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Saudi Economic Review

NCB Monthly Views on Saudi Economic and Financial Developments

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Executive Summary

- The Kingdom and gulf allies have made it very clear over the past year that they are not accommodative of new entrants to the oil market, especially as US shale oil output remains strong. Moreover, Saudi Arabia remains very focused on increasing its market share in key regions, especially Asian markets.

- The Euro Area continues to struggle as near zero inflation rate is threatening growth prospects in the region. The EUR will resume its weakening trend, potentially plunging to new lows towards year-end exacerbated by the ECB's commitment to maintain and introduce further easing.

- Adverse El-Nino's impact on agricultural products in the southern hemisphere is expected to be the strongest on record. However, the global food grains market is currently well-supplied, rendering El-Nino's effect on commodity prices to be country, and region-specific.

- As for measuring consumer demand, the point-of-sale (POS) transactions revealed the first annualized sales decline in six years, posting SAR14.1 billion; which is 3.5% short of last year's figure.

- The Saudi stock market is on the path to record a second consecutive annual decline for 2015 as the index dropped 2.4% last year. Stocks showed resilience in the first half of this year, however, prices collapsed during the second half.

- Until there's more clarity on the mechanism in which the government will achieve a sizeable and sustained reduction in the general deficit, we expect to see commercial banks treading carefully next year, re-adjusting their credit portfolios to incorporate higher future interest rates.

- Non-oil trade in the Kingdom have set new lows in September with exports valued at SAR12.9 billion; marking a 31.6% slump compared to the same period last year.

View of the Month

Gauging the risks on the banking system through non-performing loans (NPL) reveals that banks are well poised to encounter possible shocks. As the lack of oil revenues trickles down on the economy, NPLs are likely to increase as the businesses environment becomes more competitive. However, the current level of NPLs registered a slight drop of 2.1% on an annual basis to settle at SAR15.1 billion by September.

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Macroeconomic Indicators

	2011	2012	2013	2014P	2015F	2016F
Real Sector						
Average KSA Crude Spot Price, Arab Light, USD/BBL	108.1	110.2	106.4	97.2	55.0	60.0
Average Daily Crude Oil Production, MMBD	9.3	9.8	9.6	9.7	10.2	10.2
GDP at Current Market Prices, SAR billion	2,510.7	2,752.3	2,791.3	2,798.4	2,509.4	2,724.4
GDP at Current Market Prices, USD billion	670.4	734.9	745.3	747.2	670.1	727.5
Real GDP Growth Rate*	10.0%	5.4%	2.7%	3.5%	3.9%	2.2%
CPI Inflation, Y/Y % Change, Average	3.7%	2.9%	3.5%	2.7%	2.3%	2.5%
External Sector						
Current Account Balance, USD billion	158.5	164.8	135.5	76.9	-38.6	-36.0
Current Account Balance/GDP	23.6%	22.4%	18.2%	10.3%	-5.8%	-4.9%
Net Foreign Assets with SAMA, USD billion	535.9	648.5	717.7	725.2	640.2	578.2
Fiscal Sector (Central Government)						
Actual Revenues, SAR billion	1,117.8	1,247.4	1,156.4	1044.4	665.3	703.7
Actual Expenditure, SAR billion	826.7	873.3	976.0	1109.9	1032.2	980.6
Expenditure Overrun, %	42.5%	26.6%	19.0%	29.8%	20.0%	12.9%
Overall Budget Balance, SAR billion	291.1	374.1	180.3	-65.5	-366.9	-276.9
Budget Balance/GDP	11.6%	13.6%	6.5%	-2.3%	-14.6%	-10.2%
Break-Even Oil Price	75.3	73.9	82.6	100.1	88.7	85.4
Financial Sector						
USD/SAR Exchange Rate	3.75	3.75	3.75	3.75	3.75	3.75
Growth in Broad Money (M3)	13.3%	13.9%	10.9%	11.9%	10.3%	9.5%
Growth in Credit to the Private Sector	11.0%	16.4%	12.1%	11.9%	10.4%	9.3%
Average 3M SAR Deposit Rate	0.7%	0.9%	1.0%	0.9%	0.9%	1.3%
Average 3M USD Deposit Rate	0.3%	0.4%	0.3%	0.3%	0.4%	0.7%
Spread, in Basis Points, SAIBOR-LIBOR	40.9	55.2	68.7	69.5	60.0	70.0

Sources: Thomson Reuters, SAMA, and NCB

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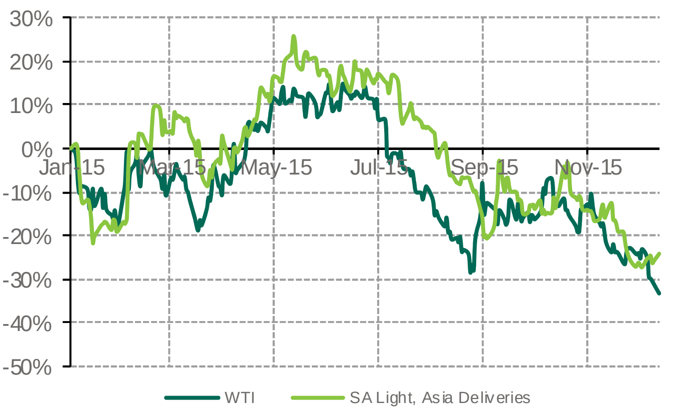
Oil Market

Oversupplied Market Despite Shale Decline

Brent crude oil prices averaged USD46 a barrel in November, declining by 15% since the beginning of the year, besides trading in a narrow range through the month. Oil futures posted moderate gains in late November, with Nymex WTI and ICE Brent crude for January delivery rising by 1.5%, and 1.3%, respectively. The Brent crude oil premium to WTI crude oil widened in late November to USD4.0 a barrel, mainly because of US crude oil inventories, which are rising to record levels. Moreover, the continuing oversupply in world markets and a strong US dollar has limited the impact of the heightened geopolitical tensions in the Middle East on oil prices. It is predicted that a further oil price slump is on the way as regular storage facilities are nearing full capacity. In addition, weaker global economic growth and low inflation as well as the strength of the dollar will most likely remain major headwinds for the oil outlook in 2016.

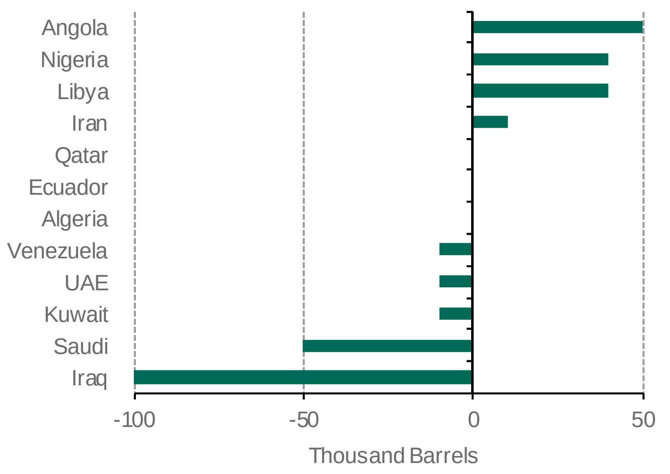
Chart 1: Oil Price Developments, YTD



Source: Thomson Reuters

On the supply side, global oil stocks in developed countries have expanded to a record level of almost 3.0 billion barrels, according to the IEA. US crude stocks have built rapidly and even recent data point to potential further increases, with large volumes of Middle Eastern crude oil heading to the US. Since bottoming in August, total US commercial crude stocks have climbed 37.0 million barrels, reaching 487.0 million barrels in November. In Saudi Arabia, production increased to 10.28mb/d in October, the first rebound following the drop from a record output of 10.6mb/d in June. Competition is increasing among OPEC members, with Iraq having raised its output by a 1.0mb/d over the past year to 4.2mb/d. A recent southern Libya peace deal has given hope for the restart of two major groups of oil fields in the Murzuq basin. These fields have combined output potential of up to 0.4mb/d. However, there are no guarantees as history of short-lived ceasefires offers little grounds for confidence towards a sustainable resumption in production.

Chart 2: OPEC's Monthly Oil Production Changes



Source: OPEC Survey

As expected, OPEC kept its 30mb/d output ceiling unchanged in its latest meeting. According to OPEC, its production reached 31.4mb/d in October. With Iran planning to add 1.0mb/d by the end of 2016, and Saudi Arabia maintaining its production at current levels, it would appear that OPEC production will swell further next year. Despite a drop in oil prices of around 32% since June's meeting, Saudi Arabia, UAE, and Kuwait are not expected to back down from their strategy of fighting for market share over price. The Kingdom and gulf allies have made it very clear over the past year that they are not accommodative of new entrants to the oil market, especially as US shale oil output remains strong. Moreover, Saudi Arabia remains very focused on increasing its market share in key regions, especially Asian markets. Contrary to the ample evidence of weaker prices, gulf countries have been stressing that they perceive market tightness and accordingly a rebound in oil prices in the near term.

On the demand side, global demand growth is forecast to slow to 1.2mb/d in 2016 after surging to a five-year high of 1.8mb/d in 2015, according to IEA. Moving forward, the momentum is expected to ease towards its long-term trend, as the significantly lower oil prices, colder-than-year earlier winter weather and post-recessionary bounces in some countries are likely to gradually fade away. Moreover, in addition to the impact of slowing Chinese economy, concerns over demand could also be affected by Japan's economy being back into recession, which will add to the worries that slowing global economy will reduce demand further.

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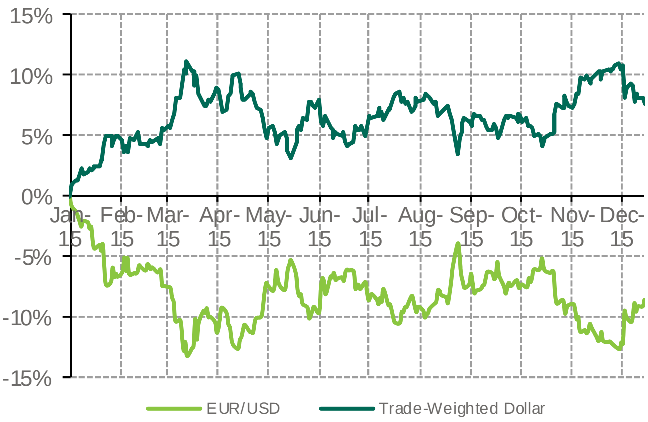
Foreign Exchange

Fed Gears up for Normalization

Demand for the greenback is expected to intensify in the months ahead due to widening growth and interest-rate differentials between the US and the rest of the world. Monetary policy normalization at the Fed is increasingly likely in December, rattling the already weak emerging market currencies. Brazil and Turkey are highly exposed markets as political uncertainty and fiscal pressures weigh on their respective currencies. The Euro Area continues to struggle as near zero inflation rate is threatening growth prospects in the region. The EUR will resume its weakening trend, potentially plunging to new lows towards year-end exacerbated by the ECB's commitment to maintain and introduce further easing. China's growth deceleration is unsupportive of commodity prices; thus, commodity currencies will maintain a broad-based weakening profile in tandem with emerging markets.

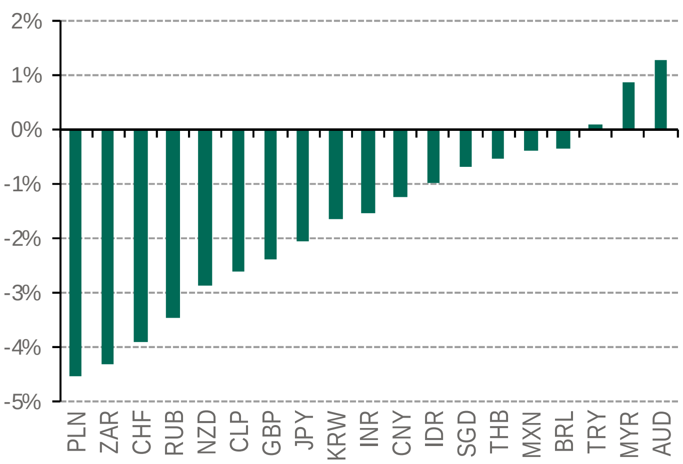
Chart 3: Trade-Weighted Dollar and the Euro



Source: Thomson Reuters

Strong US fundamentals propelled the US dollar against its major peers back to double-digits in November. The trade-weighted dollar recorded a surge of 11% YTD by the end of the month, standing at 100.17. Unemployment rate was at 5% in November, the lowest rate since April 2008. Preliminary November non-farm payroll figures also indicate that around 211,000 jobs were created during the month. In addition, October job figures were revised upwards to 298,000 jobs, making it the strongest monthly job growth this year. Bullish investor sentiments will underpin the USD going forward and attractive yields will continue the trend of capital repatriation, supporting overall GDP growth. The Euro has underperformed throughout November as the ECB hinted that more monetary stimulus is underway. The December policy meeting will be crucial in this respect as the current QE program and negative key deposit rate have fallen short of stoking inflation. As such, we expect more divergence between the Fed and the ECB to provoke another sharp downward adjustment for the EUR on par with what we saw in Q1 this year. In November, the single currency fell 12.7% YTD, standing at USD1.05. On par with the Fed's direction, the Bank of England (BoE) is also expected to start its own policy normalization early 2016. Despite the solid growth in the British economy of over 2% since 2Q 2013, the BoE key interest rate remained at 0.5% since March 2009. Persistent weak inflation barred policy makers from moving forward interest rate hikes and warranted a hawkish tone at the BoE. However, with base effect from commodity and energy prices taking place next year, we may see headline inflation rise above 1%. Meanwhile, the GBP took a new downward trend since August as inflation concerns were reiterated in the BoE's minutes. By the end of November, the pound sterling stood at USD1.5, down by 3.3% YTD.

Chart 4: Monthly Foreign Exchange Rate Changes



Source: Thomson Reuters

Intensifying political stress in Brazil with the impeachment proceedings of President Roussef is reflecting negatively on investment sentiments in the country. Real GDP contracted by 2.6% in the second quarter, leaving an estimated negative growth in 2015 at around 1.3%. The Brazilian real edged higher from its year-lows since September but remains as one of the most battered currencies in the EM. At BRL3.9 for the dollar, the real had lost 31.3% of its value by the end of November since the beginning of the year. On a side note, the inclusion of the Renminbi in the IMF SDR basket on November 30th is a milestone set towards internationalizing the Chinese currency, and its usage beyond mainland China.

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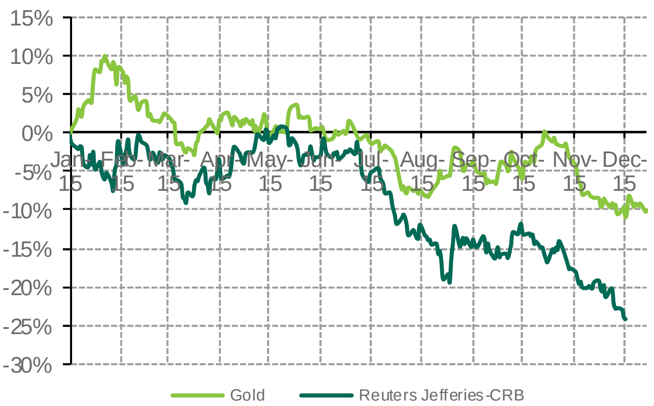
Commodities

Commodities to Rock-Bottom

Global commodities extended their declines in November amid a Chinese slowdown, a rallying USD, and strong oversupply. Bearish sentiments over prolonged market correction in China and falling capex reflected negatively on base metals such as copper and aluminum. Continued strength in the US dollar and the lurking Fed rate hike pushed gold prices down further despite concerns over China's economy and the Greek debt. Adverse El-Nino's impact on agricultural products in the southern hemisphere is expected to be the strongest on record. However, the global food grains market is currently well-supplied, rendering El-Nino's effect on commodity prices to be country, and region-specific. Moving into next year, we see no inflection point for commodities as fundamentals remain weak and the market is to be strongly oversupplied for the majority of 2016. The Iranian nuclear agreement which will be implemented in the first half of 2016 is expected to keep energy prices low as the country's oil production returns to pre-sanction levels. In addition, assuming that Iran will manage to attract enough foreign investment and technology over the coming years, the utilization of its natural gas reserves will likely add more downward pressure to energy prices as Iran has the world's largest known gas reserves. By the end of November, the Reuters/Jeffries CRB index recorded182.5, indicating that commodity prices fell 20.6% YTD, the lowest level this year.

Chart 5: Reuters Jefferies vs. Gold



Source: Thomson Reuters

Waning demand from China led to supply curtailments in base metals, namely copper and aluminum. The London Metal Exchange (LME) records show warehouse stock of copper stood at 3 million tons by the end of October, inching down by 4.4% from September. In contrast, LME warehouse stock for aluminum recorded a significant decline of 16.4% M/M, reaching 267.9 thousand tons due to high-cost capacity smelter closures in China. Nevertheless, prices remained downward trending throughout November as base metals face the greatest bearish fundamental shock in decades. Copper prices reached their lowest YTD levels on the 23rd of November at USD4,490/ton, tumbling by 28.7%. Aluminum, due to its frequent and diversified use was subject to a lesser downturn than copper which suffered by declining global capex. Additionally, aluminum prices recorded their lowest levels this year on the 23rd of November, standing at USD1,435.5/ton, thus declining by 22.5% YTD. Fed rate hike expectations and dollar appreciation are weighing on demand for gold which consequently lost 10.6% YTD, closing below USD1,100/oz for the first time since November 2009. In the last trading week of November, gold prices closed at USD1,059.2/oz.

Chart 6: Base Metals

Source: Thomson Reuters

Agricultural commodities dwindled to new lows in November, pushing the S&P/ Goldman Sachs Agriculture Index to 286.5, a downturn of 11.1% YTD. Food grains are experiencing a huge supply glut resulting from the commodity super cycle. Corn futures to be delivered in December are approaching a 15% YTD decline at 359.25 cents/bushel, while wheat dipped further to 465.7 cents/bushel, slashing as much as 24.2% of its value YTD. We expect food grains to remain on a downward trend due to ample global supply overcoming the limited effect of adverse weather conditions.

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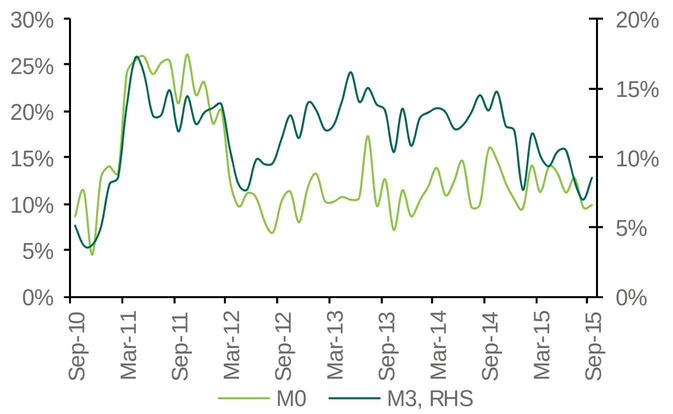
Money & Inflation

Fiscal Shifts Reshape the Financial Market

In September, annualized growth in broad money supply edged up slightly compared to a month earlier recording 8.5%. Despite the slight improvement, it falls notably short of last year's average growth rate of 13.1%. As the fiscal deficit widens from lower oil returns, the government pursued a balanced approach in plugging the budgetary gap. Instead of relying solely on the Kingdom's massive foreign reserves, which stood at USD647 billion by the end of September, the Kingdom also sought financing through issuing debt to local banks throughout the second half of the year, benefitting from ample liquidity. In the medium term, the Kingdom could potentially tap international bond markets for the first time in order to shore up public finances without absorbing liquidity from local banks. Therefore, grappling with the sharp fall in oil prices to below USD40/bbl from 115/bbl just a year ago, and the expensive military intervention in Yemen dictated the utilization of the Kingdom's debt capacity.

Chart 7: Growth in Monetary Aggregates

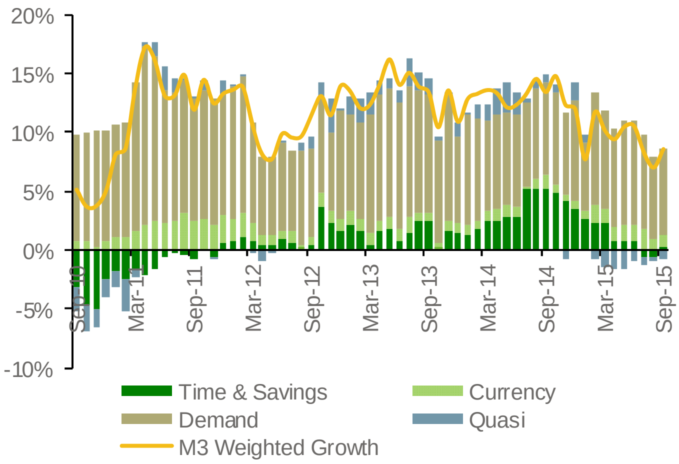


Sources: SAMA and NCB Estimates

The monetary base recorded an annualized growth of 9.9% influenced by a 7.1% growth in deposits with SAMA, owing to a deceleration in the rate of decline in deposits of public financial institutions. Currency outside banks maintained a 10.8% growth at SAR175.2 billion, representing as much as 54.6% of the SAR320.8 billion monetary base. Moving to "M2" money supply, demand deposits surged 13.1% Y/Y which is in line with last year's average. Low yielding savings accounts tend to be less attractive to businesses and individuals who prefer to deposit their funds in checking accounts. Therefore, demand deposits represent the bulk of deposits, constituting around 64.7% of M2 money supply. Surging by 13.1% Y/Y, demand deposits stood at SAR1.064 trillion in September, of which 91.3% is owned by businesses and individuals. Time and savings upturned by an annualized 1.3% after two consecutive monthly declines in July and August. At SAR406.7 billion, time and savings deposits are more evenly distributed between the private and government sector respectively at 49.9% and 50.1%.

Quasi monetary deposits inched down 0.9% Y/Y to SAR182 billion on the back of declining foreign currency deposits by private and government entities. The withdrawal of foreign currency deposits by government entities constituted the biggest drag on quasi money as their levels shrank by 7.5% to SAR67.4 billion compared to a year ago followed by a 2.7% decline in foreign currency deposits by private entities to SAR83.7 billion. In contrast, remittances and letters of credit (LCs) surged by 34.2% and 12.7%, respectively, recording SAR18.3 billion and SAR12.5 billion.

Chart 8: Money Supply, Contribution



Sources: SAMA and NCB Estimates

Inflationary pressures in the Kingdom remain low largely due to subdued food and energy prices. The dollar strength pushed commodities to 6-year lows in the advent of an eminent Fed rate hike. Foodstuff prices in the Kingdom rose 1.9%, muting the CLI basket while housing is creating an upside pressure with its 3.8% appreciation. As for measuring consumer demand, the point-of-sale (POS) transactions revealed the first annualized sales decline in six years, posting SAR14.1 billion; which is 3.5% short of last year's figure. We expect that the Kingdom will maintain an average of 2.1% inflation this year and edge slightly higher to 2.5% next year due to base-effect.

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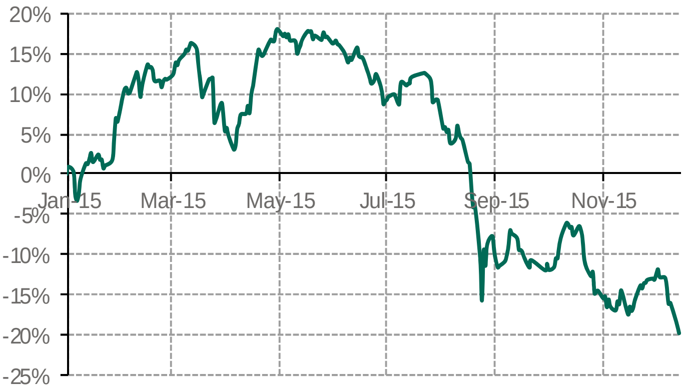
Capital Markets

Budget and Fed Looming over Stocks

As we near the end of another financial year, 2015 will be remembered by the oil glut which spurred a market-share war, slashing oil prices by around 60% Y/Y. The main source of revenue for Saudi Arabia is likely to continue in its suppressed levels as OPEC's latest meeting shows no signs of cutting production in the near future. Quite the reverse, OPEC's current output of 31.77 million barrels per day is susceptible to increase in 2016 as the group did not commit to a production limit neither collectively nor individually. Consequently, oil prices tumbled to a seven-year low which will certainly pressure domestic stocks. The Saudi stock market is on the path to record a second consecutive annual decline for 2015 as the index dropped 2.4% last year. Stocks showed resilience in the first half of this year, however, prices collapsed during the second half. Despite rebounding during the month of November by 1.6% following three months of consecutive declines, the index reached the lowest level in almost three years at 6'881.42 on 15 November. On a sub-sectoral level, the energy and banking sectors contracted by 8.0% and 2.8%, respectively, last month. Meanwhile, the media sector sky rocketed by speculative money 117.8% during November. The industrial investment sector recorded a substantial growth of 13.2% M/M while the hotel sector registered a 9.2% gain.

Chart 9: Tadawul All-Share Index



Source: Tadawul

The declines in stock prices has deterred capital away from the stock market. The level of activity continues to reflect muted environment in one of the few investment channels available for locals. During November, the average daily traded value volumes reached SAR4.89 billion, a mere 0.3% gain on October's daily average. Tadawul's weekly ownership and trading activity report reveals that Saudi institutions were taking the opportunity to expand their portfolios while selling activity was attributed to Saudi individuals, GCC investors, and foreign investors. The attrition follows a global trend in equities which have been pressured by faltering economies in emerging markets and Europe while the US embarks on the first interest rate hike since 2006. Tadawul ended the month of November to register a YTD decline of 13.1% and we do not foresee the market recouping any more during December. The challenges will move into 2016 as oil prices will likely remain lower for longer despite the attractive valuations. Tadawul and the Capital Market Authority will need to attract investors with tools such as reinstating the ability for companies to buy-back their shares.

Chart 10: Average Daily Traded Value

Source: Tadawul

As for the primary market which has been quiet since June, Tadawul announced the fourth initial public offering (IPO) in 2015. During December, Alandalus Property Company will offer 21 million shares, representing 30% of its SAR700 million capital. Accordingly, the market has introduced a total of 283 million shares in 2015. As the price of the offered shares for Alandalus is set at SAR18, IPOs raised a total of SAR4.2 billion in 2015, compared to SAR25.23 billion in 2014. The primary market next year will likely remain subdued due to the current economic cycle.

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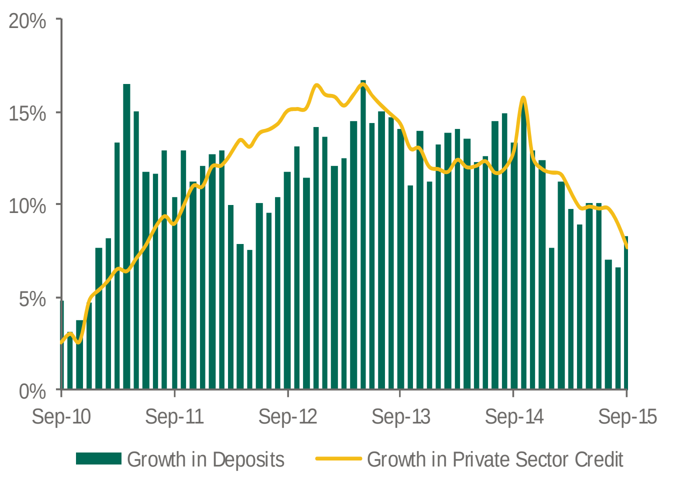
Loans Market

Saudi Banks Embark on a New Era

In the month of September growth in total bank credit dipped to its lowest level since June 2011 recording 7.3% Y/Y, standing at SAR1.33 trillion. The slowdown in the depositary base growth spurred by government withdrawals stand behind the deceleration in bank loans. Broad money supply (M3) rose by 8.5%Y/Y affected by a subpar annualized growth in time and savings deposits of 1.3%. Time and savings accounts represent around 22.2% of M3 money supply amounting to SAR406.7 billion, of which government deposits are 50.1%. Therefore, the declining government contribution in time and savings impacted bottom-line growth in deposits. In addition, deposits of foreign currency recorded a contraction for the 10th consecutive month, halting growth in quasi monetary deposits. The slowdown in momentum for deposits in addition to the government tapping into the local debt market led Saudi banks to respond proportionally, adjusting their loans portfolio.

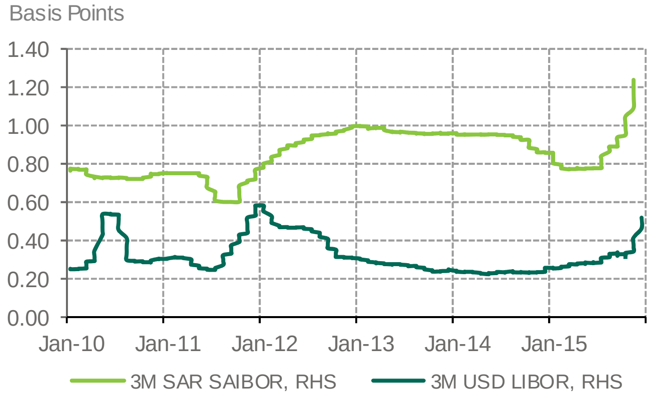
Chart 11: Private Sector Financing



Sources: SAMA and NCB Estimates

Prolonged low prices of oil took a toll on the government's revenue base, and deficit financing in this case is a plausible solution; given the Kingdom's very low debt levels. The decision to issue debt in the local bond market underscores concerns of a credit crunch facing the Kingdom in the medium term; especially with the Fed moving towards normalizing its monetary policy. Private sector credit rose by 7.7% Y/Y to SAR1.29 trillion, a rate much below last year's average of 12.5%. Although The government's share of Saudi bank loans is currently at 2.9%, amounting to SAR38.6 billion, the SAR67 billion worth of government bonds held by banks reveal a surge of 24% Y/Y, and is expected to rise further, potentially reaching SAR100 billion by year-end. We note that bank holdings of SAMA bills have declined by 24.6% to SAR172.3 billion. This shows that the treasury bills which SAMA uses as a tool to mop up excess liquidity in the market are gradually being phased out to allow for the longer maturity domestic bonds to be fully subscribed.

Chart 12: Liquidity and Risk Detector



Source: Thomson Reuters

Capacity utilization at Saudi banks as represented by the loan-to-deposit ratio (L/D) standing at 80.5% in September represents a healthy utilization of deposits within last year's levels. By maturity, the composition of Saudi bank credit shows that 51.6% is short term, valued at around SAR686.3 billion, while medium and long-term loans represent 17.2% and 31.2%, respectively valued at SAR229.8 billion and SAR414.4 billion.

Until there's more clarity on the mechanism in which the government will achieve a sizeable and sustained reduction in the general deficit, we expect to see commercial banks treading carefully next year, re-adjusting their credit portfolios to incorporate higher future interest rates. The 3-month SAIBOR has already surpassed 100 bps in November for the first time since September 2009, pre-empting the Fed's expected rate hike in December. On the other hand, LIBOR stands at 41bps, inching up to the highest levels since 2012.

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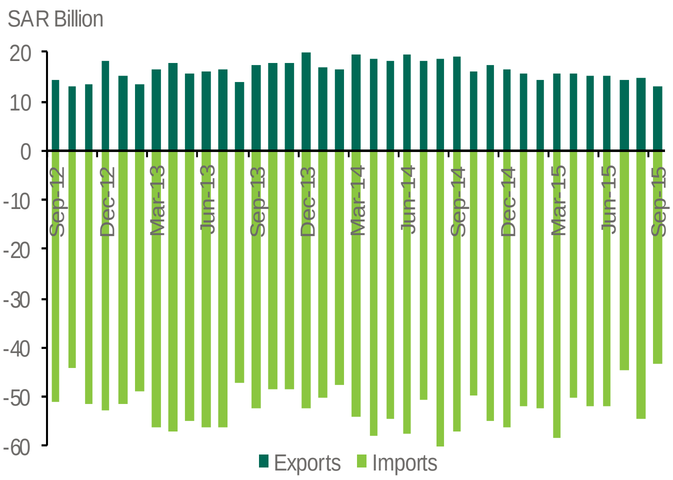
External Trade

Trade Gap Widens on Weak Commodities

Non-oil trade in the Kingdom have set new lows in September with exports valued at SAR12.9 billion; marking a 31.6% slump compared to the same period last year. On the import side, the Kingdom also incurred the lowest import bill this year of around SAR43.4 billion, dwindling by 24.1% Y/Y. By weight, non-oil exports recorded 3.7 million tons, falling by 18.6% Y/Y, while imports recorded 5.5 million tons in September, tumbling by around 28.9% compared to a year ago.

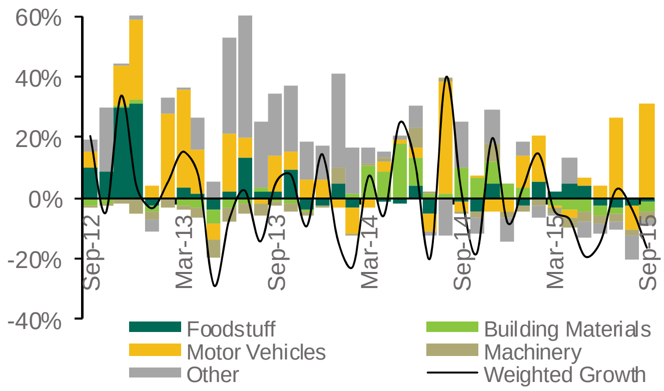
Chart 13: Saudi Non-Oil Trade Balance



Sources: SAMA and NCB

Rapidly declining global oil prices and waning global demand did not only impact the Kingdom's oil returns, but also largely impacted non-oil exports which currently represent are (61.8%) as result of vertical diversification and extending the oil production chain. The exposure of the non-oil sector to the oil markets led plastics, which account for 33% of the Kingdom's non-oil exports, to plummet by 31.8% Y/Y in September to SAR4.3 billion. Exports of chemical products contribute to 28.8% of the total monthly returns at SAR3.7 billion. In comparison to last year's figures, however, exports of chemical products slid by 41.6% Y/Y. Exports of base metals were not exempted from the slump as they tumbled by 28% Y/Y in September. The main export destinations during the month were the UAE, China, and India which unanimously show significant reductions on a Y/Y basis. The UAE marked the least decline with non-oil exports worth SAR2.1 billion, inching down by 4.1% Y/Y. China's share of the monthly exports was markedly downsized at SAR1.3 billion, recording a 46.9% slide compared to last year. India topped Singapore as the third largest trade partner in September at SAR798 million, albeit falling by 41.6% Y/Y.

Chart 14: Attribution Analysis of Letters of Credit Opened



Sources: SAMA and NCB

On the import side, imports of machinery and electrical equipment represent 25% of the monthly total at SAR10.8 billion, declining by 22.7% Y/Y. Furthermore, imports of transport equipment slid 10.3% Y/Y, recording SAR8.7 billion, while imports of base metals tumbled 33.7% Y/Y, standing at SAR4.4 billion. The top exporters to the Kingdom are China, the US, and Germany, accounting for 10.5%, 10.4%, and 5.5%, respectively. Imports from China nose-dove by 26% Y/Y in September this year to SAR5.7 billion. Likewise, the import bill from the US also shrunk sizably by 22.2% Y/Y at SAR5.6 billion. Imports from Germany were reduced by 24.2% in value terms from last year to SAR 2.9 billion. The consistent declines in all of the import bill categories reflects the government's attempt to prioritize and consolidate expenses to mend the fiscal gap. We expect the downward momentum to be extended next year, although with lesser annualized declines due to base effect.

Imports financed through banks as indicated by letters of credit (LCs) show an annualized 8% decline in September at the total of SAR 17.7 billion. The largest portion of bank LCs are geared towards motor vehicles (around 22.5%) which has been the most resilient category in the past months, falling by 6.8% Y/Y to SAR4 billion. Foodstuff LCs amount to SAR2.3 billion, falling by 7.9% Y/Y, while LCs for building materials tumbled by 33.5% at SAR1.4 billion.

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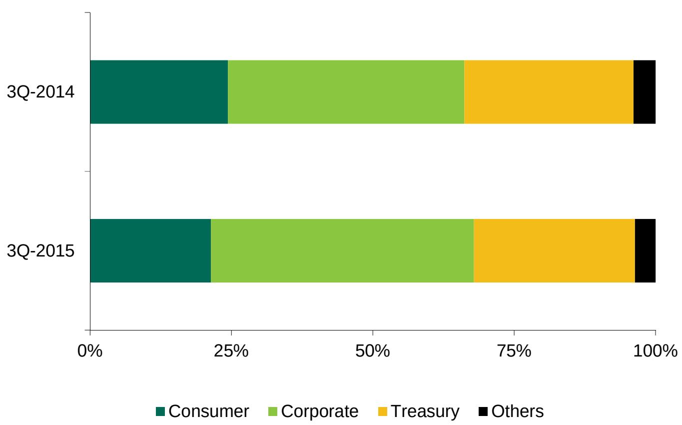
Special Focus:
Resilience of the Banking Sector

The oil collapse started in the third quarter of 2014, while OPEC did not expect US shale's resilience at the time, a production cut now will have little effect as demand continues to falter on the global front. However, GCC countries are much better equipped to endure a prolonged period of low oil prices given their large reserves and relatively low debt to GDP levels compared to other OPEC members who have been calling for a different strategy. The gulf's respective financial sectors are well capitalized and remain unscathed amidst the oil collapse. For Saudi, the banking system has benefited from the government's adamancy to continue spending in order to maintain a positive trajectory for the economy. Throughout the first nine months of 2015, the 12 locally incorporated banks recorded a combined net profit of SAR33.7 billion, a gain of 5.6% over the same period last year. Banks continue to reflect a preference towards the corporate segment which has been quite lucrative over the past few years. Operating income for the corporate segment increased by 11.5% annually while operating expenses decreased by 11.8% annually, reflecting greater efficiency as small-medium enterprises have been a rising sector. Meanwhile the consumer segment shows a decline in bottom-line income by 7.4% Y/Y as operating expenses diminish returns in a highly penetrated segment. As for the treasury segment, it remains muted given the suppressed interest rate environment. However, as the US initiates the normalization process, opportunities within this segment will become rewarding over the medium term.

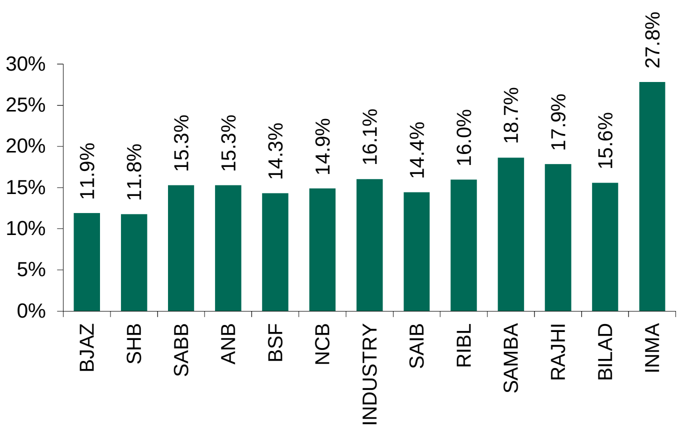
Chart 15: Banks' Net income by Segment



Source: Banks' Financial Reports

Given the banking system's growth coupled with their conservative approach, banks underwent capital increases this year, growing a collective 10.7% since the beginning of the year. This allowed banks to register a tier 1 capital adequacy ratio at 15.9% by the end of September, a slight drop from 16.1% a year ago. Total assets and total liabilities grew in tandem at 6.9% Y/Y and 6.6% Y/Y, respectively. The depositary base accumulated SAR106.7 billion through 9M2015 to reach SAR1.7 trillion, gaining 6.7% Y/Y. This facilitated the opportunity for banks to extend further credit lines as their loans portfolio grew by 7.1% annually. The asset/liability composition reflected by the loans-to-deposits ratio was unchanged at 78.5 by the end of September, up from 77.4 in 2014, indicative of further opportunities to grasp. The Saudi Arabian Monetary Agency (SAMA) will be wary of banks experiencing liquidity shortages as the government is expected to increase their bond issuances next year to plug the fiscal deficit. Additionally, banks will be able to compete with higher margins as the interest rate environment eases gradually which will support income levels on lower volumes given the slow economic cycle.

Chart 16: Banking System Tier-1 Capital Adequacy Ratio, 3Q2015



Sources: Banks' Financial Reports

Gauging the risks on the banking system through non-performing loans (NPL) reveals that banks are well poised to encounter possible shocks. As the lack of oil revenues trickles down on the economy, NPLs are likely to increase as the businesses environment becomes more competitive. However, the current level of NPLs registered a slight drop of 2.1% on an annual basis to settle at SAR15.1 billion by September. The NPL ratio (NPLs divided by gross loans) reflects the safer dynamics of the current credit market which has been encouraged by SAMA's vigilant and prudent guidance. By the third quarter of 2015, banks registered an industry-wide NPL ratio of 1.1%, in comparison to the 1.2% recorded in 3Q2014. The banking system is at a turning point of a new era as the slower economic cycle coincides with the Fed's interest rate hike. Nonetheless, banks are highly capitalized and are capable to withstand the full brunt of the oil collapse.

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