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Credit FAQ:

DRAFT: How Will Saudi Arabia's New Mortgage Law Affect Domestic Banks?

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The Saudi government's implementation of a package of five laws composing Saudi Arabia's new mortgage law is drawing closer, although an official roll-out date has yet to be communicated to the market. This legislation will transform home financing in Saudi Arabia to property-secured lending from the current practice of extending loans based on salary assignment, or banks' automatic deductions from borrowers' salaries to repay home loans. Standard & Poor's Ratings Services believes that domestic banks will consequently expand their mortgage lending activity significantly over time, strengthening their competitive advantage versus nonfinancial companies and foreign banks operating in Saudi Arabia.

We understand that the Saudi Arabian Monetary Agency (SAMA), the central bank, is currently in informal talks with market participants to fine-tune drafts of three of the five laws, those on real estate financing, financial leases, and the supervision of finance companies. We will monitor any changes SAMA makes to the draft legislation and how they could affect our view of the economic and competitive conditions for the domestic banking system. We believe the traditionally cautious and conservative SAMA will take the necessary time to come up with the proper framework to identify and segregate risks, as it has demonstrated in the past, for instance, when Saudi commercial banks spun off their investment banking lines into separate legal entities in 2007.

Below we answer frequently asked questions about Saudi home financing and the impact of the new mortgage law on domestic banks.

Frequently Asked Questions

Do you anticipate rating actions on Saudi banks in the wake of the new mortgage law?

No. The eight Saudi banks we rate carry stable outlooks (see table 1). We monitor accuracy and consistency of ratings on an ongoing basis and believe that the development of mortgage lending in Saudi Arabia is in its early stages and not meaningful enough to trigger changes on its own.

We believe that in its current form the mortgage law package will take at least two years to kick in meaningfully into rated banks' balance sheets, which currently represent about 90% of Saudi consolidated banking assets. Consumer real estate financing, despite surging in 2012, only accounted for 5.1% of total banking system loans as of June 30, 2012, or less than 5% of GDP. This compares with the double-digit penetration figures of residential mortgages as a percentage of GDP generally seen in most other G-20 countries, such as about 40% in France or roughly 50% in Germany according to the International Monetary Fund (IMF).

Over the next few years, we will assess how each rated bank further develops its strategy related to mortgages and any potential credit impact. For instance, if we believe a specific bank is losing market share in mortgages, which we view as a segment that is tightly-monitored, relatively safe, and lucrative, we could take a more negative view on this bank's business position. Similarly, if we believe a bank is adopting more aggressive lending policies and growth patterns, translating into an elevated risk profile and lower capitalization metrics and weaker-than domestic peers funding profile, we would potentially take a more negative view on factors that contribute to determining our assessment of its stand-alone credit profile.

Table 1

Saudi Banks--By Total Assets				
Banks	**Acronyms**	**Total assets* (Mil. SAR)**	**Counterparty credit rating as of Feb. 18, 2013**	**Systemic importance**
The National Commercial Bank	NCB	345	A+/Stable/A-1	High
Al Rajhi Bank	ARB	267	A+/Stable/A-1	High
Samba Financial Group	SFG	199	A+/Stable/A-1	High
Riyad Bank	RBK	190	A+/Stable/A-1	High
Banque Saudi Fransi	BSF	158	A/Stable/A-1	High
The Saudi British Bank	SABB	157	A/Stable/A-1	High
Arab National Bank	ANB	137	A/Stable/A-1	High
Saudi Hollandi Bank	SHB	69	N.R.	--
The Saudi Investment Bank	SAIB	59	A-/Stable/A-2	Moderate
Bank al-Inma	BaI	54	N.R.	--
Bank al-Jazeera	BaJ	51	N.R.	--
Bank al-Bilad	BaB	30	N.R.	--

*As of Dec. 31, 2012. SAR--Saudi Arabian riyal. N.R.--Not rated. Source: Tadawul, Standard & Poor's. N.R.--Not rated.

Why is the new mortgage law important for Saudi Arabia?

Because it will increase individuals' access to home financing, which is positive in our view owing to the country's widening housing gap and increasing social needs, given the lack of affordable housing in the middle-income segment. Against the backdrop of social unrest and political instability in a number of Middle East and North Africa sovereigns, Saudi Arabia has already announced in early 2011 social measures equivalent to 25% of GDP. We believe that the Saudi government's responsiveness to urgent social needs, including the availability of housing and jobs, plays an important role in appeasing social demands and containing the potential for unrest in the country.

The Saudi population is growing fast, with a compound annual growth rate of 3.3% over 2007-2011 by our estimates. Lifestyles are changing, with a decline in the average size of households, and at least half of the population is now under 21. In addition, at least one-third of the under-30 group is jobless, according to press reports. The government has announced a housing plan to deliver 500,000 new affordable housing units in Saudi Arabia, among various measures. We understand that the government has already earmarked $67 billion to finance this program from the 2011 fiscal surplus.

Are Saudi banks the main providers of home financing to retail customers?

No. The Real Estate Development Fund (REDF)--a specialized government-owned entity--has historically been the primary home-finance provider. In its September 2011 Article IV publication, the IMF puts the REDF market share at about 80% of outstanding Saudi home financing in 2011. The IMF further indicates that REDF is struggling to keep up with demand, resulting in a waiting list well over 15 years, and to monitor the quality of lending, of which it reports half as delinquent. Saudi authorities, in the run up to the implementation of new mortgage laws, boosted REDF's capital by $11 billion in March 2011, aiming to increase the availability of housing loans. The government has also transferred REDF to the Ministry of Housing, which was upgraded from its former status of General Housing Authority, with a budget of Saudi Arabian riyal (SAR)15 billion.

Why have Saudi banks been reluctant to extend home financing until recently?

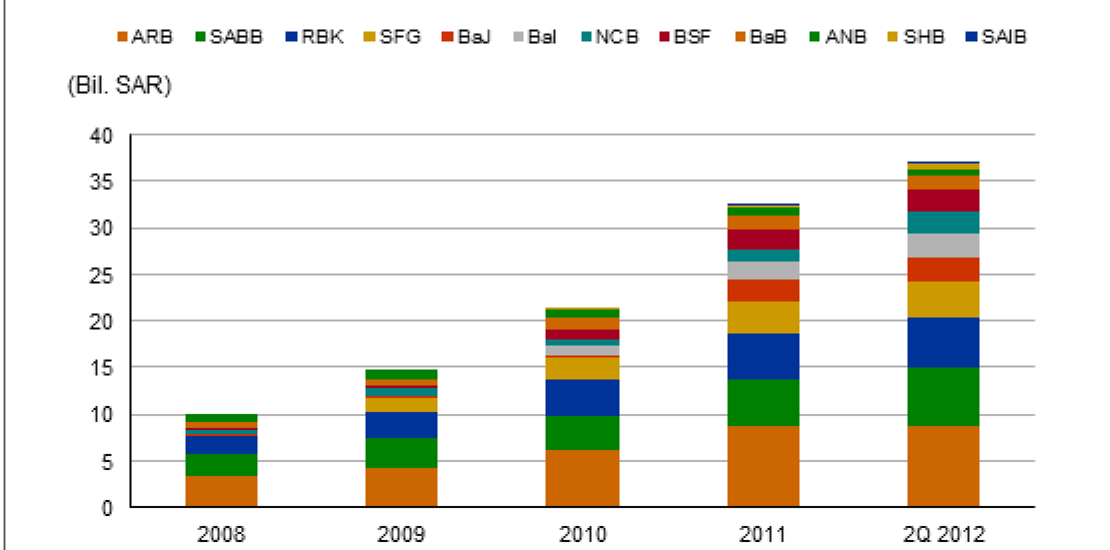
The legal uncertainty surrounding foreclosure after a borrower's default has been the primary stumbling block. Saudi banks have therefore traditionally offered home-buying loans, and not mortgages, because home-buying loans are not fully secured by the properties being acquired but instead primarily secured by banks' automatic deduction of loan repayments from borrowers' salaries.

Have conditions for home financing changed recently?

Yes, Saudi banks' Pillar III disclosures under Basel II show a clear accelerating pattern in term of residential housing loan booking (see chart 1). REDF's standing as the largest provider of home financing seems therefore increasingly contested. According to SAMA, retail real estate financing stood at about 18% of consumer financing as of June 30, 2012, versus 8% in 2008. In particular, the newest and smallest banks were very active in home financing segments as early as 2010, rapidly gaining market share over traditional players.

Chart 1

Saudi Banks' Residential Housing Loan Portfolios



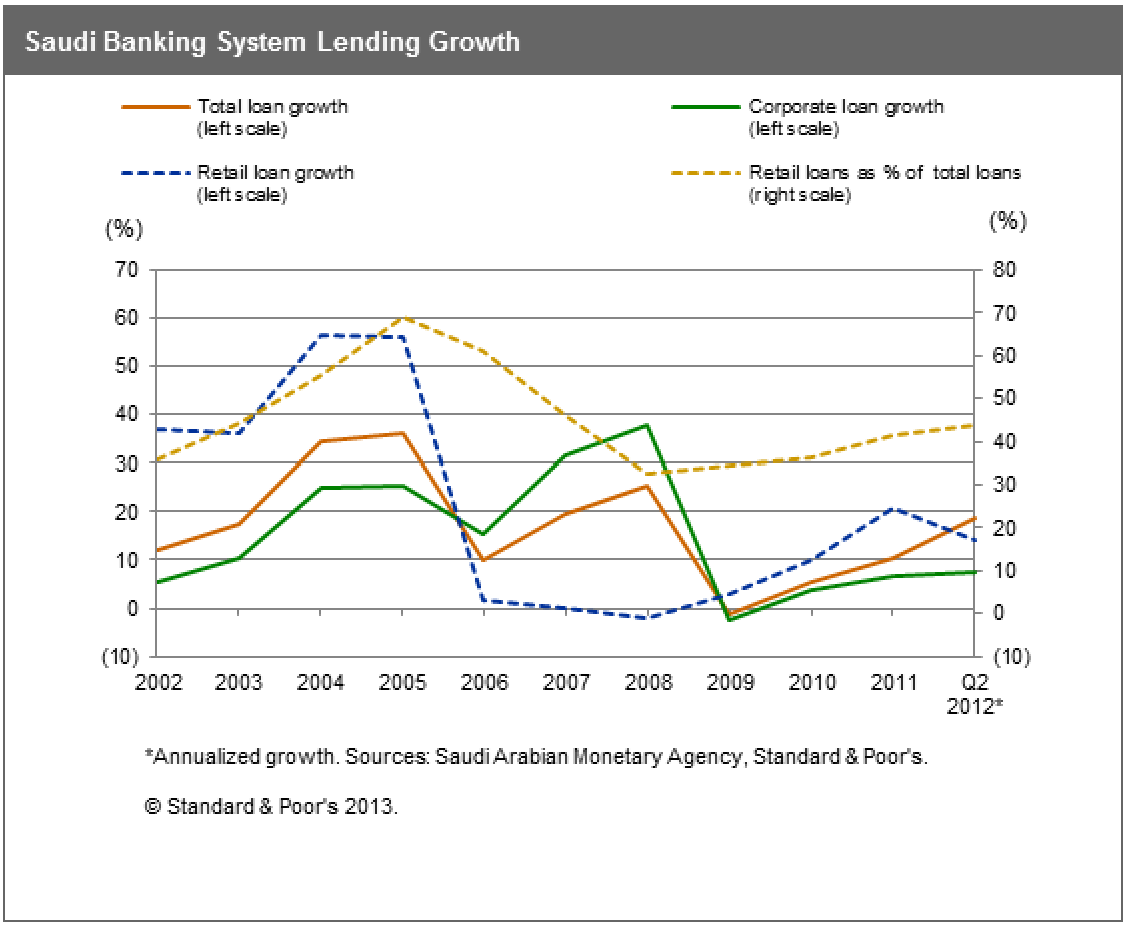
Residential mortgages in Basel II, Pillar 3 documentation. ARB--Al Rahji Bank; SABB--The Saudi British Bank; RBK--Riyad Bank; SFG--Samba Financial Group; BaJ--Bank al-Jazeera; BaI--Bank al-Inma; NCB--The National Commercial Bank; BSF--Banque Saudi Fransi; BaB--Bank al-Balid. ANB--Arab National Bank; SHB--Saudi Holland Bank. SAIB--The Saudi Investment Bank. Sources: Standard & Poor's, Pillar 3 documentation. SAR--Saudi Arabian riyal.

Why did home financing accelerate in 2012?

Firstly, we believe that banks anticipated the government's authorization to foreclose on a pledged property. The waiting list at the REDF, coupled with its SAR500,000 ceiling for a home loan, which we understand is no longer sufficient to buy a property in most areas of Saudi Arabia, has opened the door for banks to cater to strong demand for home financing.

Secondly, we believe Saudi banks have also spotted a good opportunity in home financing as a means to sustain the current lending revival to retail customers (see chart 2).

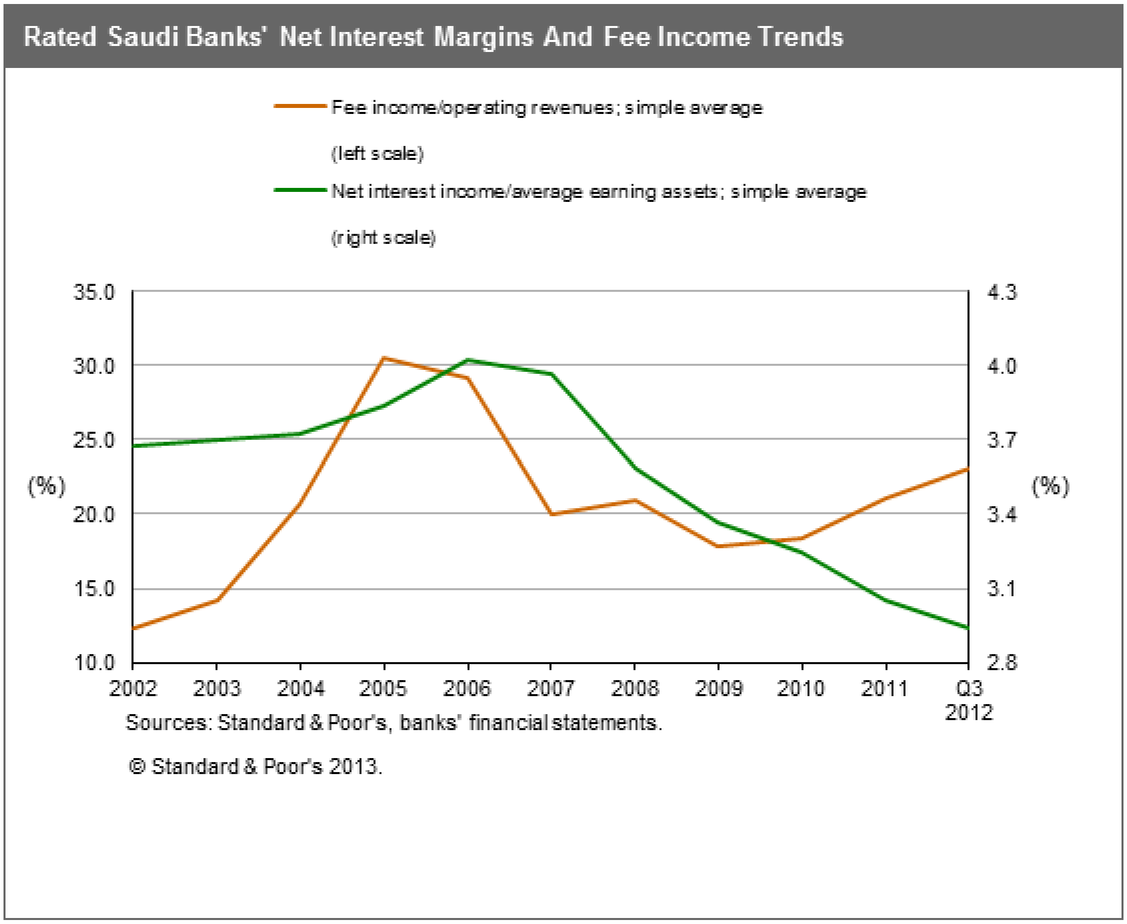
Chart 2



Against the current gradual recovery in corporate loans, we consider that retail lending is particularly vital for Saudi banks' to protect overall bottom-line results in a low-interest environment. Banks are seeking higher-yielding and fee-rich opportunities--typically retail-related business, including lending and brokerage--to avoid financial performance being on the wane until rates pick up on the asset side.

Since 2008 growth in Saudi banks' lending volumes has decelerated, only to pick up more strongly in 2012, while a major portion of their assets matured and were replaced by lower-yielding and long-tenor instruments. We estimate that rated Saudi banks' net interest margins (NIMs) gradually contracted to 2.9% on Sept. 30, 2012, from 4.0% in 2007 (see chart 3). We expect these NIMs to remain squeezed over the coming two years, owing to potentially accelerated repricing of short-term liabilities and the likely absence of any signal of an interest rate hike in the U.S. Still, Saudi banks enjoy generally lower cost of funding than their foreign counterparts due to their higher portion of unremunerated deposits, which is nevertheless exacerbated in the current low-interest rate environment.

Chart 3



Do you think SAMA will lower the risk weight it applies to calculate banks' capital adequacy from 100% to the 35% that Basel II prescribes, given that Saudi Arabia's current home loans will become property-secured mortgages?

For SAMA to take this step, it would have to be convinced that risks associated with mortgage lending had decreased. For the moment, though, how and when existing home financing portfolios might transition to mortgages under the law remains to be seen. Notably, it remains unclear whether these portfolios will remain on banks' balance sheets or transferred to separate real estate finance companies. In our opinion, existing home loan portfolios--largely based on Islamic leasing structures ("Ijara") will co-exist with conventional property-secured mortgages. Also, the government has not indicated how banks will be able to foreclose on properties, and a track record of effective foreclosure will take time to build.

SAMA has not communicated publicly on its willingness to be more flexible in terms of regulatory minimum capital-adequacy ratios (CARs) for banks, should it choose to lower the risk weights it applies to mortgage lending. Lowering this risk weight would provide significant relief to Saudi banks' CARs--about 1% to 2% depending on the bank--especially taking into account our view of the potential erosion in banks' capital adequacy over the next few years in a context of likely renewed growth but contracting margins. In any case, we think SAMA will continue to apply its existing conservative approach to capital requirements.

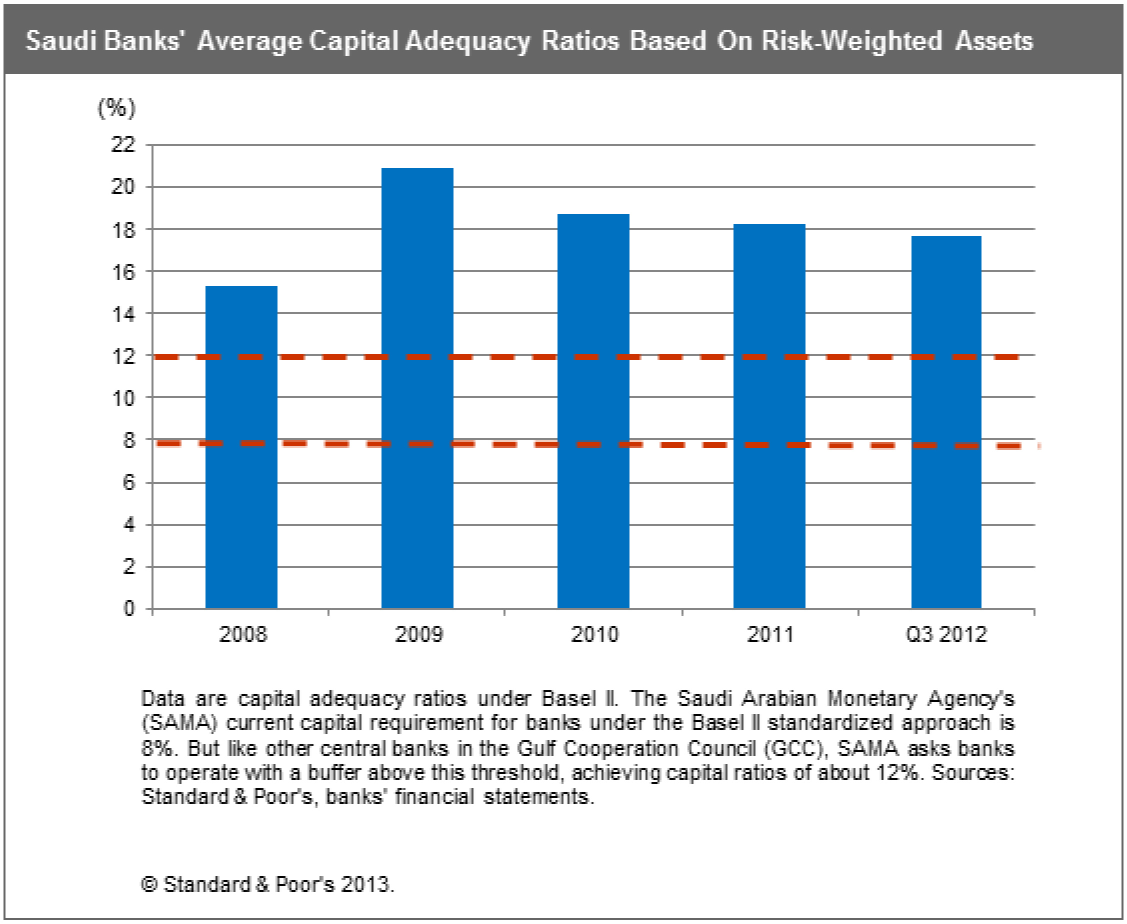
To our knowledge, SAMA has not yet provided guidelines to banks on limits of loan-to-value (LTV) ratios limits or debt burden ratios, both of which are largely left for individual banks to decide. As of today, there is no LTV limit, although we understand banks generally operate around estimated averages of 70%-80%, which we consider to be in line with international standards. Similarly, current debt burden ratios, lowered in 2008, are equivalent to one-third of an individual's salary (or one-fourth of a retiree's pension) for consumer loans, which we understand do not include home financing. We believe Saudi banks generally operate with a soft guideline of about 50%-60%.

How would a decision by SAMA to lower its risk weight affect Standard & Poor's ratios of risk-adjusted capital for rated banks?

The impact would be neutral. Under our risk-adjusted capital (RAC) framework, we already attribute a risk weight of about 35% to home loans provided in Saudi Arabia when we calculate our RAC ratios. Our risk weight takes into account the strong quality of home loans over the years, their extension in general to Saudi nationals with stable jobs, and the banks' use of automatic salary deductions for loan repayments. Any decision by SAMA to lower its risk weight would therefore have no impact on our RAC ratios for Saudi banks, which are among the strongest worldwide under our methodology.

We note that SAMA's current capital requirement for banks under the Basel II standardized approach is 8%. But like other central banks in the Gulf Cooperation Council countries (GCC), SAMA asks banks to operate with a buffer above this threshold, achieving capital ratios of about 12%. In addition, we believe that SAMA's overall comfort zone for banks' capital ratios, including undisclosed Pillar II requirements, stands between 12% and 14%.

Chart 4



What economic risks could the rollout of the new mortgage law entail?

The pace of growth of mortgage lending could pick up and create an asset bubble owing to easier access to home financing. However, we think this development is unlikely. All other things remaining equal, we do not expect to lower our assessment of economic risk for the Saudi banking system under our Banking Industry Country Risk Assessment (BICRA) methodology in the foreseeable future. We believe the Saudi residential market is largely driven by real demand, and that speculation has not pushed up prices, in contrast with trends in some neighboring GCC countries, such as in the United Arab Emirates. Also, we believe Saudi banks' total lending growth will remain around 12%-18% in 2013, along the lines of 2012 levels.

Would competitive dynamics in the banking system change significantly? Specifically, do you think nonbank finance companies or foreign players could become a competitive threat?

No, not under our base-case scenario. We think domestic commercial banks would capture most of the potential growth in mortgage lending, much as they did when the regulator reorganized the investment banking sector in 2007. For instance, Arab National Bank already operates under the parent/subsidiary model prevalent in the domestic investment banking sector via its affiliate Saudi Home Loans.

We expect banks to further develop their organizational structures to not only fully include mortgages, and also the associated insurance products. Domestic banks have sufficient balance sheet power, in our view, and already have sufficient physical coverage of Saudi Arabia. This would be difficult to replicate for most privately-held finance companies, and certainly for the handful nondomestic bank branches allowed to operate under domestic regulation. Lastly, domestic banks are already familiar with Sharia-compliant finance-lease lending as outlined in the new mortgage law package.

Could the increased activity of nonbank financial companies represent a risk for the banking system?

Yes, if there's a lack of sufficiently tight regulation to avoid a spillover into the commercial banking system, such as for instance the downfall of investment companies in Kuwait. In our view, the new mortgage law package aims to provide a comprehensive framework to monitor real estate finance companies, which we believe is essential to avoid the possible build-up of banks' contingent liabilities relative to real estate financing, especially if these companies become aggressive competitors and aim to win higher-risk retail customers.

That said, we consider SAMA to be an effective, thoughtful, and hands-on regulator. Positively, the Saudi authorities have also planned for state loan providers resembling Fannie Mae and Freddie Mac in the U.S., currently designated as the Saudi Real Estate Refinancing Corporation, to provide liquidity and stability to the fledgling mortgage market. We understand this entity will be able to issue mortgage-backed securities, notably to avoid any funding issues stemming from the expected strong growth in mortgage lending over the longer term.

What short-term benefits do you see for the banks?

First, the draft legislation prescribes strict approval chains, standardized contracts, and mandatory reporting on mortgage borrowers. We consider these steps as positive developments, especially because authorities have laid the foundation for the creation of a centralized database, along the lines of that of the Saudi Credit Bureau, which in our view has enabled consumer finance to grow according to its potential. Second, the new law also outlines the possibility for the REDF to work with banks, which could further boost banks' fee collection, and enable a larger portion of Saudis to access home financing.

If a boom in residential construction occurs following the implementation of the new mortgage law, how would it affect the Saudi insurance sector?

Domestic insurers, of which there are currently 30, would likely seize the opportunity to diversify away from current concentration in compulsory motor and health insurance by adding property insurance and term-life cover to their product offering. In the event of a residential construction boom, we would initially expect a hike in demand for insurance protection for building materials and construction assets. Further out, we would expect rising demand for personal coverage including mortgage protection, personal property, and contents risk.

Based on international experience, we believe that insurers with strong links to the key mortgage providers stand to reap the highest benefits. Specifically in Saudi Arabia, all insurers operate under the compulsory--and Sharia-compliant--cooperative structure, but only about half a dozen are explicitly takaful. Even though all domestic players can claim to be Sharia-compliant, we believe that these explicitly takaful insurers will have a degree of competitive advantage, particularly in the religiously sensitive area of life insurance.

At the same time, some domestic banks have ownership links with certain local insurers, and by sourcing business for these insurers in the mortgage activity, these banks may earn potentially significant fee income from their partner insurance companies. (see table 2).

Table 2

Saudi Banks' Main Insurance Affiliates And Subsidiaries			
Bank	**Insurance affiliate/ subsidiary**	**Stake (%)**	**Main partners**
The National Commercial Bank	Alhli Takaful Co.	30	FWU Group (Germany, 13.1%), International Finance Corp. (EGY, 13.1%), VH Vermogenslage (Germany, 7.4%)
Al Rajhi Bank*	Al Rajhi Company for Cooperative Insurance (22.5%)		Oman Insurance Co. (UAE, 10%)
Samba Financial Group	--	--	--
Riyad Bank*	Al Alalmya for Cooperative Insurance Company	20	Royal Sun & Alliance Insurance Middle Eat Ltd. (UAE, 50%)
The Saudi British Bank*	SABB Takaful	33	HSBC Asia Holdings (UK) Limited (U.K., 31.0%)
Banque Saudi Fransi*	Allianz Saudi Fransi Cooperative Insurance Company	33	Allianz France (France, 16.2%), SMA Holding (Norway, 16.2%)
Arab National Bank	ANB--AIG (under formation)	40	MetLife Alico (N/A), AIG (N/A)
Saudi Hollandi Bank*	Wataniya Cooperative Insurance Company	20	Saudi National Insurance Co. (Bahrain, 27.5%), New Reinsurance Co. (Switzerland, 10.0%)
The Saudi Investment Bank	The Mediterranean and Gulf Cooperative Insurance and Reinsurance Co.	19	Mediterranean and Gulf Insurance and Reinsurance (Bahrain, 40.5%)
Bank al-Inma	Alinma Tokio Marine Company	29	Tokio Marine & Nichido Fire Insurance Ltd. (Japan, 28.7%)
Bank al-Jazeera	AlJazira Takaful Taawuni	100	--
Bank al-Bilad	--	--	--

Note: This table doesn't necessarily show the ultimate shareholders. *Owner of a takaful insurer or insurance agency (insurance broker). N/A--Not applicable. Sources: Standard & Poor's, Zawya.

Related Criteria And Research

- Banking Industry Country Risk Assessment Update: February 2013, Feb. 11, 2013
- Banking Industry Country Risk Assessment: Saudi Arabia, Dec. 21, 2012
- Saudi Arabia (Kingdom of), July 20, 2012
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- Gulf Banks' Capital Positions Compare Well With Those Of Global Banks, June 26, 2012
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- Credit FAQ: Middle East Unrest's Credit Impact: How We Assess The Political And Economic Risks In Sovereign Ratings, March 3, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
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