Saudi Arabian Monetary Agency

A Case Study
On
Globalization and the Role of Institution Building in the Financial Sector in Saudi Arabia

10th September 2003

<u>**Saudi Arabian Monetary Agency**</u>

TABLE OF CONTENTS

Saudi Arabia – Case Study

1. Introduction

Since the dawn of its modern history, Saudi Arabia has been an open and liberal economy which has benefited and extensively flourished from free movement of goods, services, capital and human resources. Consequently, it has played an important role in supporting international efforts towards a more globalized and interlinked world economy. Also, during this period Saudi Arabia has recognized the importance of institution building to ensure that the country can develop an economy based on strong and stable fundamentals which can allow an optimal participation in the global market as well as meet the challenges of swings and turbulences in the global economy. This paper prepared for the G-20 Finance and Central Bank Deputies' Meeting on 26 May 2004 in Mexico City, presents the experiences of Saudi Arabia for a case study on '**Globalization and the Role of Institution Building in the Financial Sector**.'

The history of these experiences in globalization and institution building for the Saudi Arabian Financial System are best presented in the context of the evolution of its banking system and the role played by the Saudi Arabian Monetary Agency (SAMA), the central bank, in the institutionalization of the financial market. This is because for over half a century, Saudi banks and SAMA have been the major players in the Saudi financial system. This history can be divided into distinct phases – the genesis, the adolescence period of the 1970's, the trials and tribulations of the 1980's, and the consolidation and growth of the 1990's which lead into the prospects for the new millennium. This paper traces the main theme through six decades of the evolution of the Saudi banking system, which is characterized by strength, stability and remarkable resilience. It is also supported by consistency in financial and monetary policies and strong banking supervision.

2. The Genesis and Early Years

The Genesis of the Banking System. The genesis of a modern banking system in Saudi Arabia has its roots in the creation in October 1952 of the Saudi Arabian Monetary Agency (SAMA) with primary responsibility for monetary stability. Prior to this, branches of a few foreign banks and some local money changers provided all financial services to meet the needs of the trading community and the pilgrims. By 1952, the inflow of the royalty revenues from increasing production and demand for oil had contributed to a sharp rise in government revenues and expenditures. As this gave a boost to the domestic economy, demand for financial services rose sharply. The Government followed open and liberal policy which encouraged a competitive banking environment and permitted opening of new domestic and foreign banks in Saudi Arabia. SAMA's creation was followed by the licensing of more foreign bank branches including Banque de Caire, Banque du Liban et d'Outremer and First National City Bank of New York. This was the first wave of foreign banks that linked Saudi Arabia firmly with the global financial markets. Some domestic banks were also licensed. The National Commercial Bank was licensed in 1953, and Riyad Bank started operation in 1957 and Bank Al-Watany in January 1958.

Introduction of Paper Money. During the period 1950 to 1956, there was the partial introduction of paper money in the form of Pilgrim Receipts which were supported by precious metals and foreign currencies. By 1960 the Government was able to hold down inflation, the Riyal was officially pegged to US Dollar and was stable, foreign currency reserves had gone up and the government had issued paper currency to replace all Pilgrim Receipts. Nearly all government debt had been repaid, an accomplishment that lasted for years to follow.

The Growing Pains. The first banking problems faced by Saudi Arabia took place in 1960. Riyad Bank and Al-Watany Bank, which had commenced operations in 1957 and 1958 respectively, faced serious liquidity problems arising from mismanagement and improper loans by board members in both banks. By 1960 Bank Al-Watany was technically insolvent and was unable to settle the claims of local depositors. SAMA liquidated the Bank and merged its operations with Riyad Bank. By 1961, SAMA required Riyad Bank to reorganize, and with Government's approval, SAMA, on behalf of the Government, acquired 38% of the shares of the Bank. These events tested the Government's resolve to defend the stability of the nascent banking system. The Government not only took action, requiring a merger but also came in strongly as a shareholder to prevent a bank failure. This sent a clear signal that Saudi authorities wanted to maintain and fully support a strong, stable and credible banking system. Notwithstanding government ownership stake, Riyad Bank continued to operate as a private sector institution with no major interference from the authorities.

Strengthening of the Regulatory Framework. These banking difficulties led to a new Banking Control Law in 1966, which gave SAMA broad supervisory powers to license and regulate all banks. Banks were required to meet stringent capital adequacy, liquidity, lending ratios and reserve requirements. A system of on-site and off-site prudential supervision was introduced and SAMA strengthened its supervisory capabilities. The Law also supported the concept of a Universal Banking Model, which permitted banks to provide a broad range of financial services including banking, investments, securities, etc. through their branches. Consequently, banks became the primary licensed financial institutions and expanded rapidly covering the entire country. Clearly, this was a most important institutional development.

3. Consolidation and Restructuring of the 1970's

Consolidation of Banking Industry. The 1970's were a period of rapid expansion of the banking system to keep pace with the significant rise in government revenues and expenditures and the financing of major development projects aimed at infrastructure and industry. There was tremendous growth in the financial position of the commercial banks between the period 1970 to 1980, with the total assets increasing 40 times from US$ 720 million to US$ 24.8 billion and deposit increasing from US$ 426 million to US$ 18.1 billion. The demand for commercial credit lagged the increasing liquidity available in the banking system and also low cost medium to long-term credit was easily available from the government lending institutions. Consequently the foreign assets of the commercial banks grew rapidly from 19% of total assets in 1972 to 44% at the end of 1980. This period further strengthened the links between the Saudi financial system and the global financial markets. This was driven by the need of SAMA and the Saudi banks to place their excess liquidity in the global market. Significant and important relationships between local and foreign banks evolved which have continued over the past decades. SAMA itself became an important player and in 1983 entered into General Agreement to Borrow with the IMF.

Role of Money Changers. By 1979, of the 12 banks in operation, only 3 were non-Saudi, and the total number of bank branches had almost doubled to 140. However, many major cities, which were frequented by pilgrims and many small remote communities were also served by over 250 branches of money changers who provided currency exchange and other minor financial services.

Establishment of Special Purpose Government Funds. In addition to the banks and money changers, during the 1970's the Government created five major lending institutions namely; Saudi Credit Bank, Saudi Agricultural Bank, Public Investment Fund, Saudi Industrial Development Fund and the Real Estate Fund. These institutions provided medium-term and long-term development finance to supplement the short-term funds provided by commercial banks. These institutions played a key role in financing the medium and long-term capital needs of the nascent industrial sector. They also freed up the banks to pursue less risky short and medium-term financing. This was considered essential at the early stage of development when the economy lacked a modern infrastructure and a trained human resource base.

Restructuring Related to Foreign Banks. The Government had always encouraged foreign banks to open branches within the Kingdom and consequently, by 1975, 10 international banks with 29 branches were present. However, with the Second Five-Year Plan, commencing in 1976, the Government promoted a policy of converting foreign banks' branches into publicly-traded companies with participation of Saudi nationals. This policy had a number of objectives. The incorporation and floatation of shares of these banks encouraged broad based public participation that also contributed greatly to the development of a stock market in the Kingdom as bank shares had particular attraction for investors. Also it promoted banking activities and the formation of banking habit among the population. By encouraging foreign banks to take large shareholdings in the newly incorporated banks and by offering them management contracts, the foreign partners' position was strengthened. They could, not only, exercise significant management control but could also benefit fully from national treatment accorded to banks fully owned by Saudis. By 1980, of the 12 banks in operation 3 were non-Saudi while 7 had substantial foreign ownership, and the total number of bank branches had risen to 247.

Further Challenges. Notwithstanding that growth, significant gaps remained in the provision of banking and financial services. Some of the key gaps included, small business credit needs; chequing facilities were limited to cash withdrawals; foreign currency transfers were non-existent or were provided mostly by money changers; lack of consumer loans and facilities for small savers; antiquated banking methods; non-existent computer technology; and a regionally based clearing house system. A major deficiency at that time was the high dependence of banks on expatriate workers and a lack of Saudi nationals in banking business. Thus by 1980, Saudi Banks and Saudi authorities faced the challenge of rectifying these deficiencies.

4. Banking Problems and their Resolution of the 1980's

The Trials and Tribulations. The decade of the 1980's was a tumultuous and testing period for Saudi banks and the financial system. In line with the tremendous increase in government revenues during 1979 to 1981 and subsequent slow-down in 1982 to 1986, the Kingdom's Commercial banks saw rapid expansion followed by a difficult period of adjustment, deterioration in asset quality and retrenchment; some type of a boom and bust episode.

As oil prices tumbled from the all time high in 1981 and continued to decline in the next five years, it put significant pressure on the quality of banks' assets which deteriorated with the economic slowdown. The credit to private sector which had increased over 500% during the period 1976-81 only grew by 20% over the next five years, at a rate of less than 4% per year. The Banks suffered much from non-performing loans which increased to over 20% of all loans by 1986. Banks' profits suffered significantly and loan loss provisions and loan write-offs mounted. By 1988 most banks had made sufficient provisions for doubtful accounts and the average provision for the Banking System had risen to over 12% of total loans.

The Causes for the Banking Problems. The causes for the problems faced by the Saudi Banks mainly arose from the macroeconomic imbalances which were created by a steep rise in the government revenues and expenditures in 1979 to 1981 period followed by a precipitous decline in oil revenues. Government revenues which had risen to SR 333 billion by 1981 started a rapid decline and dropped to just SR 74 billion by 1987. The rapid rise in bank assets and liquidity in late 70's and early 80's had given rise to a sharp increase in demand for private sector credit. Some banks expanded too rapidly, and did not have adequate credit assessment and monitoring procedures. They also lacked required technical expertise, faced a shortage of qualified human resources and had inadequate technology. Consequently when the steep decline in the economy occurred, many companies and businesses suffered from a lack of liquidity and faced a credit crunch. The construction and contracting sectors which had boomed earlier, faced the biggest setback and many projects were affected. Banks had difficulties to recover their loans and the collateral in many cases proved to be difficult to realize.

Another Test for the Supervisory System. In 1982, SAMA faced another major supervisory challenge when irregularities appeared in Saudi Cairo Bank's operations. Two senior managers were involved in unauthorized trading in bullion during the 1979-81 period, and had concealed accumulated losses that exceeded the Bank's share capital. SAMA required the Bank to issue new shares and double its capital in 1986. SAMA arranged this increase to be taken up entirely by the Public Investment Fund (PIF). The Bank also benefited from "low-cost" deposits from the Public Investment Fund. These measures helped the Bank with liquidity and rescued it back to a healthy position.

The Government's Response. In this period SAMA in concert with the Ministry of Finance took a number of steps to ensure the stability of the financial system and to help the Banks to overcome the prolonged economic downturn. These include the following;

1. Banks were required by SAMA to seek its approval prior to announcing their dividends. The Banking Control Law requires all banks to build their statutory reserves equal to their share capital. SAMA further encouraged Saudi banks to build additional reserves to strengthen their capital base.

2. Most foreign shareholders in Saudi Banks enjoyed a tax holiday for the first five years of their ownership. To encourage retention of profits, the tax holiday was extended in most cases by another 5 years after which a deferred tax scheme was permitted.

3. In 1986 SAMA obtained a ruling from the Tax Department that permitted the tax deduction of loan loss provisions on an accrual basis. This encouraged Banks to increase their loan loss provisions for doubtful accounts.

4. To encourage Saudi Banks to increase their interbank dealings and to support the development of a riyal inter-bank market, a tax ruling was obtained which exempted foreign banks from withholding taxes when carrying out inter-bank transactions with Saudi Banks.

5. Corporate Governance. SAMA recognized the need to encourage banks to take strong steps to improve their risk management and control procedures. Consequently it took major initiatives in the area of corporate governance. Firstly, it required all banks to develop and strengthen their internal audit departments, and secondly it issued minimum internal control guidelines. Also SAMA issued accounting standards for Commercial Banks in Saudi Arabia which were in line with International Accounting Standards.

6. Creation of Banking Disputes Committee. In 1987, Saudi authorities established a Banking Dispute Committee by the order of the Council of Ministers. The creation of this Committee as the only relevant quasi-court to handle dispute between banks and their customers significantly strengthened the legal system. By law, all banking disputes had to be referred to this Committee and the rulings of this Committee were given the same enforcement support as decisions from any other court.

7. Exchange of Information on Large Borrowers and on Delinquent Loans. In the early 1980's, SAMA established a credit information service that provided information to Saudi Banks on all large exposures of the Banking System. This enabled banks to better assess the credit position and risk of big borrowers. Also in 1986, SAMA permitted Banks to exchange information on delinquent borrowers as a means of applying collective pressure on them. These measures have proved quite effective in resolving problems of delinquent loans.

Consolidation through Mergers and Formation of Banks. In terms of bank mergers and restructuring in the 1980's, there were three major events. Firstly, the United Saudi Commercial Bank was formed in 1983, to take over the remaining branches of three foreign banks, namely United Bank of Pakistan, Bank Melli Iran and Banque du Liban d'outer Mer. This completed the process of conversion of foreign bank branches into strong joint-venture banks involving foreign and Saudi shareholders. Also, in 1984 Saudi Investment Bank was given a full commercial license and in 1988 a license was given to Al-Rajhi Banking and Investment Corporation to convert the Al-Rajhi family's money changing business to a full-fledged commercial bank. With these developments, by 1990 the Saudi Banking System had 12 commercial banks of which 9 had foreign shareholders.

Recapitalization. The difficulties of the mid-80's led to a process of significant increase in banks' capital under encouragement of SAMA. During the period 1988 to 1993, 7 of the 12 Saudi Banks increased their capital through new share floatation. As a result, the capital and reserves for the banking system had doubled from SR 15 billion at end of 1988 to SR 30 billion by end of 1993. Subsequently, during the following decade Saudi banks have remained highly capitalized by international standards, and their average Risk Based Capital Adequacy ratio remained around 20%. Also their capital was mostly in form of tier-1.

A Stronger Banking System. Despite the tumultuous economic conditions during the 1980's Saudi Banking System grew rapidly. The number of branches, 247 in 1980 reached 1,036 by end of 1990. Three new banks – Al-Rajhi Banking and Investment Corporation, Saudi Investment Bank and United Saudi Investment Bank – were added to the list. Total employees also rose significantly from 11, 000 in 1980 and to about 25,000 by 1990. Another aspect of expansion was the opening of overseas branches of major Saudi banks with branches in UK, Bahrain, Beirut and Turkey.

Laying the Foundations for a Securities Market. In 1982, SAMA introduced an instrument known as Bankers Securities Deposit Accounts (BSDA's). This was a forerunner to the Treasury Bills which followed subsequently. Also in 1985, the Government issued new rules through SAMA permitting the creation of a stock market. A Supervisory Committee including senior officials from SAMA, Ministry of Finance and Ministry of Commerce was established to develop rules and regulations and to establish surveillance system. The day-to-day operations of the shares market and its supervision was left to SAMA.

Subsequently, in 1988 the Saudi Government introduced the Government Development Bonds program to provide an important investment instruments to banks and other investors in the Kingdom. SAMA was appointed to act as the debt manager. Subsequently, SAMA put in place arrangement whereby banks were able to Repo of up to 25% of their Saudi Government Bond holdings with SAMA. Their Repo rate was subsequently increased to 75%.

Improved Services through Introduction of Technology. During the early 1980s, SAMA recognized the potential and the need to enhance and strengthen the Saudi financial markets through greater investment in modern technology. In this area, SAMA took a leadership role and developed a comprehensive strategic plan to guide the banking system towards modernization. The underlying objectives of this strategy included elimination of duplication of efforts and waste, development of a national infrastructure, etc. Significant changes were made to modernize the Banking System. Specific highlights included the following:

- Introduction of an Automated Cheque Clearing System in 1986.
- The linking of Saudi Arabia with the SWIFT payment network.
- Introduction of a national Automated Teller Machine System which permitted customers access to their accounts from any machine in the Kingdom and from the major financial markets.
- Introduction of debit, credit and charge cards.
- Introduction of the Point-of-Sale terminals that link customers, traders and banks.

These systems promoted efficiency and cost-effectiveness in provision of banking services. They also ensured enhanced competition as banks had to compete in developing and implementing technologically advanced systems. As SAMA led the development of national systems, it ensured efficiency, consistency, cost-effectiveness and a level playing field for all banks.

5. Challenges of the 90's – Systemic Stability and Consolidation

The Challenge of the Gulf Crisis. By beginning of the 1990's the Saudi Banking System had largely recovered from the difficulties of the mid-80's. Banks had expanded their branch network, introduced stronger management methods and new technologies, raised new capital, improved their profitability and set aside large provisions for doubtful accounts. They were healthy and profitable and the 90's augured well for the Banking System. However, with the invasion of Kuwait by Iraq in August 1990, the Saudi Banking System faced its biggest challenge. The Gulf crisis fully tested the strength of the Banking System and SAMA's capability as a central bank and a banking supervisor. The crisis affected the monetary situation profoundly. Customer withdrawals of domestic deposits during August 1990 were 11% of total customer deposits. These were largely converted into foreign currency and transferred abroad. By September 1990, the pressure had eased. SAMA had ensured the availability of foreign currency to meet customer demands and by providing more liquidity through Repo arrangements and placing of foreign currency deposits with banks. Banks also coped well by liquidating their foreign assets. By end of 1990, the banking system-wide deposits had returned and the year to year decline was only 1.6%.

The Economic Boom and Bank Recapitalization. Following the resolution of the Gulf crisis there was a mini boom in the economy. During 1991 there was a massive surge of about 20% in the deposit of the Banking System. Banks domestic loans and advances grew 90% during the period 1990-95 and all other banking indicators including Rate of Return on Equity and Average Assets continued to be very positive with many banks making record profits during this period. Despite difficult international conditions, the banks continued to show solid and stable growth and strong profitability during the second half of 1990's.

Strengthening of Capital Base of the Banks. The Saudi Banks under guidance of SAMA used the bullish sentiments in the stock market to raise substantial amounts of capital. As noted earlier, 6 of the 12 banks increased their capital during 1991-92 period. The trend to increase the banks' capital base continued during the second half of the 1990's, and 3 Saudi Banks went to the market during the 1993-1997 period. The objectives of the capital increase have been as follows;

1. To strengthen the capital base of banks. This was to ensure that banks continue to meet the capital adequacy standards required by the Banking Control Law and the Basel Risk Assets based Standard introduced by SAMA in 1992.

2. To increase the deposit-raising potential of the banks.

3. To broaden the base of shareholders as more small investors entered the market, the floatation of bank shares provides an attractive opportunity for them to hold shares.

4. To permit Banks to use their additional capital to increase their provision for doubtful accounts and to ensure that they were all provided against non-performing loans.

5. To help Banks with funds to invest in computers and information technology and development of new products and services.

The Capital Adequacy Ratio. These objectives were largely achieved and Saudi Banks with a Risk Asset Ratio of about 20% at 30 June 2003 are highly capitalized by international standards. Following the Gulf crisis the Banking system has coped well with the domestic economic cycles and the volatilities and turbulence of the international financial markets. Despite difficult international conditions, the banks showed solid and stable growth and reasonable profitability during the 90's.

Mergers and Acquisition for Further Consolidation. The restructuring of the Banking System continued with the 1997 merger of United Saudi Commercial Bank and Saudi Cairo Bank into United Saudi Bank. In 1999, United Saudi Bank merged with Saudi American Bank to form the third largest bank in the Kingdom. This consolidation of Saudi Banks is primarily driven by shareholders who wish to maximize share values and who believe that size matters.

Further Technological Investment in the Shares Market. In August 1990, SAMA introduced a major enhancement of shares market by unveiling an electronic share trading and settlement system (Electronic Shares Information System). This system encouraged banks to open their vast branch network to investors who wished to trade in shares. The system permitted same day trading and settlement (t+0) features and also a paperless system where share certificates became obsolete. Over the next decade, number of shares traded and values traded grew in geometric progression. Many new companies were floated and existing companies tapped the share market. In 2001, the Electronic Share Trading System has been further enhanced and is now capable of handling government and corporate bonds, mutual funds and new investment products. This is a key infrastructure development that will strongly support the recently announced Capital Market Law.

6. Recent Legislative Changes with Significant Implications for the Saudi Banking and Financial System

In support of the Government policy of further economic liberalization, the pace of change for broadening and opening the financial sector has picked up significantly in the past five years. The Saudi Government is bringing in a string of legislative and procedural changes to permit rapid growth and innovation: the objective being increasing investment, job creation and competition. Some of the most significant initiatives include the following:

The Foreign Investment Law. In April 2000, Saudi Government promulgated a new Foreign Investment Act which announced major changes to the existing legal and regulatory environment ushering in a new era of foreign investment in Saudi Arabia. The new Foreign Investment Act also had implications for the financial sector as it further opened up the Saudi market to foreign investments, including 100% foreign-owned companies. The Law created the Saudi Arabian General Investment Authority (SAGIA) which has powers to issue a license to a company for most investment activities. The main objective of SAGIA is to oversee the investment affairs in the Kingdom, including foreign investments. Its functions include preparation of government policies, proposing executive plans and criteria, monitoring and evaluating performance of local and foreign investments, conducting studies in investment opportunities and coordinating with pertinent government bodies.

Since its creation in 2000, SAGIA has been an important player and influence in the development of new laws and in economic reforms to encourage investments. Since its creation hundreds of new investment projects have been approved with billions of dollars in new investments. It is worth noting that in 2000, Saudi Arabia also introduced changes to the tax system whereby the income tax to be paid by foreign companies and investors in the highest tax bracket was reduced from 45% to 30%. This has very positive implications for existing and future foreign investors in the financial sector.

The New Capital Market Law. A Capital Market Law has been promulgated in June 2003. The Law establishes a new government regulatory body, the Securities Exchange Commission (SEC), which will have authority to make rules and regulations and will have the necessary enforcement powers. SEC will be the primary regulatory body for the capital market activities and its primary responsibility will be to promote the development of an efficient, vibrant, fair and transparent market. The SEC will also be responsible for specific initiatives to deepen and broaden the securities market for enhanced socio-economic development. The Law envisages the creation of the Saudi Arabian Securities Exchange. This will be a privately owned company governed by a Board of Directors that will include members from the private and the public sectors. The Securities Exchange Company will be the exclusive market for publicly traded securities and will act as a self-regulatory organization. The Securities Exchange company has been tasked with various functions including ensuring fairness and transparency, admission of members, listing of securities, and promotion of corporate governance. It will have sole authority to settle and register transactions of securities. It is worth mentioning that the provisions of the Capital Market Law are consistent with standards published by the International Organization of Securities Commissions (IOSCO). The Capital Market Law brings Saudi Arabia's securities laws into the mainstream of modern securities regulatory practices embraced by IOSCO members.

The New Insurance Law. In July 2003, Saudi Arabia has promulgated an Insurance Law that provides a legal and regulatory framework for the domestic insurance market which was hitherto unregulated. Over the years, this market has grown sizably and over 150 domestic and international companies operate in various forms – joint-stock companies, branches, agencies, brokerage houses, etc. Many unlicensed companies and individuals sell a range of insurance and investments products including automobile, life, health and education policies. These companies take billions of dollars in annual premiums that are generally invested in foreign financial markets. The new Law provides that the Saudi Arabian Monetary Agency will become the licensing and the regulatory authority for this sector. All market participants are to be licensed and a regulatory infrastructure is being developed to ensure a competitive, vibrant and transparent market. The insurance market will have proper rules and regulations to ensure sound corporate governance and investor protection. SAMA has already developed an organizational framework and an experienced supervisory team to regulate this important sector.

7. Recap of Major Achievements and Prospects for the Next Decade

Over the past half century, the Saudi economy and the financial sector have grown manifolds and have emerged as a major force among the countries of the Gulf Cooperation Council and the Middle East. During this period, while the Saudi economy, like other economies, has been buffeted by the turbulences of the global economy and the volatilities of the oil market, the financial system has remained sound, stable and credible. It has coped well with the demands placed upon it and no Saudi bank has failed. Banking problems that have surfaced have been skillfully and adroitly resolved by the authorities using various supervisory tools and techniques.

A Strong Supervisory Framework. As is evident from this case study, sustained long-term growth and development of the Saudi Banking System and Financial System has been supported by a strong and comprehensive system of banking supervision. Since its creation in 1952 and the promulgation of the Banking Control Law in 1966, SAMA has enjoyed broad regulatory powers of licensing banks, approving their activities and taking prompt corrective action when required. SAMA has powers to make rules, regulations and guidelines for banks in all areas including capital adequacy, liquidity, lending limits, credit and market risk, etc. Also, it has powers to conduct both on-site and off-site supervision. Until the recently announced Capital Market Law, SAMA also acted as the regulator of the stock market and operated the electronic stock exchange. Also, SAMA has a dual role of providing central payment and settlement services and for the oversight of these systems. Over the years, SAMA has used its broad supervisory powers effectively to ensure that the Saudi Banking System continues to enjoy a high reputation for soundness and stability in the international financial markets. Looking ahead, systemic stability will continue to be a major goal of Saudi authorities for the financial markets and the banking system.

The recent promulgation of the Insurance law will further expand SAMA's supervisory role in an other important sector of the financial market. It will be both a licensing and a supervisory authority with power to ensure that only well capitalised companies with technically competent and well qualified management offer such services. SAMA will further encourage that adequate standards of corporate governance, market dicipline and transparency are put in place to ensure a high degree of consumer and investor protection in this sector.

SAMA has been an active player in the international banking supervisory world and has benefited greatly from its participation in several international fora. SAMA has been a founding member of the Banking Supervision Committee of the Gulf Cooperation Countries. This committee has a mandate to promote standardization of supervisory practices in member countries with a view to develop the framework for a unified banking and financial system. It is also a member of the Arab Banking Supervision Committee which promotes stronger standards in the Arab countries. SAMA also participates in several sub-committees of the Basel Committee on Banking Supervision, particularly the Core Principles Liaison Group, which helped develop the Basel Core Principle for Effective Banking Supervision; it is also a member of the Working Group on the New Capital Accord. SAMA also participates in the Basel Committee's Accounting Task Force which helps develop international accounting standards for banks. Another important international forum has been the Financial Action Task Force of which SAMA has been a member since the early 90s and has been actively participating in its main activities. Finally in November 2002, SAMA became a founding member of the Islamic Financial Services Board that was created to develop supervisory standards for Islamic financial institutions.

In addition, SAMA actively participates in various projects, studies, surveys and work conducted by the IMF and the World Bank and other multinational institutions in the areas related to financial sector supervision. For example in 2003 SAMA has invited the Financial Action Task Force to carry out an assessment of its laws, policies, practices in the area of anti-money laundering and combating terrorist financing. Also in 2004 it has invited the IMF to carry out the Financial Sector Assessment Program (FSAP). These assessments will provide a useful benchmark for Saudi authorities to compare their supervision of the financial system against international standards.

Enhanced Corporate Governance. Another important feature of the Saudi financial and banking sector has been a strong culture of corporate governance. As early as 1992, SAMA issued guidelines for the members of the Board of Directors of Saudi banks on their responsibilities. This was followed by issuance of guidance and rules on a variety of topics including the internal controls, the internal audit function, the internal audit committees, etc. Furthermore, Saudi banks were required to appoint two external auditors from the leading international audit firms. Also SAMA insisted that banks follow both the Saudi Arabian and the International Accounting Standards to present their financial statements. In recent years SAMA has required all Saudi banks to implement IAS #39 which is a major step towards fair value accounting. SAMA has also encouraged Saudi banks to participate in the annual Basel Committee Survey of Transparency of International Banks. Currently Saudi banks' financial statements reflect the highest level of transparency amongst the banks of the emerging market countries.

Impact of New Technology. Looking ahead, the Saudi Financial and Banking System is poised to take advantage of its large investments in new technologies. Most importantly there is still room for the full utilization of the capabilities of the 1997 Saudi Riyal Interbank Express (*SARIE*), which is a Real Time Gross Settlement Electronic Fund Transfer System. This system is the backbone of the Saudi payments infrastructure with significant capacity to enhance all other payment and settlement systems. It also provides capabilities for B2B and B2C business applications. Another electronic share trading and information system (*Tadawul*) has recently been enhanced to provide T+0 settlement capability and to permit trading of government bonds, treasury bills and mutual funds in addition to corporate shares. This system functions as an electronic stock exchange and is of critical importance to the implementation of the new Capital Market Law. Saudi banks are now offering telephone and internet banking services and working to further promote electronic commerce. It is worth noting that the Saudi telecommunications infrastructure can support all new technologies in the financial sector. Consequently the future of the Saudi financial sector is closely dependent on the timely selection, adoption and implementation of new technologies. Saudi Arabia is determined to maintain its lead in this area.

New Products and Services. Another important dimension of the future of the Saudi Financial System is the continued growth of banks' off-balance sheet and fiduciary activities. Saudi banks now manage about 125 investment funds with investments of over SR 30 billion. In addition, banks offer international stock brokerage and fiduciary banking services. Given that Saudi Arabia is one of the largest private banking markets in the world the potential for growth in this area is immense. Saudi Banks have also recently entered into bank assurance whereby they have entered into joint-venture agreements with some of the leading insurance companies to provide distribution of jointly-labeled insurance products through their branch networks. Also, recently the Saudi authorities have licensed two leasing companies which are joint ventures including major specialized leasing companies and Saudi Banks. With the new Capital Market and Insurance Laws, Saudi banks will compete with non-bank financial institutions in the provision of these services. This will lead to rapid growth and expansion of these sectors.

Another important area of growth for Saudi banks has been a demand for non-interest (Islamic) banking services. These have grown rapidly in recent years and now account for over 17% of the total assets of the Saudi banking system.

Foreign Banks' Participation. Saudi Arabian financial system has always been open to foreign presence. The government has encouraged this to promote trade, investment and economic relations and to attract expertise and technology. It already has considerable foreign investor presence as eight of the eleven banks have substantial foreign ownership. Many of the foreign partners in Saudi joint venture banks have technical management agreements. In past three years, Saudi Arabia has licensed a number of GCC banking institutions, as a result of the decision of the GCC Summit to permit reciprocal opening of their banking markets. General and specific criteria have been developed for assessing the application of new banks both from GCC and outside. In this connection, Gulf International Bank of Bahrain has been granted a license in September 2000 to open a branch in Saudi Arabia. This was followed by grant of a branch license to the Emirates Bank International, the National Bank of Kuwait and the National Bank of Bahrain. These banks are likely to commence operations in the second half of 2003 or early 2004. Applications from other foreign banks are also being considered.

Other Infrastructure Developments. Some of the other institutional developments with implications for the future of the financial sector which are worthy of note are as follows:

- The Saudi Credit Bureau: since the 1970s SAMA had recognized the need for a suitable infrastructure for the provision of customer related information to support the credit decisions by banks and financial institutions. In this regard SAMA has established and operated a Saudi Credit Information Centre for major banking customers, in 1981. This permitted Saudi banks to collect and share information on their major customers and to be aware of such customers' total borrowings. Following banking problems, in 1987 SAMA permitted banks to share and exchange information on their large delinquent customers. This exchange of information enabled banks to collectively exert pressure on such customers for the benefit of all banks. Also in 1994, SAMA permitted banks to develop a central system to maintain information on delinquent borrowers in the retail sector. This system was helpful in preventing such borrowers to obtain credit from more than one bank. In 2003, these credit information systems are being further supplemented by a classical credit reference agency that will maintain data on all borrowers in the Saudi Financial Market. The Saudi Credit Bureau is owned by the private sector under the supervision of SAMA and will be an important institution for strengthening the financial sector.

- Credit ratings: While the international rating agencies have continued to carry out solicited and unsolicited ratings of Saudi banks in the last decade, there was an absence of a solicited sovereign rating. Without such a rating international market participants were unable to compare the creditworthiness of Saudi borrowers who in turn were unable to tap the international financial markets. This situation has now been rectified, and in July 2003, a solicited sovereign rating of Saudi Arabia had been announced by Standard and Poor's rating agency. This rating is A+ for local currency and A for foreign currency borrowings. This first step will go a long way for Saudi companies and financial institutions to tap financial markets for long-term funds. Also this will encourage the development of an indigenous rating agency and perhaps a Saudi corporate bond and commercial paper market in the near future.

- Non-bank financial institutions: For the past few years, SAMA has encouraged the formation of non-bank financial companies and in this regard has licensed financial leasing companies and international credit card companies. With the advent of a new Capital Market Law there will be a tremendous boost in the non-bank financial sector. New players including stock brokers, investment fund managers, mutual funds, custodians and trustees, investment advisers, etc, are likely to open businesses. These will include different organizational and ownership structures including domestically owned companies, joint-ventures between foreign and local parties and fully foreign-owned companies. This proliferation will permit greater competition and diversity and lead to lower costs and efficiency.

The Way Forward. In this first decade of the new millennium the Saudi financial system is well poised to leap ahead and take advantage of a strong base developed over half a century. The Financial Sector should be able to leverage its traditions of openness and liberalization, its large investment in technology and its strong supervisory infrastructure. It is entering in a new era that demands increased participation, greater competition, enhanced transparency, strong supervision and corporate governance. It is in a strong position to rise up to this challenge and meet the demands of rapidly growing economy and greater customer expectations. The recent legislative, regulatory market changes augur well for a bright future.