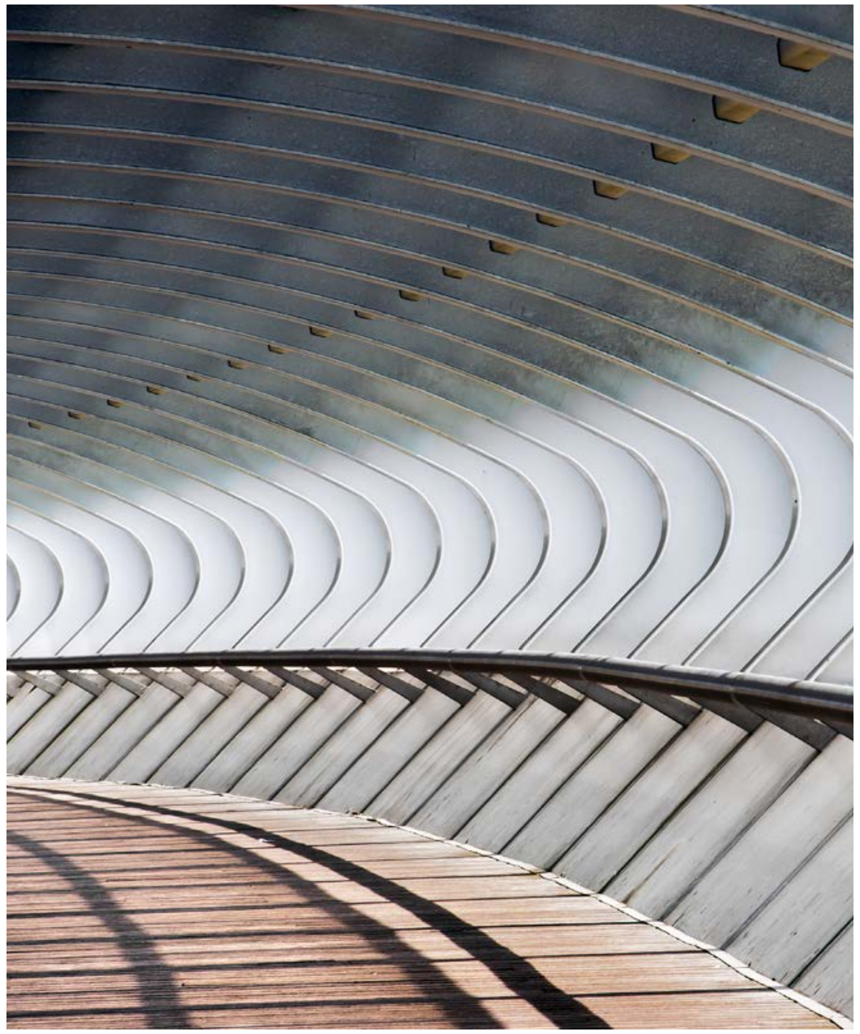
Inevitable focus on capital and liquidity requirements

Recent developments within the global banking industry re-emphasize on the continuous need of monitoring capital and liquidity positions, regardless of the size of the bank or the economic environment in which it operates.

For decades, funding gaps in the short-term have been tolerated on the basis that contractual maturities on liabilities are often rolled over, liabilities are often rolled over on contractual maturities and hence banks shall continue utilizing this opportunity and invest in long-term high-yield assets – a rationalization is required today.

This approach has had built-in controls where asset-liability committees (ALCOs) continue to keep a finger on the pulse at the bucket-mismatches, while regulators are monitoring key ratios including the capital adequacy ratio (CAR), liquidity coverage ratio (LCR), cash reserve ratio (CRR) and net stable funding ratio (NSFR). In Saudi Arabia, a country with a fast-developing banking industry, it is inevitable for market participants and regulators to continue working closely together and avoid potential challenges of capital or liquidity, as have recently been faced by some banks in markets in Europe and the US.

The number and scale of projects planned in Saudi Arabia over the next seven years is unprecedented; the total value of the giga projects program alone is over US$750 billion.[1] With such ambitious government plans and the required level of investment, the demands on the capital base of the banking sector and its liquidity position are expected to grow considerably. As construction activities crank up, banks will need to adopt aggressive expansionary strategies to maintain sufficient liquidity in order to meet respective contractual obligations.



There is a large growth agenda among banks, driven by increasing demand from public and private sector projects and continuous growth in mortgage finance. They will need innovative solutions for generating long-term liquidity and strengthen their capital base for maximizing their earnings and not losing on potential opportunities.

This will undoubtedly place substantial demands on money supply from now through 2030, but it also provides an opportunity for the sector to mature and pivot towards profit-making and growth.

The general principles of managing liquidity are understood and banks are expected to maintain sufficient liquid assets to settle liabilities as and when they arise. However, judgement is made on expected maturity of on-demand deposits that continue to represent a substantial portion of the overall liabilities of banks in the Kingdom. In an increasing interest rate environment, when depositors have also shifted their balances into savings and time deposits, the matter is further complicated. Simultaneously, banks continue to explore opportunities for profit making within contractual-liquidity gap and reinvestment of capital.

Over the last year, the ten Tadawul-listed banks saw their combined assets increase to SAR348.57 billion, predominantly on account of growth in loans amounting to SAR279.97 billion, with as major liquidity contributors the current short-term deposits. However, we have also seen an upsurge in Tier I capital issuance across the banking participants that added SAR28.[1] billion liquidity in addition to banks' annual earnings of SAR62.7 billion. This cumulative support of an increased equity base helped banks to fund long term assets.

SAMA has always had a robust mechanism of monitoring capital adequacy and liquidity position of banks through requirements, which includes tracking SLR, CRR and CAR. These requirements are dynamic in nature and continue to grow with the increasing size of banks' balance sheets. Moreover, banks are allowed to repo from SAMA against essentially their investments in Saudi government, if and when they are in need of short-term liquidity.

With our high-level analysis of Saudi banks' exposure to negative interest margin when global instances surfaced. Whether liabilities are priced more frequently than assets in an increasing interest rate environment. We have also noticed that on a portfolio level the risk is substantially mitigated due to non-interest bearing deposits that represent 53.05 percent of the total liabilities of listed banks.

Theoretically, the risk still exists for ad hoc transactions for attracting institutional depositors at high rate or extending financing at low margin to support growth agenda. However, with strong monitoring and engagement of ALCOs at banks, this is not expected to happen.

Banks are expected to continue analyzing their mix of deposit based between remunerative and non-remunerative and accordingly price new liquidity avenues based on the necessity and tenure of corresponding asset sought to be funded. Simultaneously, the management's judgement of expected maturity of on-demand deposits will be subject to higher diligence by those charged with governance and the regulators. Some of the banks may take a cautious approach towards underwriting loans if their loan-to-deposit ratios (LDRs) are already ranging from 82.07 to 100.98 percent, with an average of 95.49 percent. Banks may strategize to achieve a mix of high current yield and a more favorable outlook.

The government in Saudi Arabia has taken a series of initiatives to attract foreign direct investment including measures to attract interest in the capital markets, hence an expected rise in both the equity and fixed-income markets is likely to benefit the banking industry as well. Simultaneously, there have been attempts of loans securitizations, while it is expected to grow in the future for helping banks as well as other non-bank financial institutions (NBFIs) to enhance overall ecosystem. Banks can offer their robust process of credit initiation and plan for larger volumes, while NBFIs can achieve sustainable income on their available liquidity. Overall, there is an increased awareness of liquidity demands and efforts are being made by the regulators and market participants to achieve growth aspirations.

Finally, Basel III final reforms have already been implemented from 1 January 2023, which we will cover in greater detail later in this publication.

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