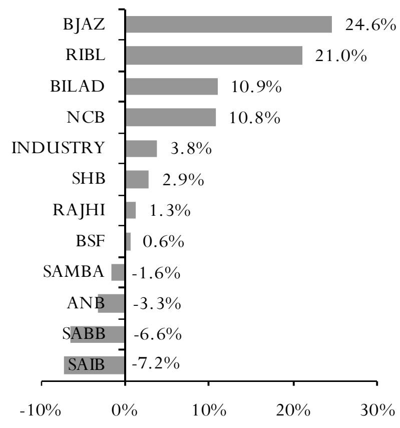
Growth in Net Loans, 9M, Y/Y



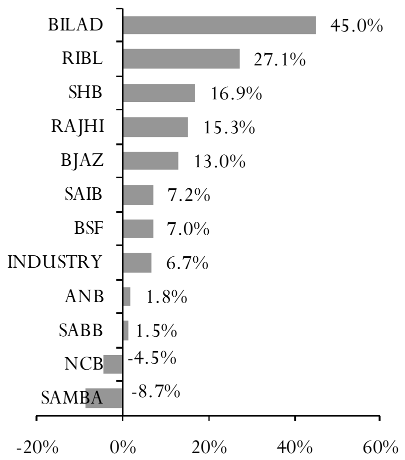
Growth in Deposits, 9M, Y/Y



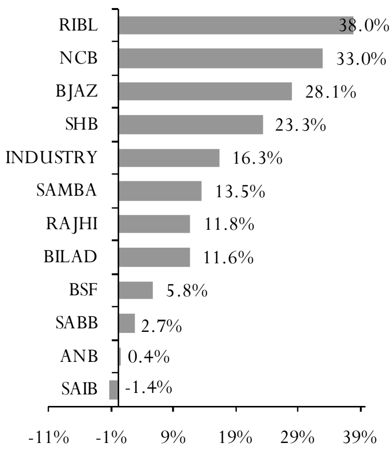
Growth in Total Assets, 9M, Y/Y



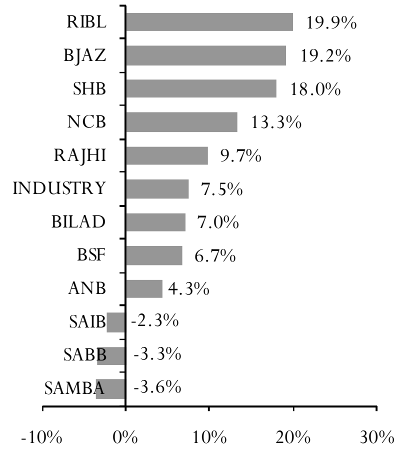
Growth in Net Loans, 6M, Y/Y



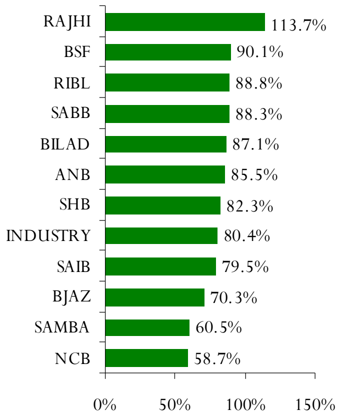
Growth in Deposits, 6M, Y/Y



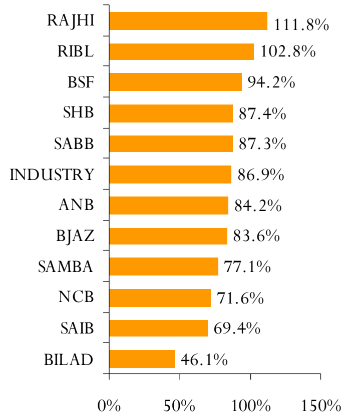
Growth in Total Assets, 6M, Y/Y



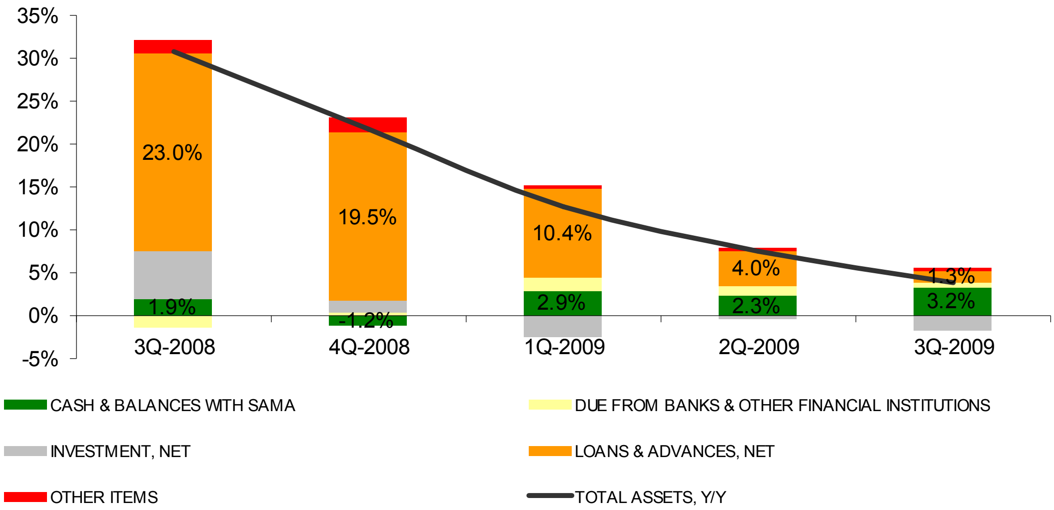
Loan-to-Deposit Ratio, 3Q09



Loan-to-Deposit Ratio, 3Q08



Total Assets Growth, Contribution



V. Profitability

What were the Drivers of Net Income and Core Revenue?

Over the last four quarters, growth in the revenues stagnated and in the bottom-line remained in the red. For 9M 2009, our coverage universe had reported a negative figure, a 7.3% Y/Y decline, albeit at a slower pace compared to 1Q and 2Q, at –10.3% and –11.8%, respectively. The downside drivers remained in place, mainly: (1) the barely growing core operating revenue (COR), with a mere 1.3% Y/Y growth rate, reflecting the shrinking revenues from banking services and foreign exchange, which did offset the expansion in net special commission income (NSCI), and (2) the unabated growth in provisions for credit losses that rose to around SAR5.9 bn in 3Q, a 26.8% Q/Q and 281% Y/Y.

Contribution to earnings growth reveals a steep downslide, with total provisions, mainly credit provisions, deducting a sizable 14.2% from the annual growth rate last quarter and COR adding an insignificant 2.2% compared to 22.3% in 3Q 2008. The notable exception was the increased contribution from the other non-core income to 7.5% and the ability of banks to contain their operating expenses. To start with, the declining status of COR was due to the 3.6% negative contribution from banking services and exchange income, largely offsetting the 4.9% attributed to NSCI. An expected outcome, in our opinion, on the back of reduced brokerage and trade finance volumes and fees. The fact that the total value of letters of Credit (LCs) opened dwindled by 38.1% Y/Y and the average daily traded value on the Saudi Tadawul had fell to a three-year low of SAR 5.4 bn, both by the end of 3Q, accentuates our firm belief that the 2005-2006 stellar performance for banking fees is far from being attainable at this juncture.

Despite the growth in the heavy-weight NSCI, which had been the supporting factor for the positive growth in COR and reduced negativity in the bottom-line, its 8.2% contribution to net income had been the lowest on record and its 4.9% contribution to COR had been the smallest since 4Q 2002. Certainly, this stresses the role of the depressed global interest rates and the prevailing moderate credit cycle. Even though this will not bode well for future profitability, banks were able during 9M to avoid a much steeper downfall. On an industry level, the NSCI spread remained relatively stable, falling by just 7 basis points (bps) during 1Q-3Q, especially as most banks took advantage of the reduced benchmark rates to re-price their liabilities downwards and, in turn, reduce their cost of funds to match the drop in their yields on earnings assets. In 2Q-3Q, the spread had bottomed-out at 3.6%, signaling that the pressures on the downside are waning for the earnings yield, which plunged by 116 bps from a year earlier. On a negative note, however, this implies that domestic banks are becoming more constrained in their attempts to reduce their cost of funds pertaining to special commission expenses.

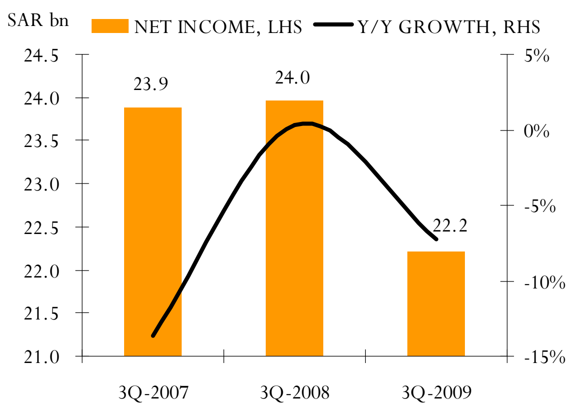
Nevertheless, the bright side to the earnings story in 3Q had been the positive contribution from non-core income, namely gains from trading, non-trading and fair value through income statement (FVIS) investments. The upsurge in bonds and financial instruments on a global scale since March had, definitely, allowed Saudi banks to recoup part of the unrealized losses they encountered during last year's investment provisioning cycle that totaled a substantial SAR4.5 by the end of 4Q 2008. On a quarterly basis, trading income grew by 21.4% in 3Q after the hefty 88.1% in 2Q, and gains on non-trading investments registered a whopping 210% in 3Q. This explains in large part the lower provisions set aside for the impairment of financial instruments in 2Q and 3Q, which fell by 88.8% and 178% Q/Q, respectively. Furthermore, we do believe, local banks can continue in their conservative approach of investing in high grade fixed-income securities, mostly government treasuries, given the generous spreads by historical standards in an environment with exceptionally low benchmark interest rates. The fact that interest rates are expected to remain subdued for an extended time frame do provide an income generating opportunity at a relatively minimum risk.

A relatively positive trend is the improvement in operating efficiency on the cost side, evident from the ability to contain operating expenses, which rose by 5.1% Y/Y, the lowest on record, and by 1.6% during 1Q-3Q timeframe. Apparently, banks are in a phase of "cost control", with the increase in salaries at a meager 1.3% Y/Y in 3Q , the smallest since 4Q 2007, and the rise of 4.5% Y/Y in general & administrative expenses at a seven-year low. It is our view that this tightening is favorable because it will trim the unnecessary cost structures and lax spending that usually evolves during an up-cycle. We expect the cost-to-income ratio, currently hovering around 60% to fall back to 50% range within the next couple of quarters if this trend continues.

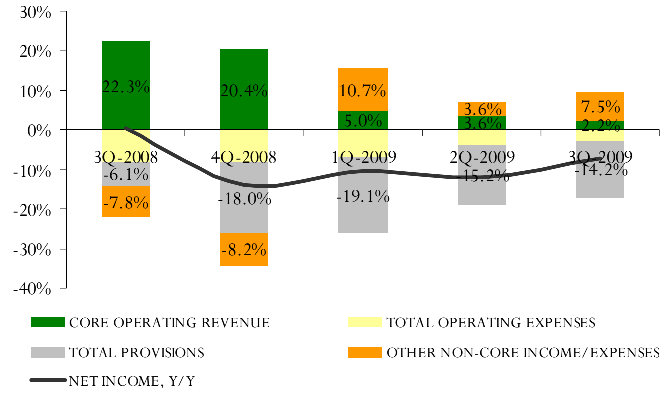
Our assessment of the contributors to earnings growth complements the previously mentioned growth drivers for the balance sheet to reflect a moderate phase. A phase during which banks will restructure their asset-liability mix to match the current dynamics that are benign relative to previous quarters. Although NSCI and credit facilities will always command the largest shares in income and assets, respectively, given their core status, the expectation is for credit provisions, investment income and operating expenses, at a lesser degree, to contribute more in shaping the outlook for profitability up until the end of 2010.

Profitability Contribution Analysis

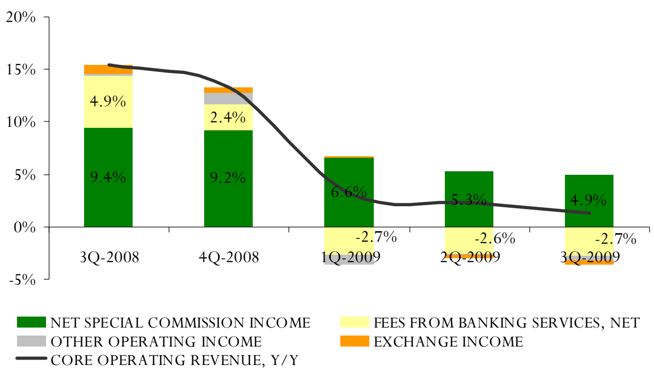
Consolidated Net Income Growth



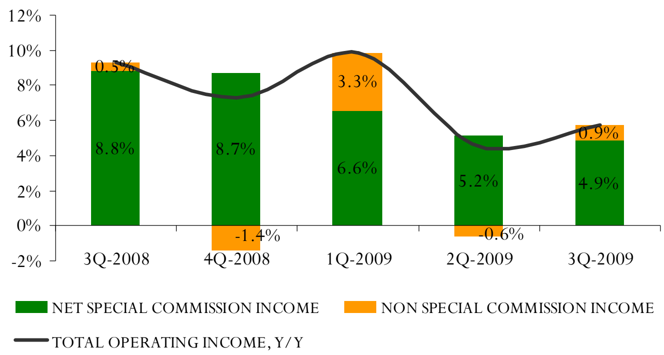
Net Income Growth, Contribution



Core Operating Revenue Growth, Contribution



Operating Income Growth, Contribution



Who are the Leaders and Laggards?

The cross-section analysis of micro-level dynamics within our coverage universe did reveal similar trends inline with industry aggregates and averages. However, the aim is to identify and analyze those banks with divergent performance. On a quarterly basis, four banks, namely RAJHI, SHB, BSF, and SAIB have reported a quarterly increase in profits, ranging from RAJHI's insignificant 1.3% to SHB's 66%. The double-digit growth in SHB's bottom-line can be attributed to two factors: (1) a base-effect due to the reduced level of provisions set aside, and (2) the growth in NSCI due to the success in lowering the cost of funds faster than the shrinking yield on earning assets, with the NSCI spread, losing only 5 bps compared to –20 bps in 2Q. On the red side, BILAD and BJAZ had been the worst performers, posting -92.4% and -43% Q/Q, respectively, due to the all familiar credit provisions that rose by 106% and 191.7%, respectively.

When it comes to the heavy-weight NSCI and NSCI spreads, RAJHI maintained its status as having the highest yields coupled with the lowest cost of funds in the industry because of a high share of fixed rate personal loans in its loan-mix (above 50% in 4Q 2008), and a deposit base that is predominantly non-interest bearing deposits (82% in 4Q 2008). In a very low interest rate environment, RAJHI had notably increased the NSCI spread by a significant 16 bps to a substantial 6.38%, a staggering 249 bps positive gap from the second highest SAMBA at 3.89%. Besides RAJHI, three banks, namely SAMBA, BSF, and ANB had improved their spreads by 5-7 bps, a signal that the spread contraction might have bottomed-out for these banks, especially that SAMBA and BSF have reported a sequential increase of 1-2 bps in 2Q.

SAIB, on the other extreme, however, have the lowest spread at a minor 1.82% on the back of the highest cost of funds among our coverage universe, a 65 bps above SHB, the second highest. The dismal performance of SAIB is characteristic of small banks, facing tough competition in attracting deposits and pricing credit facilities, especially with a relatively weak backbone of branches. Despite the fact that NCB had recorded an impressive increase of 35 bps in 1Q, it had lagged in 2Q and 3Q, losing 44 bps and 20 bps, respectively, the highest shedding in the spread among its peers. The reasons behind NCB's performance lies in the repricing momentum for assets and the funding base since the yield on earnings assets fell by 85 bps relative to a drop of 20 bps in the cost of funds during the last two quarters. To conclude, the repricing momentum on assets and liabilities had been favorable for most banks last quarter, with the degree of spread contraction waning for some and stabilizing for others. An additional factor that lends support to our expectation of stable spreads going forward, is the extremely accommodative monetary policy adopted by SAMA that will most likely remain at play well into 2010.

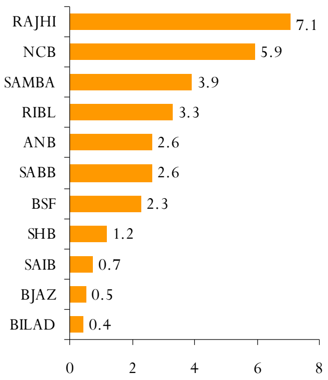
On an industry level, as explained, investment income and capital gains had improved due to the semblance of normalcy in capital and money markets, which enabled domestic banks to recoup SAR2.14 bn in 2009 YTD (+563% Y/Y), largely in trading income, FVIS income in particular, and partly in gains from non-trading investments. The noticeable trends are the rising share of FVIS income in the last three quarters and the gains from non-trading instruments compared to traditional trading income from foreign exchange and fixed-income. Banks that benefited from normalcy in FVIS investments included NCB that registered a positive YTD FVIS income of SAR136 mn compared to a hefty loss of SAR565.9 mn in 9M 2008. The exception in 3Q was BSF that reported an aggregate trading income that fell short of that recorded by the end of 3Q, a 64.2% Y/Y decline of around SAR300 mn.

Interestingly in 2009, provisions continue to be an important theme for the banking story, similar to the case in 2008, but with different dynamics. On aggregate, provisions had amounted to SAR6.7 bn by the end of 3Q, a figure deceivingly below SAR3.3 bn in 9M 2008, especially with the bulk of the provisions made in 4Q 2008. Local banks incremental provisioning hanged around SAR2 bn for each of the quarters, indicating the strategic orientation to cover any expected or unexpected losses or impairments. The main difference, however, between 2008 and 2009YTD is the fact that investment provisions had given way to credit provisions that currently dominates the quarterly allocation of banks, reaching 100% of total provisions in 3Q. For the second consecutive quarter, only four banks from our coverage universe had reduced their credit provisions in 3Q compared with eight in 1Q. The largest lenders by market share, RAJHI and NCB as well as the smallest lender BJAZ had increased their quarterly allocation by 81% , 27.4%, and 191.6%, respectively. On the contrary, SAMBA, the fourth-largest lender, reported a sequential drop in its credit provisions by 20.9% in 3Q.

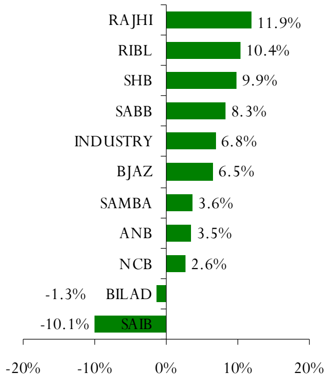
Looking ahead, the operating environment for Saudi banks will pose challenges, especially that business volumes in the credit segment, brokerage, and trade finance are not expected to show an abrupt resurgence, and the fact that interest rates and margins are expected to stabilize at current levels. Bottom-line, the prevailing volumes and prices are not supportive of double-digit growth rates in profitability and core revenue, as was the case four years ago. Banks, in our opinion, must go back to the basics in restructuring their revenue and cost bases at the current phase of this cycle, which can be time well spent if another upbeat cycle do arrive.

Profitability Indicators

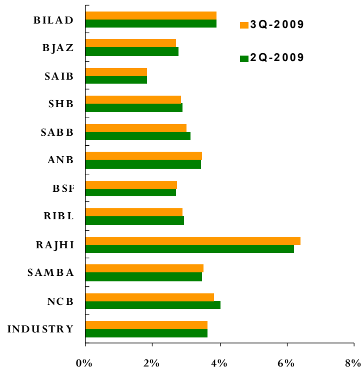
NSCI[5], SAR bn, 9M09



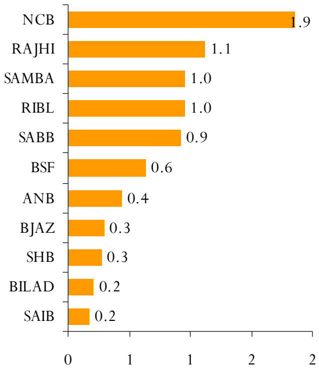
Growth in NSCI, 9M09



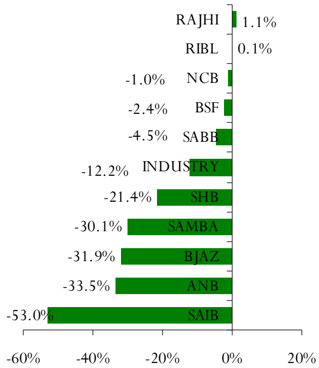
NSCS[6], YTD



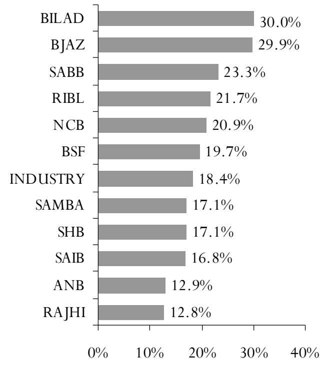
Banking Fees, SAR bn, 9M09



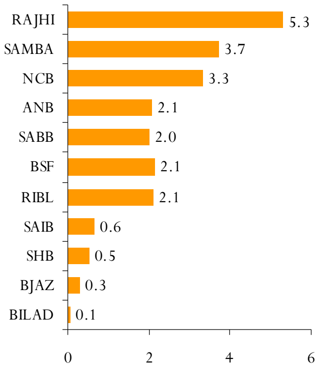
Growth in Banking Fees, 9M09



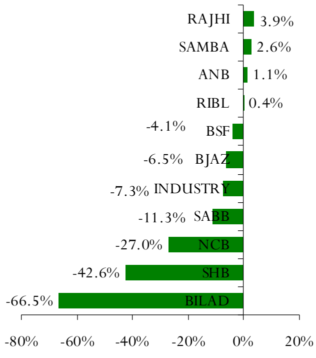
Banking Fees/OI[7], 9M09



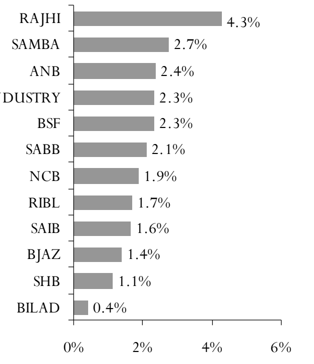
Net Income, SAR bn, 9M09



Growth in Net Income, 9M09



Return on Average Assets[8], 9M09



VI. Liquidity and Soundness

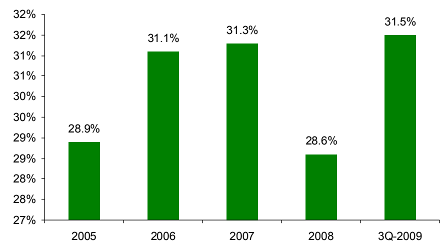
Awash with Liquidity

There is no doubt that the lending capacity, of our coverage universe, had approached its limit in 2008,with credit growth surpassing the expansion in the funding bases and, in turn, propelling the loan to-deposit ratio (L/D) to a record high of 86.9%. Surprisingly, however, the critical funding constraint had diminished significantly in 4Q 2008 and 9M 2009, with the moderation in private credit growth and the steady double-digit growth in deposits (10.5% Y/Y in 9M09). The steep decline in the L/D ratio that currently stands at a relatively comfortable 80.4% in 3Q had fuelled a protracted system-wide liquidity glut, evident in the shift in asset composition. In 2009YTD, as discussed earlier, the ratio of cash in vaults and at SAMA rose to 9.9%, up from 7.1% a year earlier. This liquidity glut had a positive impact on the SAR interbank market that stabilized around its historical average of 40 bps above the benchmark reverse repo.

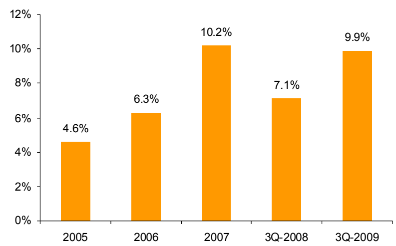
Consequently, this higher cash ratio boosted the size of the minimum risk assets, mainly cash and risk-free investments, which led to an improvement in the Capital Adequacy Ratio (CAR) for most banks through the decrease in the risk-weighted assets. By the end of 3Q, core CAR had increased in the range of 1.7-3.1% from a year earlier. The notable cases, included SAMBA, SAIB, ANB, and RAJHI, with the slight growth in the bottom-line complementing the enhancement in the risk profile of assets. Only three banks fell short, namely RIBL,BJAZ, and BILAD by 0.3-3.9% due to: (1) the negative contribution of non-asset based fee income to earnings, a traditional weakness for BJAZ, (2) a steep 66.5% decline in BILAD's net income, the worst performer, and (3) an increase in the risk-weighted assets of RIBL, given the 17.7% surge in loans &advances by the end of the 3Q.

Liquidity and Utilization Indicators

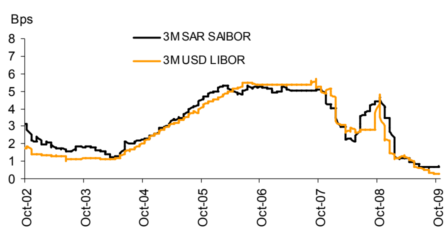
MRA[9]/Total Assets



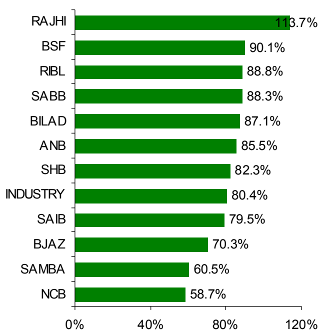
Cash[10]/Total Assets



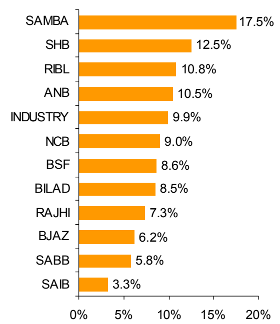
3MSARSAIBOR-3MUSDLIBOR



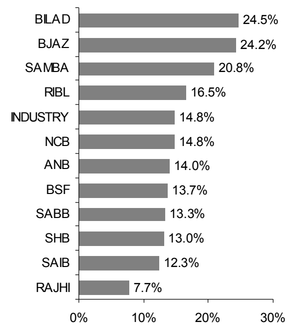
Loan-to-Deposit Ratio, 3Q09



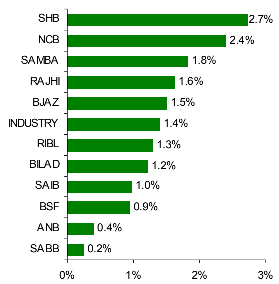
Cash/Total Assets, 3Q09



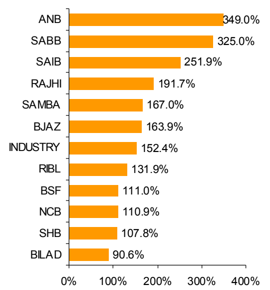
MRA/Total Assets, 3Q09



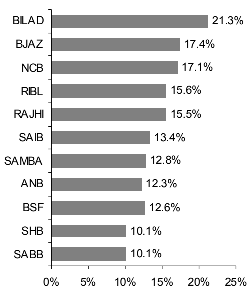
NPL Ratio[11], 08



NPL Coverage Ratio[12], 08



Tier 1 CAR[13], 3Q09



Annex: Glossary of Key Terms and Formulas

1/ Loan to Deposit Ratio: The ratio of loans and advances, net, to customer deposits. In the case of Islamic banks, we use the ratio of investments, net, to customer deposits.

2/ Capital Adequacy Ratio: The ratio of Tier 1 and Tier 2 capital to risk-weighted assets as reported in the footnotes of banks' financial statements.

3/ Net Loans: Net loans and advances on the balance sheet of conventional banks and net investments on the balance sheet of the two Islamic banks, Al Rajhi and Al Bilad. Net loans and advances is equal to gross performing loans plus non-performing loans, net, minus total provision (portfolio and specific provisions).

4/ Deposits: Customer deposits as recorded on the balance sheet on both commercial and Islamic banks.

5/ NSCI: Net Special Commission Income: Net special commission income, which is the Saudi equivalent to net interest income, is the difference between special commission (interest) income and special commission (interest) expense. In the two Islamic banks, it is the difference between investment income and investment expense.

6/ NSCS: Net Special Commission Spread: Special commission spread is defined as the ratio of the yield on average earnings assets to the cost on average funding base. We calculate earning assets as the sum of (1) Due from Banks, (2) Investments, Net, and (3) Loans and Advances, Net. Meanwhile, funding base is comprised of (1) customer deposits, and (2) term loans.

7/ OI: Operating Income: Operating income is the sum of NSCI and other income. The latter includes income generated by banking fees, treasury, FX dealings, dividends from investments, and other income.

8/ Return on Average Assets: Return on Average Assets (ROAA) is the Ratio of net income to average total assets. Average total assets is the simple arithmetic average of total assets in period t and period t-1.

9/ MRA: Minimum Risk Assets. We define as the sum of (1) Cash in Vaults and in SAMA, (2) Due from Banks, and (3) Investment in Government Securities. For the sake of conservatism, we exclude from our calculations net loans and advances to government and quasi-government agencies and holdings of sovereign-rated sukuks.

10/ Cash: Cash denotes the first line item on the balance sheet of banks, Cash in Vaults and in SAMA.

11/ NPL Ratio: The ratio of non-performing loans (as detailed in the footnotes) to total outstanding loans.

12/ NPL Coverage Ratio: The ratio of loan loss reserves to non-performing loans.

13/ Tier 1 Capital Adequacy Ratio: The ratio of Tier 1 capital to risk-weighted assets as reported in the footnotes of banks' financial statements.

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