June 2011

www.alahli.com

Weathering Crisis Repercussions yet Cautious on Lending

Saudi Banking Sector Review

Contents

Said A. Al Shaikh
Group Chief Economist | **s.alshaikh@alahli.com**

Authors

Tamer El Zayat
Senior Economist | **t.zayat@alahli.com**

Majed Al-Ghalib
Economist | **m.alghalib@alahli.com**

Executive Summary

- The overall Saudi banking sector structure remains unchanged, nor do we foresee any major changes that might alter asset compositions in the short–to medium-term.
- Banking, industry-wise, special commission income dropped by 11.3% to SAR44.4 billion in 2010, following 2009's drop of 17.3%, as the yield on earning assets declined to a record low of 3.9%.
- Special commission expense recorded a staggering 49.3% drop due to the decline in cost of funds from 0.98% in 2009 to 0.48% in 2010, which helped soften the contraction in Net Special Commission Income (NSCI) to an acceptable 1.3% for the industry.
- The fact that aggregate past due but not impaired loans have declined to SAR17.8 billion is indicative of the reduced stress on Saudi banks. We expect the provisioning cycle to have already peaked, and that bank-wide provisions will take a downward trajectory going forward.
- Saudi Banks will need to redeploy their liquid assets as the economy has proved to be resilient to external shocks. Coupled with the recent royal decrees, and expected approval of the mortgage law, banks must shift from amassing liquidity to lending opportunities.
- Banks continued their rather tight policy into 2011 as loans-to-deposits ratio decreased to a six-year low at 71.1%, validating banks' rather risk averseness stance.
- Lower medium grade to non-investment grade assets have declined by 13.4% Y/Y in 2010, which symbolizes the tendency of local banks to opt out of risky securities.
- Overall, the Saudi banking system remains profitable with plenty of room to grow. As the global risk averseness mood continues to diminish, Saudi banks cautiously follow suit and deem to expand their loans portfolios.
- Our profitability expectation for the remainder of the year is positive, supported by lower provisioning as NPLs and Past Due but Not Impaired remain suppressed.

Key Parameters of our Coverage Universe*

	Assets	L/D	NI	G	ROAA	MC	P/B
National Commercial Bank	298.9	52.1%	1.52	5.2%	2.1%	N/A	N/A
Al Rajhi Bank	203.0	77.4%	1.70	1.0%	3.5%	116.6	3.9
SAMBA Financial Group	190.9	60.5%	1.12	-7.1%	2.4%	51.1	2.0
Riyad Bank	180.7	82.1%	0.74	8.3%	1.7%	39.6	1.4
Banque Saudi Fransi	126.5	87.4%	0.72	0.4%	2.3%	34.9	1.9
Saudi British Bank	126.0	78.7%	0.75	21.0%	2.4%	33.8	2.2
Arab National Bank	120.5	76.1%	0.59	-7.1%	2.0%	29.6	1.9
Saudi Investment Bank	51.2	81.1%	0.21	743.4%	1.6%	11.1	1.4
Saudi Hollandi Bank	51.0	83.3%	0.24	3.5%	1.8%	9.8	1.5
Bank Al Jazira	35.9	69.3%	0.06	399.2%	0.7%	5.6	1.2
Bank Al Bilad	21.9	72.0%	0.06	5.5%	1.0%	5.9	1.9

Coverage Universe

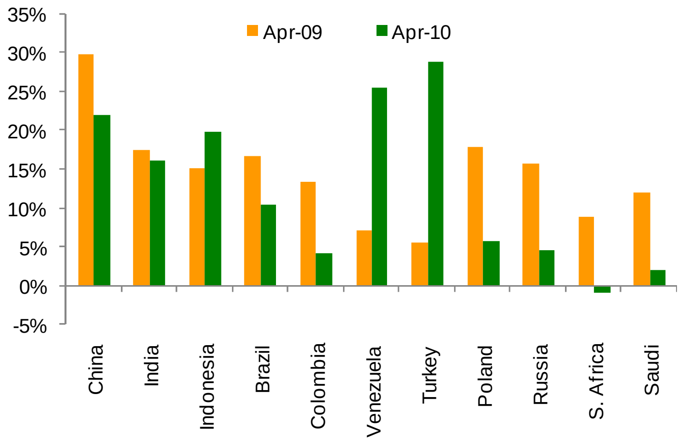
Short Name	Commercial Name
NCB	National Commercial Bank
SAMBA	SAMBA Financial Group
RAJHI	Al Rajhi Bank
RIBL	Riyad Bank
BSF	Banque Saudi Fransi
ANB	Arab National Bank
SABB	Saudi British Bank
SHB	Saudi Hollandi Bank
SAIB	Saudi Investment Bank
BJAZ	Bank Al Jazira
BILAD	Bank Al Bilad

Notes: Assets: Total assets in SAR bn in 1Q11, L/D: Loan to deposit ratio in 1Q11, NI: Net income in SAR bn in 1Q11, G: Growth in NI in 1Q11, ROAA: Return on average assets in 1Q11, MC: Market Capitalization as of 31 March 2011, P/B: Price/Book as of 31 March 2011
Sources: Financial statements, Tadawul and NCB

An Overview:

A noteworthy facet of the recent pick-up in banking activity worldwide is the growth divergence that has become the norm in the aftermath of the financial crisis. Banks in emerging and advanced economies continue to exhibit a two-track recovery that is most obvious in lending activity, with private sector credit growing at 19% in the former relative to around 2% in the latter. On the emerging markets (EMs) front, the prominent performers are currently Venezuela, Turkey, Indonesia and India, whereby bank credit grew annually by 38.5%, 37%, 31% and 21%, respectively, by the end of April 2011. A glance at Saudi Arabia's banking sector relative to global counterparts reflects the resilience and conservatism that characterizes the banking system in the Kingdom, (figure 1).

1. Bank Credit Growth to Private Sector (Y/Y)

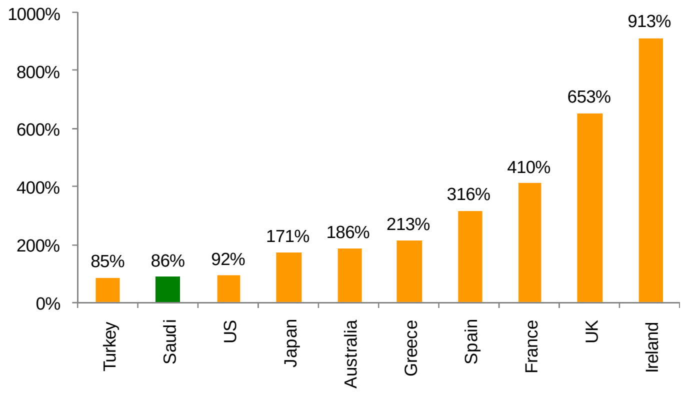


Source: WEO April 2011, NCB Estimates

However, lending activity in the domestic banking sector is not only well below the heights recorded in the years leading up to the global recession, but also lagging the EMs' average, posting only 6.5% Y/Y in April 2011, the highest growth rate since 2Q2009. The vibrant domestic economic climate supported by substantial liquidity leads us to believe that lending activity will have an upside trajectory in the medium term.

The aforementioned lag in credit growth compared to pre-crisis levels and lower capacity utilization must be taken in conjunction with the cautious attitude resulting from the deterioration of credit quality along with the recent closer supervisory operating framework.

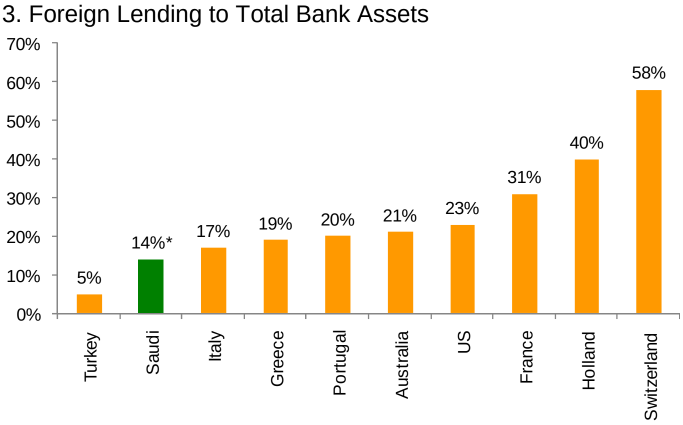
2. Banking System Assets to GDP



Source: WEO April 2011, NCB Estimates

When compared to global counterparts, three features are eminent, notably: (1) the size of the Saudi banking system relative to the economy is rather small, with bank assets to GDP at 86% compared to 913% and 316% for Irish and Spanish banks, respectively (figure 2), (2) exposure to cross-country spill-over effects are minimal, with the foreign lending ratio, mainly investment in the case of Saudi Arabia, of domestic banks around 14% of their total assets, the lowest on a global scale (figure 3), and (3) the regulatory body SAMA is vigilant not to allow a buildup in excess leverage to avoid the repercussions that can emanate from unsustainable economic growth, asset bubbles and misallocation of credit. Accordingly, such lower sys-

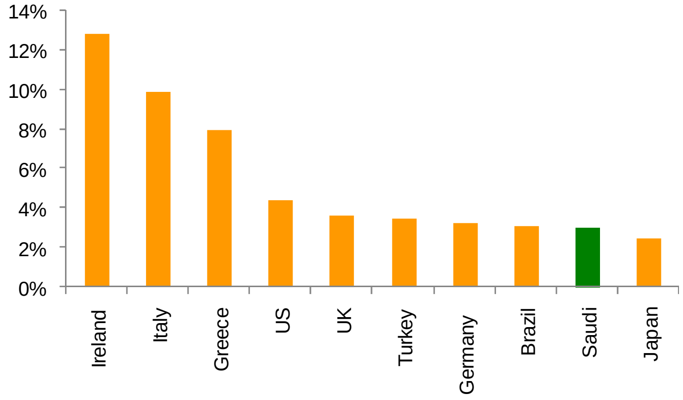
3. Foreign Lending to Total Bank Assets



Source: WEO April 2011, NCB Estimates
Note: * Mainly Investments

temic risk is desirable going forward because it reduces the severity of bank problems on broader economic activity matters. This also enables banks to tap into capital markets either for foreign currency funding in project financing or to enhance their long-term funding structures, especially when interest rates are at historical lows.

4. Non-Performing Loans to Total Gross Loans Ratio

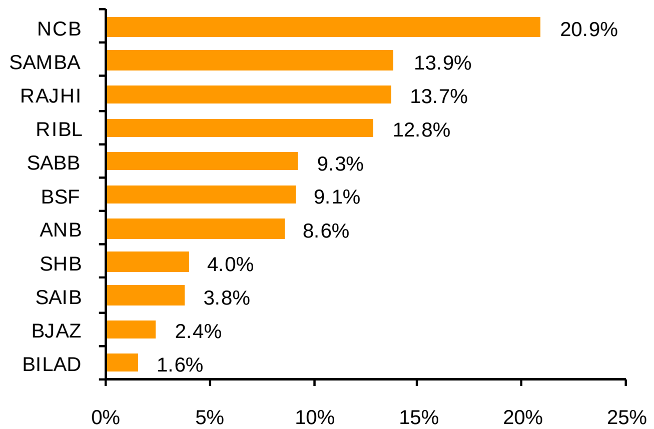


Source: WEO April 2011, NCB Estimates

I. Sector Structure

By the end of 2010, the structure of the Saudi banking system remained stable and unchanged. System-wide total assets reached SAR1,415.3 billion recording a gain of 3.3% over 2009. Our coverage universe, comprising the fully 11 locally incorporated banks, which represented 95.6% of total assets, gained almost 1.4% from 2Q10's low level of 94.4%, (Annex 1, figure 1 and 2)

5. Share in Total Assets, 2010

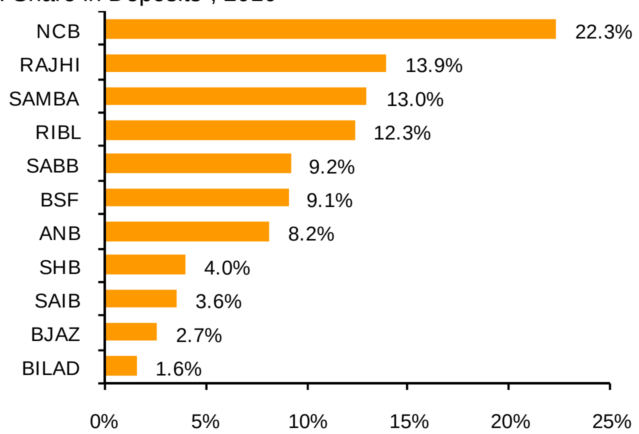


Source: Banks' Annual Reports, 2010

Total assets growth was attributed to both loans and investments over the past twelve months, indicating rather loosening risk averseness and the beginning of a post-crisis era. The shares of banks remained the same apart from RAJHI outpacing RIBL to grab the third largest position among Saudi bank by total assets in 2010. RAJHI continued its momentum into 2011 and surpassed SAMBA as the second largest bank. NCB continued to dominate this category and has widened the gap to capture %20.9 of total assets (SAR 282.4 billion) at the expense of most other banks. The largest four banks, NCB, RAJHI, SAMBA, and RIBL, capture around 61.3% of total assets, demonstrating an oligopoly market structure, (figure 5).

Regarding deposits, Saudi banks managed to hold an additional 4.9% customer deposits and reached a record high of SAR1,028.1 billion. Deposits shares among banks are almost identical to those of total assets, with NCB in the leading position at 22.3% (SAR 229.2 billion) and BILAD at the bottom of the list with 1.6% (SAR 16.9 billion).

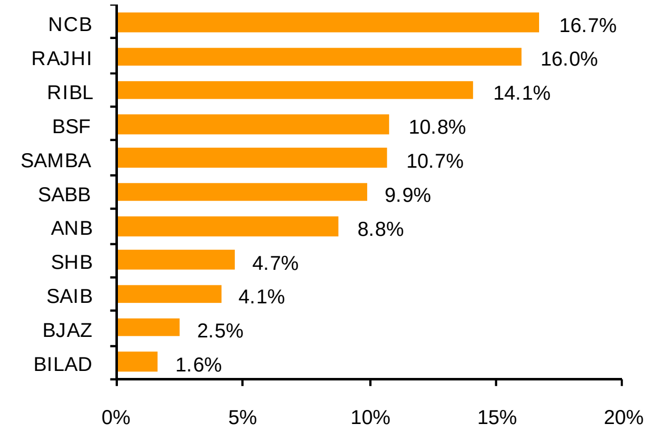
6. Share in Deposits[2], 2010



Source: Banks' Annual Reports, 2010

This allowed banks to easily expand their loans portfolios (see Liquidity section), which are expected to expand even further in 2011 and 2012. SAMBA, RIBL, and ANB reduced their lending facilities and their shares in net loans lost 0.8%, 0.5%, and 0.4%, respectively, in 2010. Picking up the difference were NCB, RAJHI, and BJAZ gaining additional shares of 1.3%, 0.6%, and 0.4%, respectively. The overall sector structure remains unchanged moving forward into 2011 and we do not foresee any major change that might alter compositions in the short to medium-term.

7. Share in Net Loans[1], 2010

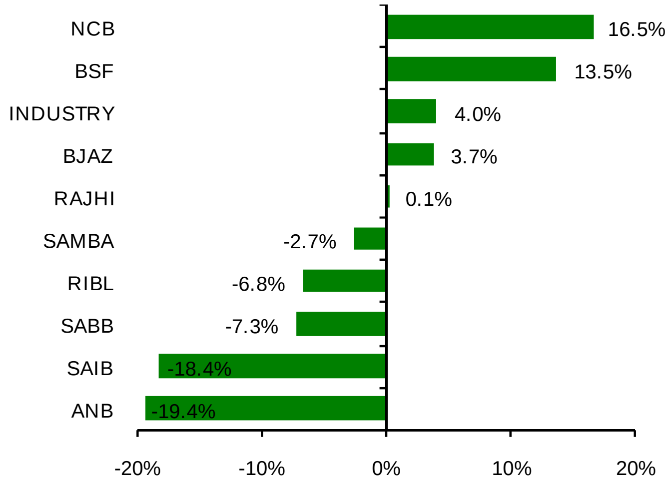


Source: Banks' Annual Reports, 2010

II. Profitability

During the moderation year of 2010, Saudi banks managed to increase their aggregate net income by 4% Y/Y to around SAR26.7 billion, driven by a pick up in banking fees and lower provision allocations. SHB and BILAD made substantial annual growth figures, 820% and 137%, respectively, largely due to base effects. They are followed by NCB and BSF that registered 16.5% and 13.5%, respectively, on the back of reduced credit and investment provisions, (figure 8). In contrast, ANB and SAIB recorded the largest declines, plummeting by 19.4% and 18.4%, respectively, as a result of higher provisions and despite the increase in net special commission income (NSCI) in the case of SAIB. Industry-wise, special commission income dropped by 11.3% to SAR44.4 billion in 2010, following 2009's drop of 17.3%, as the yield on earning assets declined to a record low of 3.9%, (Annex II, figure 6).

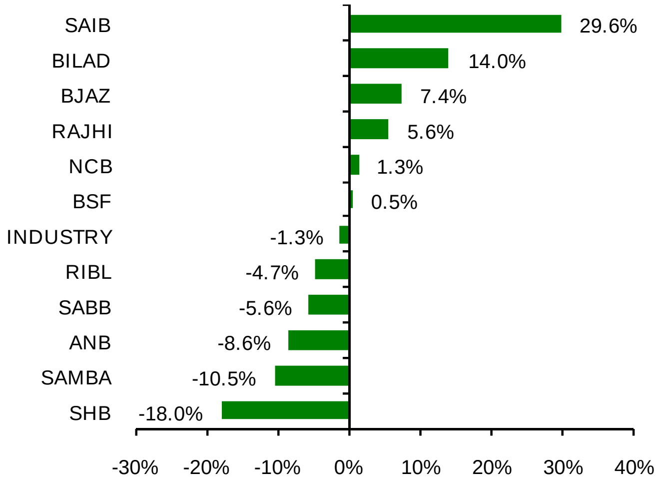
8. Net Income Growth, SAR bn, 2010



Source: Banks' Annual Reports, 2010

Note: The net income growth graph excludes SHB and BJAZ from the comparison to keep a visually comparable chart due to their huge growth figures at %820 and %137, respectively.

9. NSCI[3]Growth, SAR bn, 2010

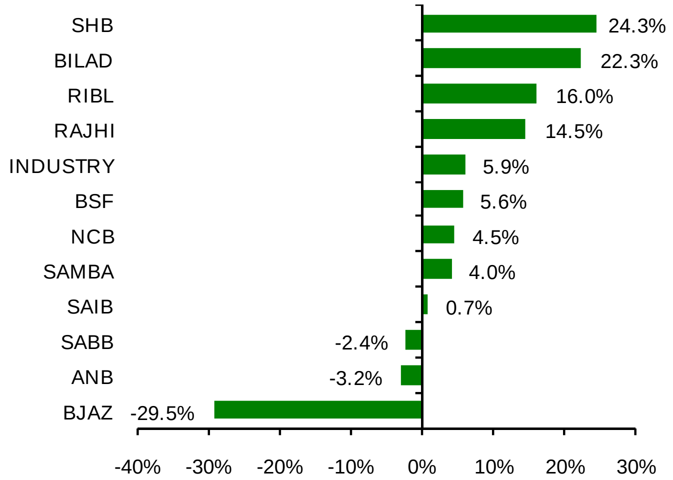


Source: Banks' Annual Reports, 2010

On the other hand, special commission expense recorded a staggering 49.3% drop due to the decline in cost of funds from 0.98% in 2009 to 0.48% in 2010 (Annex II, figure 8), which helped soft the contraction in NSCI to an acceptable 1.3% for the industry. Interestingly, relatively smaller banks fared well last year, with SAIB, BILAD and BJAZ leading growth in NSCI, thus reaffirming the focus of these banks on re-pricing liabilities and expanding lending facilities. Examples include SAIB that was able to significantly reduce its cost of funds from 1.9% to 0.8%, and BJAZ that came at a faster growth rate in granting new loans, a 20.6% Y/Y growth.

Core operating revenues remained around SAR52 billion, held back by NSCI, adding a mere SAR295 million, growing 0.6% Y/Y in 2010. In specific, banking fees managed to grow by 5.9%, despite the lower volumes of stock market trading at Tadawul, as the average daily trading volume declined from SAR5.1 billion in 2009 to SAR3.1 billion in 2010. Given its heavy reliance on brokerage, BJAZ remains exposed to stock market investors appetite, and as such banking fees declined by a hefty 29.5%. We expect a recovery in 2011 for the brokerage business since trading volumes and credit activities have already picked up, (figure 10). Also foreign exchange and other operating income posted a gain of 6.6%, benefiting from higher remittances and efficiency. On the other hand, operating expenses gained a mere 2.5% in 2010, compared with 3.8% in 2009, indicative of increased cost control measures. We expect this trend to continue for the remainder of 2011 and well in 2012. However, such record-low expense growth can rebound if banks' appetite for balance sheet expansion gains further momentum.

10. Banking Fees Growth, SAR bn, 2010



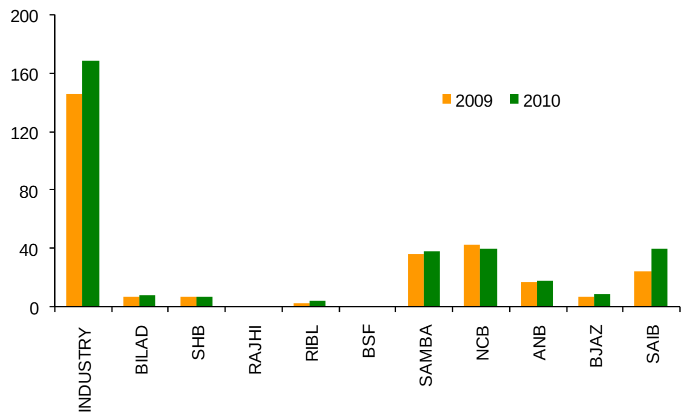
Source: Banks' Annual Reports, 2010

Overall, the Saudi banking system remains profitable with plenty of room to grow. As the global risk averseness continues to diminish, Saudi banks cautiously follow suit and deem eventually to expand their loans portfolios. With over one trillion SAR deposits on balance sheets, and a range of lending opportunities in an expanding economy, banks are set for a profitable year, as seen in 1Q11 with 5.6% growth in the industry's net income. Meanwhile, return on average assets and return on equity for Saudi banks rose to 2.2% and 16.3%, respectively, in 1Q2011 from 2% and 14.7% by the end of 2010, (Annex II, figure 14 and 15). Furthermore, massive government spending supported by the recent royal decrees will provide the stimuli for this growth, despite the full impact materializing over time. Meanwhile, banks need to address the asset liability maturity mismatch and diversify their funding base into dollars as well. In turn, they would be in a stronger position to fully seize the emerging lucrative opportunities, especially after the declining of provision levels, which are already enhancing the income to cost ratio.

III. Provisions

Similar to 2009, last year's provisions were due to loans portfolios, albeit to a slightly lesser scale. Total provisions stood at SAR9.9 billion in 2010, SAR1.3 billion less than 2009. Investment provisions have decreased by a massive 82%, as banks shifted their investments to higher grade securities. Meanwhile, provisions for credit losses only decreased by 8.9% to SAR9.5 billion. In fact, banks sought after more collaterals and increased their non-performing loans (NPLs) coverage ratio, (Annex III, figure 11). Functioning as a security cushion, collaterals increased by SAR23 billion to SAR168.7 billion, a 15.8% increase, with SAIB adding SAR15.8 billion on its own.

11. Collaterals held by Banks, SAR bn

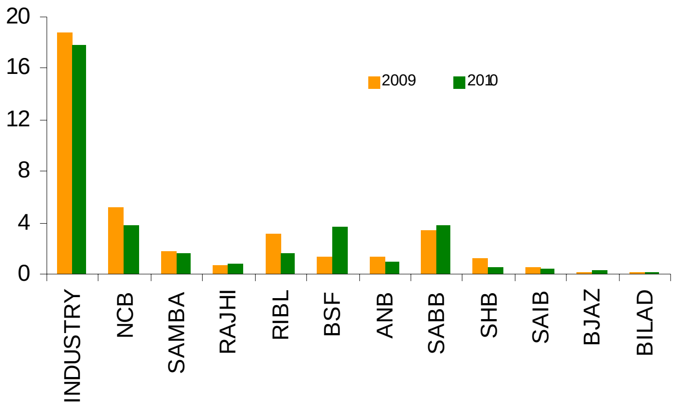


Source: Banks' Annual Reports, 2010

As for NPLs, they contracted by 10% to SAR23.2 billion, amounting to 3% of gross loans, a better position than the 3.4% in 2009. Interestingly, NPLs for the loans category classified as "Others" have soared during the past three years by 23.5%, 80.5%, and 46.1%, respectively, and we do believe troubled family conglomerate businesses fall under this category, (Annex III, figure 13). The NPLs of last year were concentrated in the commerce, others, and manufacturing portfolios, with a combined share of 70.3%. However, banks have sufficiently mitigated specific and general portfolio risks by increasing their industry-wide coverage ratio to 115.7% in 2010 from 89.8% in 2009. Notably, BSF has the most comfortable NPL coverage ratio at 147%, as the past due but not impaired loans picked up from SAR1.3 billion in 2009 to SAR3.7 billion in 2010.

On the other side of the scale, BJAZ has the lowest ratio at 84.5%, which is still reasonable considering the low level of past due but not impaired loans. The fact that aggregate past due but not impaired loans have declined to SAR17.8 billion is certainly indicative of the reduced stress on Saudi banks, (figure 12). We expect that the provisioning cycle has already peaked, and that bank-wide provisions will take a downward trajectory going forward.

12. Past Due but not Impaired Loans, SAR bn



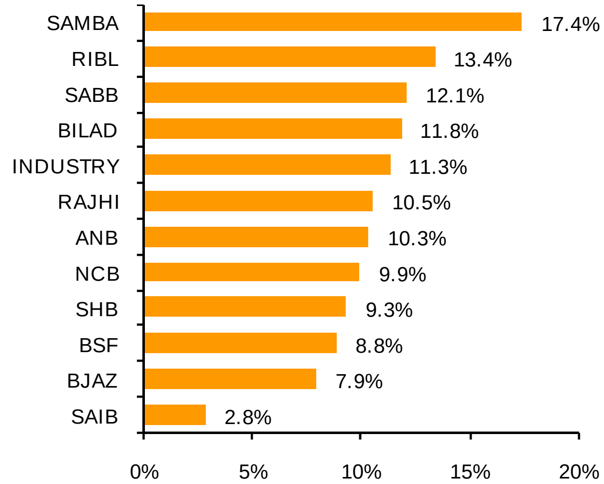
Source: Banks' Annual Reports, 2010

Notes: The collaterals depicted for RIBL and BSF are assets pledged for credit commitments and contingencies. RAJHI's collaterals pertains to past due but not impaired loans and impaired loans and advances, amounting to SAR1.07 bn. Aggregate collaterals should be higher due to a lack of full disclosure.

IV. Liquidity

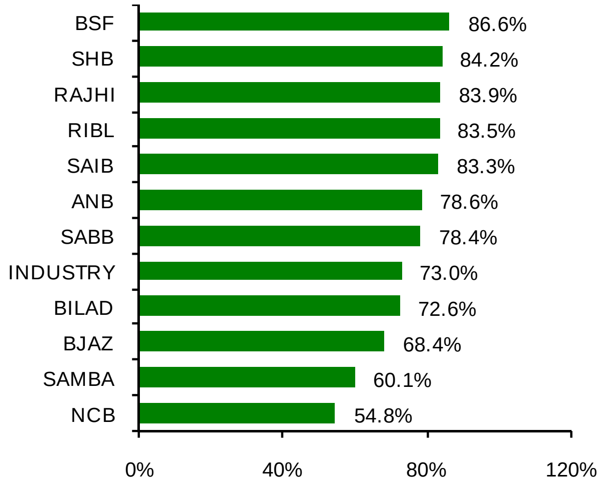
The relatively risk averse environment of 2010 prompted banks to maintain favorable liquidity positions. Still opting for highly liquid balance sheet items, mainly cash and balances with SAMA and due from banks, Saudi banks kept high levels of cash ratios. The industry's cash to total assets ratio dipped slightly to 11.3% in 2010 compared to 11.8% in the previous year. SAMBA was by far the most liquid with a ratio of 17.4%, and SAIB the least with only 2.4% cash. Yet, the industry still managed to increase the ratio of Minimum Risk Assets (MRA) to total assets to 33.1%, a six-year high, (figure 13). Meanwhile, SAMA reacted by issuing around SAR120 billion in treasury bills to absorb part of the ample liquidity. Additionally, as deposits crossed the SAR1 trillion threshold, coupled with rather tighter lending criteria, the Loans to Deposits ratio (L/D) continued its drop settling at 73% by end of 2010, losing another 1.9% after 2009's contraction of almost 11%, (figure 14). Only four banks managed to increase their L/D ratio: SAIB, SHB, and SAMBA made appreciable gains of 5.4%, 3.9%, and 2.9%, respectively, due to their shrinking deposit bases, while BSF gained marginally 0.7%, given its consistent performance and stable balance sheet items' composition. Due to its largest deposits base, NCB has become accus-

13. Cash/Total Assets, 2010



Source: Banks' Annual Reports, 2010

14. Loan-to-Deposit Ratio[8], 2010

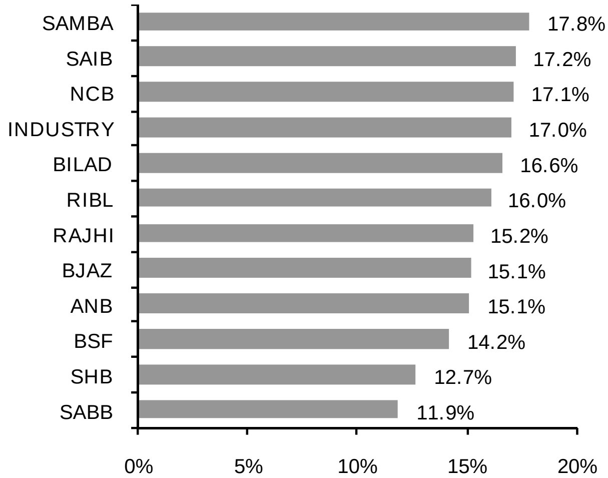


Source: Banks' Annual Reports, 2010

tomed to having the lowest L/D ratio, falling to 54.8% in 2010, followed by SAMBA with 60.1%. Banks continued their rather conservative lending into 2011 as L/D ratio decreased to a six-year low at 71.1% in 1Q2011, validating banks' rather risk averseness stance.

The abovementioned led to the improvement in Capital Adequacy Ratio (CAR) caused by higher levels of retained earnings, statutory and excess reserves. By the end of 2010, tier 1 CAR reached 17%, with only three banks reporting declines, namely BILAD, BJAZ, and NCB by 3.3%, 2%, and 0.7%, respectively, (figure 15). On the monetary front, interest rates remained suppressed signifying the accommodative demand-supply dynamics for

15. Tier 1 CAR[9], 2010



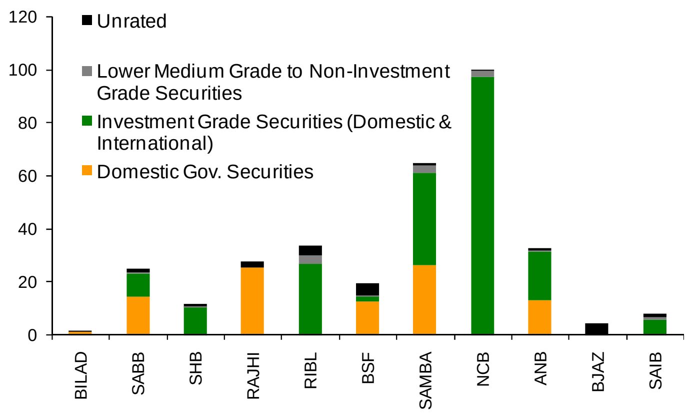
Source: Banks' Annual Reports, 2010

SAR denominated funds (Annex III, figure 10). The highly liquid state of the banking industry surely provides ample lending opportunities that are yet to be grasped. As Saudi banks weathered the aftermath of the financial crisis, this marks the second year of a still highly liquid state. Saudi banks will need to redeploy these liquid assets as the economy has proved to be resilient to external shocks. Coupled with the recent royal decrees, and expected approval of the mortgage law, banks need to shift from amassing liquidity to expanding their loans portfolios.

V. Investments

The incremental growth in net investments in 2010 and 1Q 2011 by SAR54 billion has indicated that domestic banks are proactive in mobilizing the huge excess reserves left idle at SAMA, currently earning less than the reverse repo rate. On an aggregate level, however, trading income (which largely encompasses income from foreign exchange and fixed income trading) has declined by 48.0% Y/Y and 6.8% Y/Y, respectively, in 2010 and 1Q 2011. Additionally, income from financial instruments (designated as fair value through income statement (FVIS) and gains on non-trading investments) took a downward trajectory, declining by 38.9% and 48.4% in 1Q 2011, after registering an-

16. Credit Exposure of Investments, SAR bn, 2010



Source: Banks' Annual Reports, 2010

nual positive gains of 17.7% and 137.5% in 2010. This performance will no longer appear that worrisome if we factor in the range bound status of the capital markets since May 2010, alongside the re-surfacing of sovereign debt worries over EU that derailed the upside movement seen in 2H 2009 and 1Q 2010.

Data pertaining to the investment assets, as reported by most banks in FY2010, reflects this continued increase in domestic and foreign investment in terms of volume and quality. Domestically, the demand for Saudi government securities has increased by 28.9% Y/Y, from SAR72.8 billion to SAR93.8 billion. We believe this figure could have been significantly higher, due to the fact that some banks did not explicitly mention the value of government instruments, opting instead to tag them as investment grade alongside other corporate securities. In our opinion, most of the increase was accounted for in treasury bills, particularly following SAMA's involvement, propping up issuances by SAR76.7 billion to replace matured Saudi Development Government Bonds (SDGBs) during 2010 and up to the end of April 2011.

The allocation to investment grade securities has risen albeit at a benign 5.9% Y/Y growth to SAR205.2 billion. On another positive note, lower medium grade to non-investment grade investments have been reduced by 13.4% Y/Y, which symbolizes the tendency of local banks to opt out of risky securities. Based on the geographic concentration of investment assets, the kingdom continued to dominate, reserving the highest share at 62.8% last year from 60.2% in 2009. This is contrary to the receding shares of Europe and North America that fell to 9.9% and 12.9%, respectively, in 2010 from 14.1% and 14% in 2009; an expected outcome given the intense sovereign debt crisis that plagued EU in May and November as Greece and Ireland sought emergency bailouts.

Annex I: Glossary of Key Terms and Formulas

1/ 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).

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

3/ 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.

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

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

6/ 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.

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

8/ 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.

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

10/ 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.

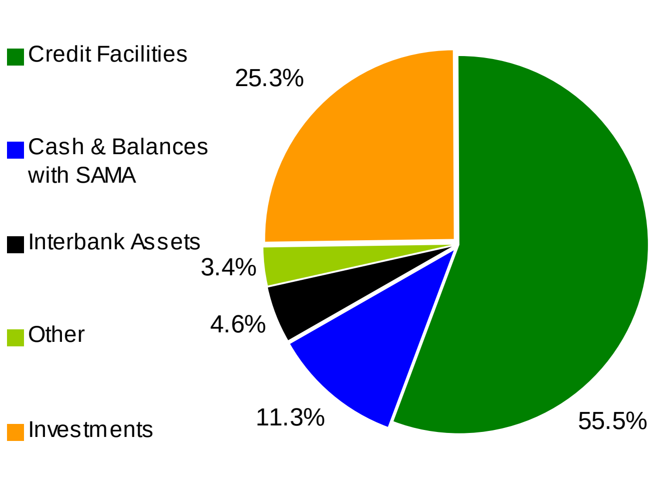
11/ Yield on Earning Assets: The ratio of special commission income to the average earning assets, comprised of due from banks, net loans and net investments.

12/ Cost of Funds: The ratio of special commission expense to the average funding base, comprised of customer deposits, term loans and due to banks.

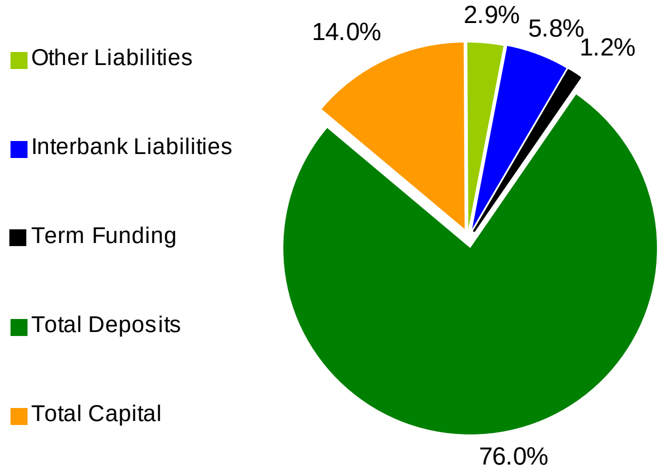
13/ Return on Average Assets: Return on Average Assets (ROAA) is the Ratio of net income to average total assets. Average total assets is the simple arithmetic average of total assets in period t and period t-1.

Annex Ⅱ: Banking Indicators

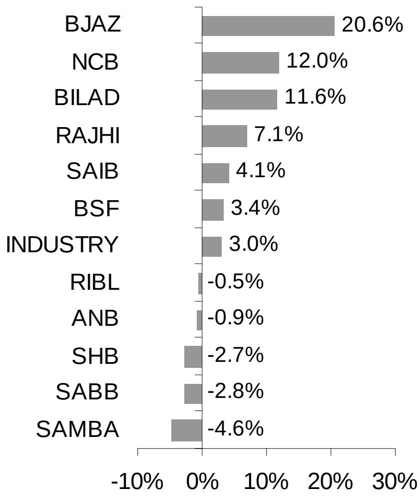
1. Asset/Investment Mix, 2010



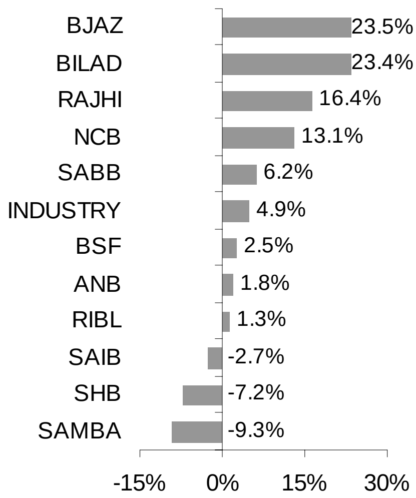
2. Liability/Funding Mix, 2010



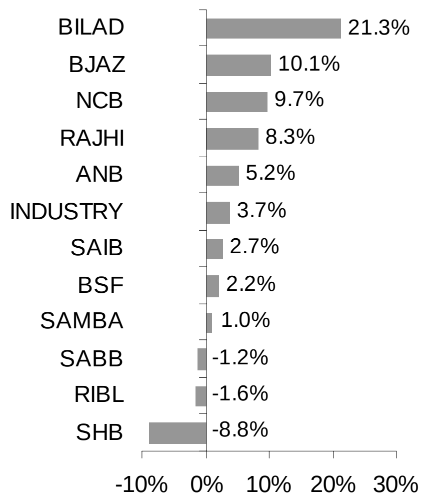
3. Growth in Net Loans, 2010



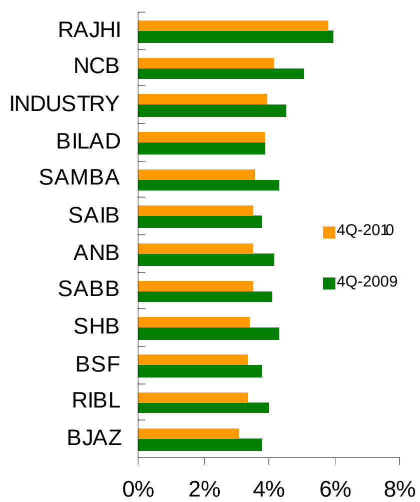
4. Growth in Deposits, 2010



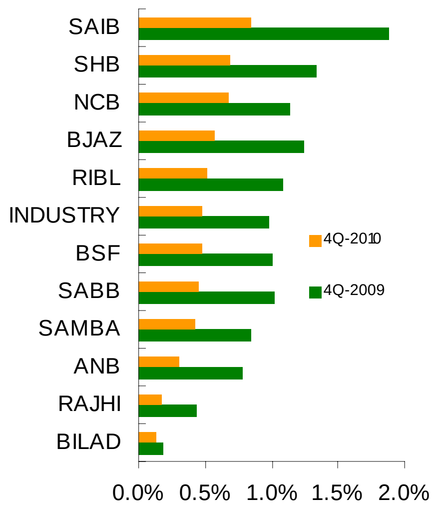
5. Growth in Total Assets, 2010



6. Yield on Earning Assets[11]



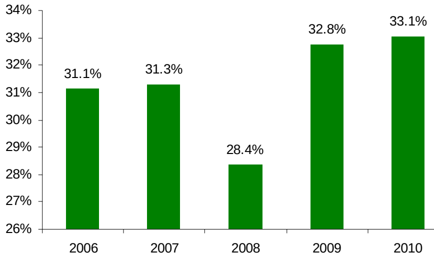
7. Cost of Funds[12]



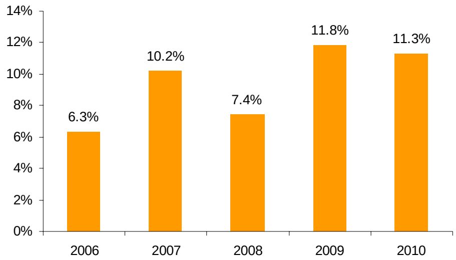
Source: Banks' Annual Reports, 2010

Annex III: Banking Indicators

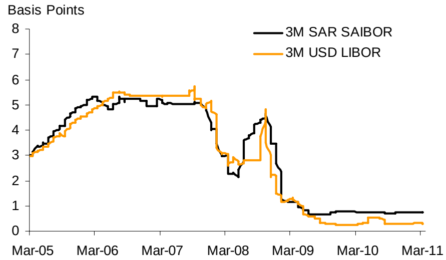
8. MRA[6]/Total Assets



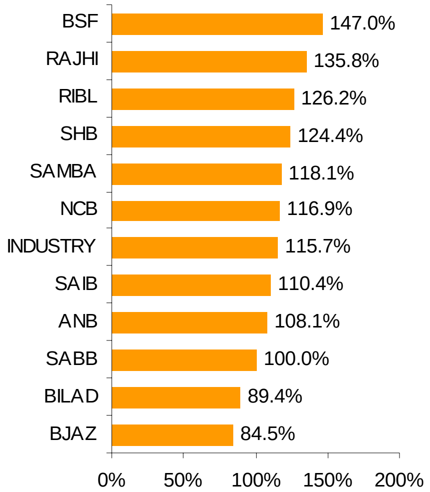
9. Cash[7]/Total Assets



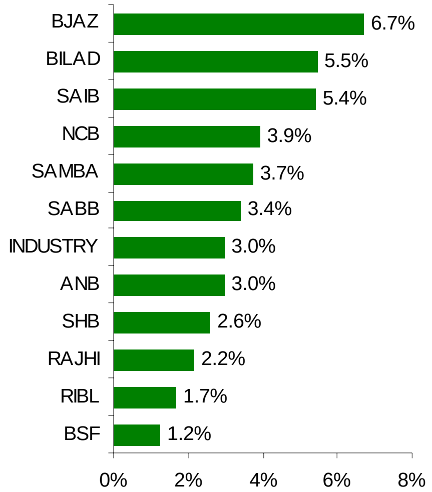
10. 3M SAIBOR - 3M LIBOR



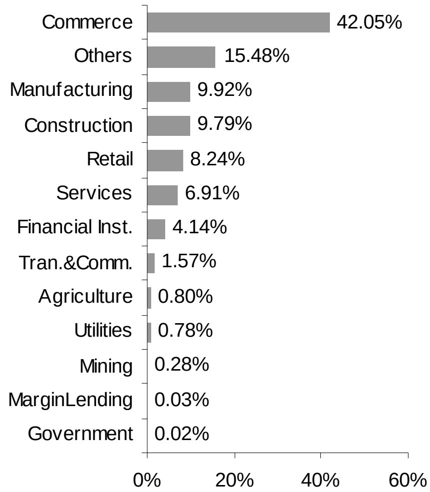
11. NPL Coverage Ratio[4], 2010



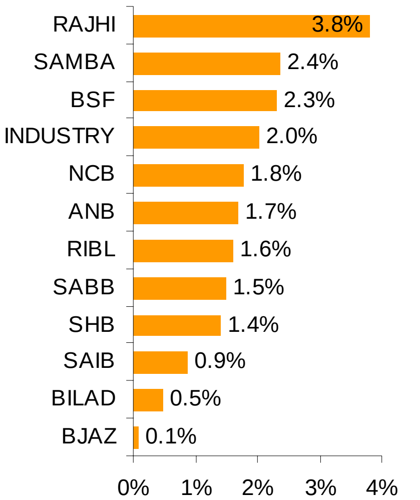
12. NPL Ratio[5], 2010



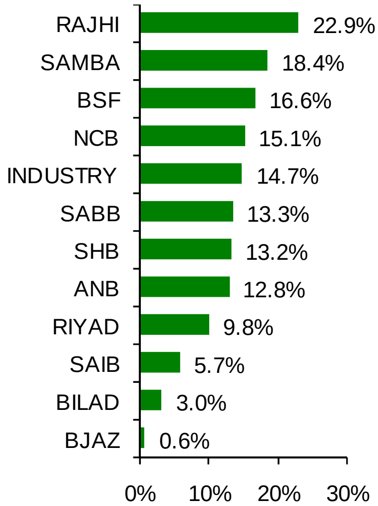
13. Sector Risk Concentrations*



14. Return on Average Assets[13], 2010



15. Return on Equity, 2010



Note: *Shares of specific provisions by economic activity as 31 December 2010.
Source: Banks' Annual Reports, 2010.

NCB الأهلي

Economics Department

The Economics Department Research Team

Head of Research

Said A. Al Shaikh, Ph.D
Group Chief Economist
s.alshaikh@alahli.com

Macroeconomic Analysis

Jarmo Kotilaine, Ph.D
Chief Economist
j.kotilaine@alahli.com

Tamer El Zayat, Ph.D
Senior Economist/Editor
t.zayat@alahli.com

Ali Al-Reshan
Economist
a.alreshan@alahli.com

Majed A. Al-Ghalib
Economist
m.alghalib@alahli.com

Dania Orkoubi
Economist
d.orkoubi@alahli.com

Sector Analysis/Saudi Arabia

Albara'a Alwazir
Senior Economist
a.alwazir@alahli.com

Paulina Chahine
Senior Economist
p.chahine@alahli.com

Lama Kiyasseh
Economist
l.kiyasseh@alahli.com

Management Information System

Sharihan Al-Manzalawi
Financial Planning & Performance
s.almanzalawi@alahli.com

To be added to the NCB Economics Department Distribution List:

Please contact: Mr. Noel Rotap
Tel.: +966-2-646-3232
Fax: +966-2-644-9783
Email: n.rotap@alahli.com