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Background

In Part 1 of this series, we highlighted the 12% deterioration in the "Return On Assets - RoA" for 9 key Saudi Banks for the 2 reference years of 2019 and 2023. We also hypothesized that should Saudi Banks crawl up to their 2019 RoA levels then, such banks can potentially generate an additional operating income of SAR 2 B!

In this article, we examine some of the revenue dynamics that underpin this deterioration in RoA to spur executive thinking of remedial changes.

Dynamic #1 – The Cling To Interest Income

Over the past 4 years, the collective "*Share of Interest Income To Total Income*" for the examined Saudi Banks stood staunchly at 78-79%. This commanding lion share of interest income dwarfs other income streams such as- Fees, Commissions and Trading as depicted in above the diagram.

To place this ratio into a global perspective, the - re calculated like for like - "*Interest Income Share To Total Income*" of global banks in 2023 were- Bank Of America (56%), HSBC (51%), Banco Santandar (54%),and Bank Of China (75%).

Conventional wisdom dictates that we live in a favorable fiscal environment of high interest rates and unbudging inflation rates. Yet, in the absence of a rigorous analysis of assets prices, maturity curves, and contractual terms, this conventional wisdom may render to be questionable at best and reckless at worst.

We advise that banks executives carefully examine the following common RoA growth inhibitors-

1. Trapped, Underpriced Assets. This includes fixed price loans (e.g. personal and auto loans) originated few years back at a rate lower than today's favorable rates. Possible remedies include- (i) asset securitization and sale to retail investors at a more favorable price, (ii) incentivizing borrowers to execute bullet payments or settle in advance and (iii) promoting vehicle upgrades and loans top-ups.

2. Idle Corporate Facilities. This includes pre-approved committed working capital facilities (e.g. overdrafts, trade finance) that are often idle or partially activated. While these facilities are typically short-term (less than one year) and generously priced, their low utilization continues to be a challenge to RoA growth.

3. Product Bundles. This includes bundling loans with cash management services (e.g. payments, transfers, FX, escrow) to improve the revenue yield per dollar of assets, especially in the Small-To-Medium Enterprises (SMEs) and Corporate segments.

Dynamic #2 – The Decline In Net Interest Margin (NIM)

Let's consider a proxy calculation of NIM as [NIM = Net Interest Income / Total Value Of Loans, Advances and Investments]. After all, regional banks' investment portfolio is biased towards fixed income instruments (e.g. bills, notes, bonds), with a little appetite for derivatives, mortgage-backed securities, and structured products.

The 9 banks have collectively witnessed a drop in NIM from 3.9 (2019) to 3.2 (2023)!

To place this ratio into a global perspective, the - recalculated like for like - NIM ratios of global banks in 2023 were- Bank Of America (2%), HSBC (1.5%), Banco Santandar (2.9%),and Bank Of China (1.6%).

This 18% drop in NIM may signal cracks in the "Asset Liability Management - ALM" models and processes. These cracks manifest in one or more of the following forms-

1. Stagnate pricing of deposits and loans that fail to reflect future market trends and customer events (e.g. premature settlement, bullet payments, deposit attrition, Current/Savings account stickiness).

2. Disconnect between ALM and commercial processes of product pricing, promotions, and sales targets.

3. Disconnect between ALM and credit risk management to validate the credit and market risk models in terms of- disbursements, delinquencies, segment concentrations and recoveries.

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Dynamic #3 – The Decline In Cost Of Risk (CoR)

Let's consider a proxy calculation of CoR as [CoR = (Statutory Reserves + Credit Loss Provisions) / Total Value Of Loans, Advances and Investments].

The 9 banks have collectively reduced their CoR from 5.9% (2019) to 4.8% (2023). This is a very positive dynamic that may not directly affect the RoA. Rather, it affects the Cost Of Assets (CoA).

Nevertheless, a healthy asset portfolio can be easily securitized and sold at a higher price. Hence, freeing funds and capital to be re-invested in higher price assets.

To place this ratio into a global perspective, the re-calculated CoR of global banks in 2023 were- Bank Of America (6.3%), HSBC (1.3%), Banco Santandar(2.4%) and Bank Of China (1.7%).

Dynamic #4 – The Increase In Commercial Loans Share Of Asset Portfolio

The "*Share Of Loans To Total Assets - LTA*" has grown from 62.6% (2019) to 66.5% (2023). This goes in tandem Dynamic #1 above.

To place this ratio into a global perspective, the - recalculated like for like - LTA of global banks in 2023 were- Bank Of America (33%), HSBC (35%) and Bank Of China (83%).

In the last part of this 3-part series, we will present a simple action plan for the executive team to drive the SAR 2 B journey of improving RoA.

Stay Tuned !!

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