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USSBC Economic Brief
Financial Sector Development Program Update

Overview

Among the ten delivery programs established in 2017 to realize Vision 2030, the Financial Sector Development Program (FSDP) has seen substantial progress despite the economic downturn stemming from the COVID-19 pandemic. FSDP has three main objectives: 1) enable financial institutions to support private sector growth through lending and strategic investment, 2) ensure the formation of an advanced capital market, and 3) promote financial planning. Progress on these fronts has been achieved through regulatory reforms in the financial services sector, as well as investments in growth areas like financial technology. This brief examines the progress of Saudi Arabia's financial sector under Vision 2030 by assessing some of FSDP's key 2020 goals under its first two objectives, including the increase of digital transactions and technology, and the facilitation of mortgage and small business lending, growth of foreign portfolio investment, and market capitalization of the Tadawul. As the Saudi economy recovers from a decline in oil revenues and a pandemic-induced recession, the financial sector will play a key role in supporting non-oil private sector growth.

Private Sector

The role of the finance industry in supporting the private sector encompasses a broad range of KPIs that includes boosting SME and mortgage lending, facilitating venture capital investment, and increasing digital payments in pursuit of a "cashless Kingdom". While Saudi Arabia aims to broadly increase private lending under Vision 2030 and the FSDP, lending to small and medium-sized enterprises (SMEs) is a cross-cutting goal of several economic programs and has seen steady growth. SME loans as a percentage of bank loans grew from 2 percent in 2016 to 6.2 percent in 2019, surpassing the FSDP's 5 percent target for 2020. As the economic crises in H1 2020 induced by the global pandemic led to a series a fiscal rescue programs, credit facilities to SMEs jumped more than SAR1.3 billion ($359.2 million) by the end of Q2. Importantly, SME lending as a percentage of total bank loans also increased to reach 7.8 percent in Q2 at the height of the COVID-19 lockdowns. Government programs included a SAR50 billion ($13.3 billion) package to support SMEs, loan and tax deferments, and wage subsidies. While lending has spiked due to the unusual economic conditions of the pandemic, maintaining SME lending above 5 percent over the next year will be challenging.

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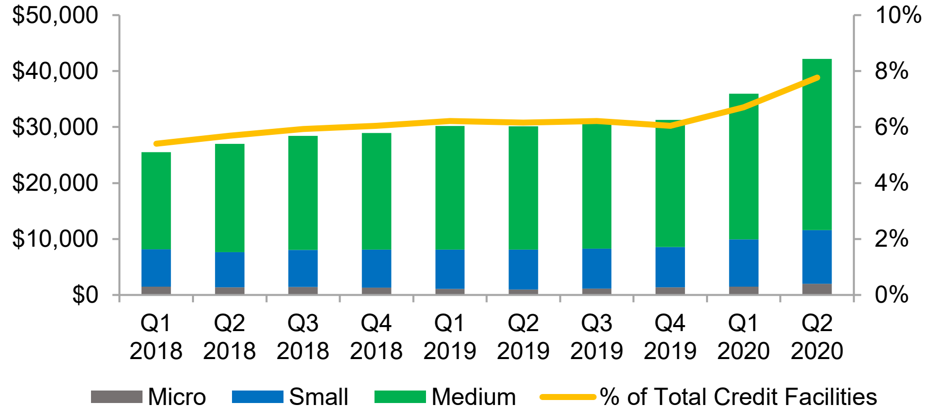
Credit Facilities to Micro, Small, and Medium Enterprises (USD Million)

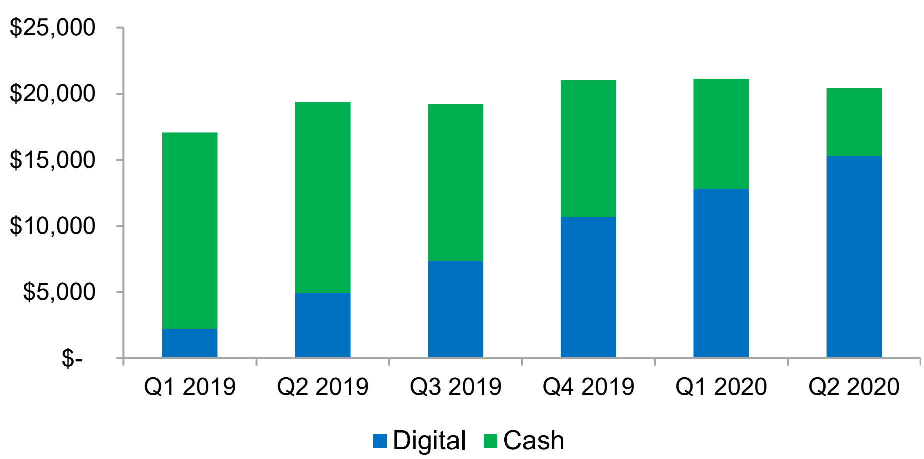


Source: SAMA

International rankings also indicate steady improvement in Saudi Arabia's small business financing ecosystem. According to the World Economic Forum's (WEF) 2019 Global Competitiveness Report, Saudi Arabia improved its global ranking in Financing of SMEs to 19th from 36th. The Kingdom's financial sector agenda sets a target goal of SAR23 billion ($6.1 billion) in SME funding through private equity and venture capital vehicles. In H1 2020, venture deals were up 29 percent from the prior year as 45 investment deals took place. Growing startup investments in 2020 follows Saudi Arabia's ranking in venture capital availability surging from 29th to 12th globally in the WEF's 2019 report.

In 2020, e-commerce has remained the top industry for venture investments, accounting for SAR239 million ($64 million) through the second quarter. The global pandemic has accelerated e-commerce business practices as consumers turned to digital payments for food and durable goods, as well as education and healthcare. In line with a Vision 2030 goal of becoming a "cashless Kingdom", the FSDP aimed to raise the percentage of non-cash transactions from 18 percent to 28 percent by 2020. Having already met this goal in achieving a 33 percent rate of digital payments before COVID-19, the pandemic drove a further surge to 75 percent as business lockdowns and curfews were in full effect.

Point-of-Sale Transactions (USD Million)



Source: SAMA

This successful digital adaptation to unique economic circumstances was made possible by long-term investments in the Kingdom's information technology infrastructure. Digital investment led by the Ministry of Communications and Information Technology and the National Digital Transformation Unit has led to 91 percent of the Saudi population being covered by mobile broadband networks and more than 80 percent of the Saudi population owning a smartphone. These trends have further boosted Saudi Arabia's transition to remote work, distanced learning, telemedicine, and grocery e-commerce during the pandemic. The shift to a digital economy has also been facilitated by a growing financial technology (fintech) sector in the Kingdom. In H1 2020, fintech was the third most active sector for venture capital investors in Saudi Arabia behind e-commerce and education.

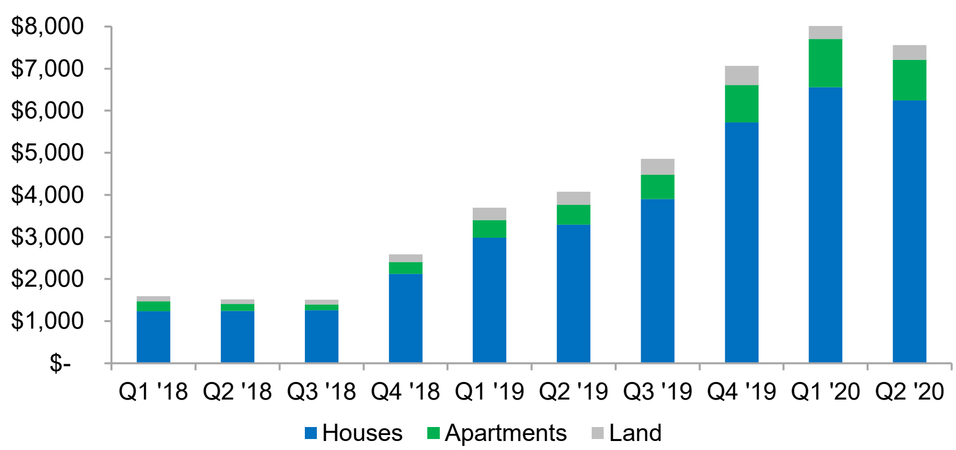
Private Sector Targets
Financial Sector Development Program (FSDP)

Target Area	2016 Baseline	Status	2020 Target
Number of licensed fintech players	0	60	3
Small and medium enterprise loans (as % of total bank loans)	2%	7.8%	5%
Share of non-cash transactions (in % of total POS transactions)	18%	75%*	28%
Outstanding real estate mortgages	SAR 290B	SAR 469B	SAR 502B

* This figure was strongly influenced by COVID-19 lockdowns. By Q4 2019, the share of non-cash transactions was 33 percent.
Source: FinTech Saudi annual report, SAMA, USSBC estimates

Financial services reforms also include meeting the growing demand for housing in Saudi Arabia and increasing home ownership to 70 percent by 2030. The FSDP set a 2020 target of increasing the share of mortgages in bank financing to 16 percent. While the government is working to increase affordable housing supply through the Ministry of Housing's Sakani program, the provision for providing mortgage-backed securities to investors has also received a boost in recent years through the creation of the Saudi Real Estate Refinance Company (SRC), a subsidiary of the Public Investment Fund (PIF). SRC was established shortly after the launch of Vision 2030 and has played an important role in helping Saudis gain access to mortgage loans. In July 2020, SRC announced it would buy a portfolio of home loans worth more than SAR3 billion ($800 million) from the Public Pension Agency.

New Residential Mortages (USD Million)



Source: SAMA

In Focus: The Emergence of the Saudi Fintech Sector

Fintech has emerged as one of the fastest growing sectors in the Kingdom and is projected to reach SAR124 billion ($33 billion) by 2023, according to Fintech Saudi. There is an active ecosystem of government agencies, universities, commercial banks, and other private sector programs and startups dedicated to the development of the sector. The Saudi Arabian Monetary Authority's (SAMA) Regulatory Sandbox and CMA's FinTech lab have played a key role in developing fintech startups in the area of crowdfunding, ledger tech, sukuk fractionalization, and other business technologies. Last year saw key developments with the launch of Apple Pay, the establishment of Saudi Payments and the continued issuance of regulatory testing licenses and regulations by SAMA and CMA to support fintech activities. Incentive programs aimed at fintech include the KAUST Taqadam Accelerator Program and Badir program, the National Commercial Bank/ Monsha'at (SME Authority) fintech accelerator, and Riyadh Bank's fintech fund.

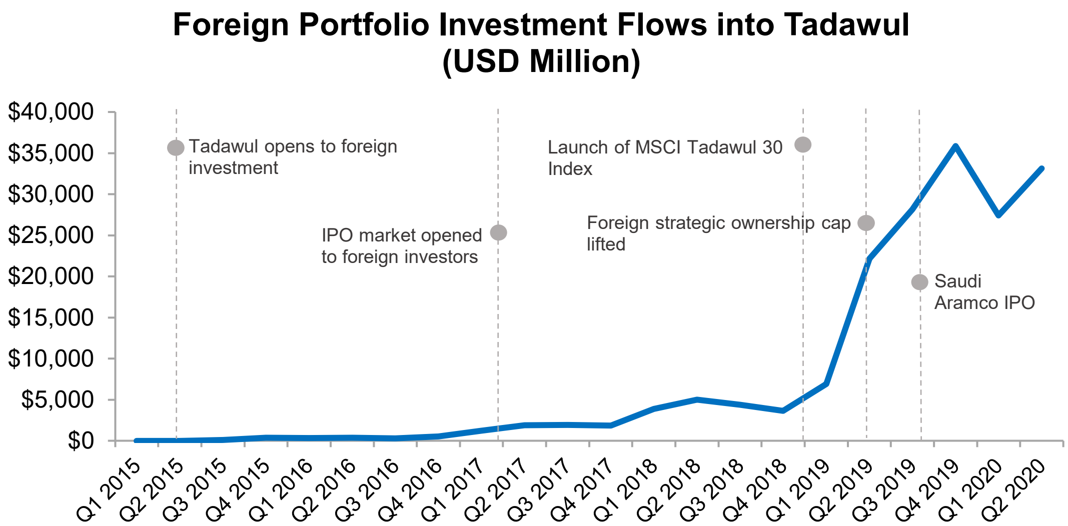
FinTech Saudi is a joint initiative launched by SAMA and CMA to support the development of the sector and help transform Saudi Arabia into an innovative fintech hub with a thriving and responsible fintech ecosystem. Although the fintech sector remains new in Saudi Arabia, it has seen rapid growth. The FSDP aimed to establish 3 fintech players by 2020. As of Q2 2020, Saudi Arabia has 60 local and international fintech startups active in a variety of industries including payments, personal finance, and insurance. Between 2018 and 2020, the number of active fintech companies in Saudi Arabia grew at a CAGR of 147 percent. The scope of these companies reinforce key FSDP goals such as providing more SME financing options, growing the Kingdom's international rankings in market competitiveness, and moving towards a cashless society with the proliferation of more than 24 payments and currency exchange companies.

Outstanding loans are targeted to grow from SAR290 billion in 2016 to SAR 502 billion by the end of 2020, according to the FSDP. As of Q2 2020, real estate mortgages have grown SAR178.6 billion ($47.6 billion) since the end of 2016, reaching 84 percent of the target level by mid-year. In August, the PIF announced it would launch a new real estate subsidiary, Roshn, to facilitate private sector partnerships to meet increasing local demand for housing. New residential mortgage have grown at a compounded annual growth rate of 16.9 percent since Q1 2018.

Capital Markets

Saudi Arabia's financial sector reform agenda includes a series of key performance indicators (KPIs) with specific 2020 targets. Most of the capital market targets under the FSDP exclude Saudi Aramco due to its outsized weight in market capitalization. According to the latest official CMA figures, the share of equity capital markets measured in terms of domestic market capitalization and debt capital markets stood at 78 percent of GDP in 2016 and reached 83.4 percent in 2019. Saudi Arabia is on track to reach its 2020 goal of 85 percent laid out in the FSDP ahead of the global pandemic. Because the recovery in equity markets has outpaced recovery in the real economy, the Kingdom is likely to meet this goal, though a lower 2020 GDP makes the ratio less reflective of the macroeconomic backdrop stemming from COVID-19.

Saudi Arabia also met its goal of raising the number of micro and small capitalization companies listed on the Tadawul from 34 percent to 40 percent by 2020. Foreign investor ownership as a percent of total market cap has risen from 4 percent in 2016 to 9.4 percent in 2019, aided by CMA scrapping the 49 percent ownership cap on foreign strategic investors in June 2019. However, the figure still lags behind its 15 percent target for 2020. While the global stock selloff in March may have seen some movement of institutional investors away from emerging markets, the Tadawul bounced back in Q2 2020 with foreign portfolio inflows jumping 20.8 percent as equity markets rebounded.



Source: CMA, Tadawul, Ministry of Investment

The month of August marked the launch of the Saudi stock exchange's first derivatives product, the MT30 Futures, and a national securities clearing center (Muqassa) designed to provide safe and transparent market infrastructure to enable the introduction of new financial products and services. These recent developments follow a series of regulatory reforms under the umbrella of FSDP to diversify the non-oil economy and attract foreign investment. The Capital Market Authority (CMA) opened the Saudi stock exchange (Tadawul) to foreign portfolio investment in June 2015 amid a prolonged period of low oil prices. The Tadawul now ranks as the largest exchange in the GCC region, having grown its total market capitalization from SAR1.6 billion ($421.1 million) in 2015 to SAR8.9 billion ($2.4 billion) by the end of August 2020. Foreign investors began investing in initial public offerings (IPOs) in October 2017 and the NOMU Parallel Market in January 2018. In September, non-resident foreign investors will be allowed to invest directly in debt instruments in a sign of further market liberalization.

Capital Market Targets
Financial Sector Development Program (FSDP)

Target Area	2016 Baseline	Status	2020 Target
Total market capitalization (shares and debt as % of GDP)	78%	83.4%	85%
Assets under management (as % of GDP)	12%	16.9%	22%
Market concentration of top 10 companies by market cap (in %)	57%	60.3%	55%
Institutional investors' share of value traded	18%	36.0%	20%
Foreign investor ownership (as % of total market capitalization)	4%	9.4%	15%
Number of micro and small cap companies listed	34%	40.7%	40%

Source: CMA 2019 Annual Report, USSBC estimates

The launch of the MSCI Tadawul 30 Index (or MT30) in December 2018 followed Saudi Arabia's classification as an Emerging Market by New York-based MSCI after satisfying international regulatory and operational standards. Shortly afterward, S&P Dow Jones Indices and London-based FTSE Russell announced Saudi Arabia's inclusion into its own emerging market indices, bringing an influx of qualified foreign investors (QFIs) into the market. Since the launch of MT30, foreign portfolio investment flows into the Tadawul have grown more than 800 percent from SAR3.7 billion ($974.6 million) in Q4 2018 to SAR33.2 billion ($8.8 billion) in Q2 2020. According to the World Federation of Exchanges, the Tadawul now ranks among the top 10 largest exchanges in the world by market capitalization and third among emerging markets. Among leading emerging markets, the Tadawul accounts for the highest market capitalization to GDP ratio. The Tadawul's profile was boosted by the public listing of Saudi Aramco which marked the largest IPO in the world and a fulfillment of a key Vision 2030 objective.

The global economic downturn amid the COVID-19 pandemic occurred only four months after the Saudi Aramco IPO in December 2019. As oil prices have remained well below budgeted levels and consumer demand is expected to be lower in the short-term following the VAT hike in July, the Saudi Aramco quarterly dividend is expected to provide SAR281.3 billion ($75 billion) through the end of 2020. Despite the pandemic, the Saudi Aramco IPO helped build momentum in Saudi Arabia's IPO market. In H1 2020, Saudi Arabia lead the MENA region in IPO activity as large firms such as Dr. Sulaiman Al-Habib Medical Group listed on the Tadawul and small-cap companies such as Sumou Real Estate Co. and Saudi White Cement Co. listed on the NOMU parallel exchange.

Outlook & Impact of COVID-19

The Kingdom has been able to weather the negative effects of the pandemic in the financial sector through quick government support to the private sector, while liberalizing investment opportunities in its capital market. Saudi Arabia's housing demand remained surprisingly strong as new residential mortgages totaled SAR28.4 billion ($7.6 billion) at the height of the lockdowns in Q2 and the Ministry of Housing added five housing plans encompassing more than 2,000 land plots in August on top of the more than 58 housing projects at various stages of construction. However, Saudi banks are facing headwinds as low oil prices have slashed state revenues and forced the government to cut capital expenditures. Asset growth at commercial banks is expected to slow further amid the downturn in the global macroeconomic environment. An associated decline in consumer spending and business confidence has resulted in a fall in credit demand in Q2. According to IHS Markit's benchmark survey, Saudi Arabia's Purchasing Managers' Index (PMI) has remained at or below the 50-point mark (50 in July, 48.8 in August) that separates growth from contraction since the onset of the pandemic. The burden on consumers will be exacerbated in the short-term by the VAT increase as businesses pass higher input costs onto consumers.

Despite the pandemic and economic slowdown, Saudi Arabia's startups substantially outpaced regional competitors in H1 2020 and the IPO market has begun heating up in Q3. Saudi Arabia's capital markets have recovered from the selloff in late March with Tadawul All-Share Index (TASI) returning to its pre-pandemic levels and the NOMU parallel market setting new all-time highs following the listing of several new companies in H1 2020. Although business conditions have remained in contraction, Saudi Arabia has seen rising business confidence and expanding inventories in Q3. As the effects of the VAT increase work through the economy, we expect to see a resilient return in consumer demand as international travel resumes and new business picks up. A precondition of that return is continued success in combating the ongoing pandemic as capital markets and business conditions remain highly sensitive to case levels. While the COVID-19 pandemic has set back some financial sector reforms, it has also accelerated e-commerce and digitization. In digital payments, the fintech sector, capital markets, and private lending, the Kingdom has shown steady progress towards FSDP targets.