CHAPTER 8

FINANCIAL SERVICES SECTOR

8. FINANCIAL SERVICES SECTOR

As the focus of development shifts to private sector activities, the financial sector will have much greater significance for achieving the Fifth Plan's objectives than in previous development plans. Non-oil private sector investment is projected to grow in real terms at an average annual rate of 6.8 percent during the Fifth Plan period. At the same time, the supply of new loans from the specialized credit institutions (SCIs) will be limited to the recycling of repayments on past loans. As a result, private sector growth and diversification will become increasingly dependent on the availability of finance from the commercial banks and other financial institutions. Furthermore, the financial sector is expected to play the paramount role in the financing of development bonds.

8.1 KEY CHALLENGES FACING FINANCIAL SERVICES

Any financial system has three basic economic functions: first, to mobilize resources by offering investment opportunities to savers and holders of financial assets; second, to disburse funds to productive uses in the economy, primarily through loans or equity investments; and third, to ensure efficient intermediation between sources and users of funds.

Although the financial system in the Kingdom has developed dramatically during the last two decades, it needs further strengthening in each of these dimensions to meet the investment requirements of the Fifth Plan more effectively. In this regard, there is a need to expand the range of investment alternatives for savers and asset holders. Opportunities for individuals to invest their personal savings in productive enterprises in the Kingdom rather than in the international money market or in physical assets, such as land and gold, need to be developed. An important step in this direction was taken in the last two years of the Fourth Plan with the issuance of government development bonds, thereby promoting both savings and opportunities for individual investors to increase their participation in the development process. The development of long term debt instruments and equity markets will create more investment opportunities and will add to the development of a domestic capital market.

The financial system is expected to play an increasingly important role in financing productive facilities and equipment. Total investment in the Fifth Plan period is targeted to be SR 386 billion, which represents an average annual real growth rate of 7.0 percent. It is projected that private sector financing will account for 37 percent of this aggregate investment, or SR 144 billion, in addition to the private sector's purchases of government development bonds.

Thus, a need arises for a growing share of the banking system's financial assets to be invested in the Kingdom, and for the range of financial services supporting the business sector to be expanded.

To achieve this ambitious investment target the following initiatives will be pursued:

- Attracting a higher proportion of private savings for investment in the domestic economy by providing profitable, safe, and marketable financial investments.

- Encouraging banks to expand their domestic lending and to provide a wider range of financial services.

- Developing a more broadly based private financial system, through the growth of non-bank financial intermediaries whose services compete with and complement the commercial banks, especially those which are potential sources of long term credit, such as equipment leasing companies and cooperative insurance companies.

- Encouraging the development of efficient capital markets, particularly a more active and efficient equity market.

8.2 FINANCIAL SECTOR DEVELOPMENT DURING THE PREVIOUS PLANS

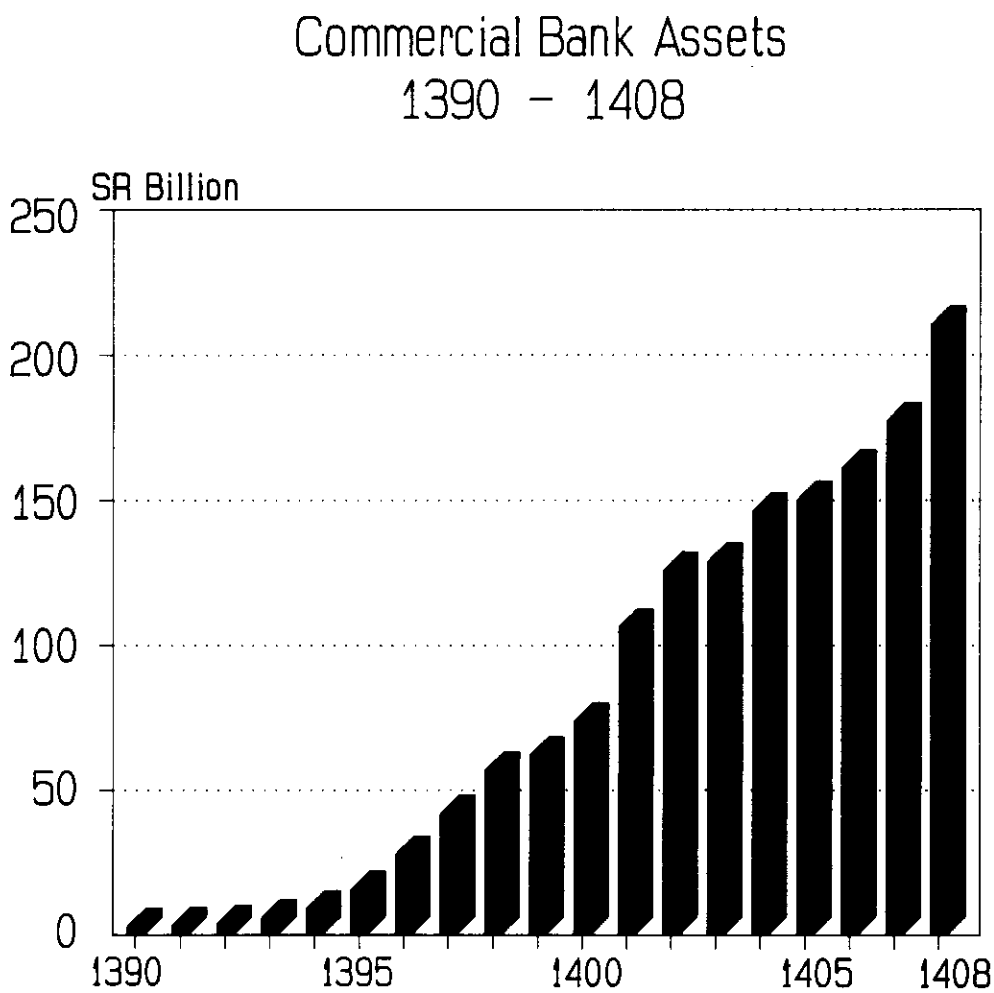
As the number of banks and bank branches increased, and with the steady improvement in customer service, the volume of bank deposits rose sharply, while at the same time the banks continued to strengthen their capital base and reserves. Over the past twenty years, the total assets of the banking sector have grown rapidly (see Figure 8.1).

The large increase in the deposit base of the banks, however, has not been matched by their local lending and investment activities, as the proportion of loans to total deposits began to decline at the outset of the Third Plan, after peaking at 59 percent in 1400/01. This ratio declined to a low point of 46 percent in 1407/08, but rose again the following year to 49 percent. At the same time, bank assets held abroad increased substantially (see Figure 8.2). This trend away from local lending was caused partly by the slowdown in economic activity during the Fourth Plan, and partly by default and collection difficulties on some outstanding loans, which adversely affected the profitability of most banks. In response to these difficulties, the commercial banks increased their reserves and bad debt provisions substantially and adopted a mortgage debts system, which assisted in rescheduling several loans.

8.3 FINANCIAL SECTOR GROWTH DURING THE FIFTH PLAN

The financial services sector (banking, insurance, business services) accounted for 6.2 percent of non-oil GDP in 1409/10, and this share is targeted to increase to 7.2 percent in 1414/15, with an average annual growth rate of 6.6 percent in the Fifth Plan period.

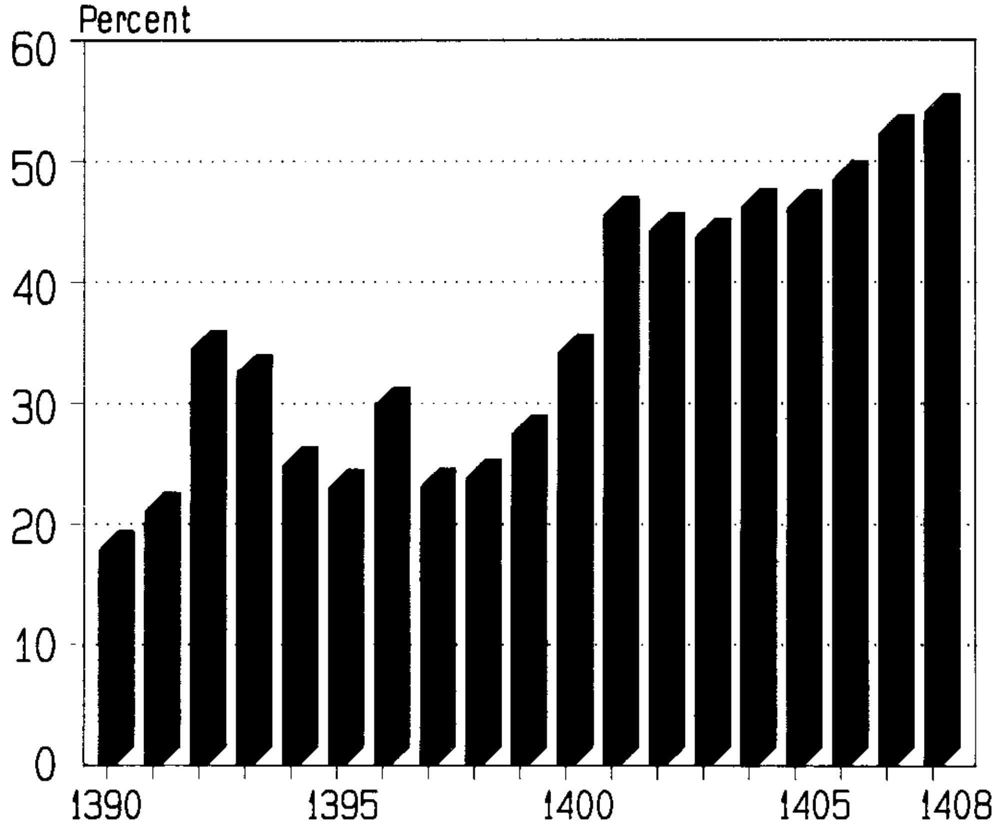
Figure 8.1



Commercial Bank Assets
1390 - 1408
SR Billion
250
200
150
100
50
0
1390
1395
1400
1405
1408

Figure 8.2

Commercial Banks: Foreign Assets as a Percentage of Total Assets 1390 - 1408



8.4 POLICIES AND INSTITUTIONAL DEVELOPMENT

The need to induce higher levels of private sector investment to achieve the diversification objectives of the Fifth Plan is clear. Two key elements of this policy are the repatriation of Saudi private sector financial assets held abroad and higher levels of new foreign direct investment in the Kingdom. In addition to investment activities already undertaken by the private sector, a key aspect of the private sector development strategy is to expand profitable opportunities for private sector investment in petrochemicals, in export-oriented diversified manufacturing, in selected government enterprises, and in new import substitution activities. In support of this strategy, a number of improvements in the financial system will be necessary in the Fifth Plan period.

8.4.1 Commercial Banks

It is common practice for the commercial banks to concentrate their activities on short-term loans, because 90 percent of their financial base is in short term liquid deposits. Greater participation by the banks in medium and long-term financing requires the introduction of debt instruments that could be easily bought and sold in secondary markets, thereby helping banking institutions to maintain their liquidity ratios.

The objective of increasing the availability of medium to longer term finance in the private sector can be achieved through the establishment of specialized banks or financing companies, owned by the private sector, that will issue bonds on the capital market to cover the long-term financing needs of industrial, commercial and business enterprises. The experience of such private development banks has been a success in many developing countries. The establishment of these specialized private sector credit institutions would require some changes in the banking supervision system, particularly with respect to allowing commercial bank participation in the capital of other companies and banks.

It is widely acknowledged that Saudi commercial banks enjoy a sound financial position, with an average ‘core’ capitalization of 10 percent (reserves, shareholder capital and retained earnings) compared to 4 percent for international banks generally. Consequently, the potential exists for these banks to establish specialized long term credit vehicles.

8.4.2 Non-Bank Financial Institutions

Non-bank financial intermediaries, such as specialized credit institutions, export development banks, capital markets (equity and bonds), leasing companies, insurance companies, and venture capital companies, need to be developed into important sources of long term finance.

Specialized Credit Institutions (SCIs)

The specialized credit institutions provide long term credit at a relatively low cost and in the past, they have been financed by budgetary appropriations. During the Fifth Plan period, it is expected that most of these institutions will achieve a higher level of self-financing, whereby outstanding loan repayments will be sufficient to meet their new lending activities to the various sectors of the economy.

The assets of these institutions amounted to SR 197 billion in 1408/09, about ten percent less than the combined assets of all commercial banks, and since their inception, loans have exceeded SR 234 billion (see Table 8.1).

TABLE 8.1

Specialized Credit Institution Loans: Cumulative Value to the end of 1408/09

	Value (SR billion)	Share (Percent)
Real Estate Development Fund	91.7	39
Public Investment Fund	63.5	27
Saudi Industrial Development Fund	49.4	21
Saudi Arabian Agricultural Bank	22.8	10
Saudi Credit Bank	3.0	1
Specialized Credit Programs	3.7	2
Total	234.1	100

The Fifth Plan lending objectives of the SCIs have been established to reflect economic conditions and the development stage reached by the various sectors of the national economy, in addition to the SCIs' projected income from loan repayments, which will constitute the major source for new credit throughout the Fifth Plan period. A summary of the SCIs' new loan targets for the Fifth Plan is shown in Table 8.2.

TABLE 8.2

Specialized Credit Institution Loans during the Fifth Plan

	Loans (SR billion)
Saudi Arabian Agricultural Bank	6.9
Saudi Industrial Development Fund	4.5
Real Estate Development Fund	18.4
Saudi Credit Bank	1.7
Public Investment Fund	5.0
Special Credit Programs	0.4
Total	36.9

Proposed Export Development Bank

The feasibility of establishing a private sector-managed specialized institution to promote Saudi exports will be studied. This proposed institution will seek to provide commercial loans to finance local working capital and export operations. Currently, this type of service is not provided by the commercial banks, who currently confine their financing activities to the transfer of payment when delivery actually takes place. An export development bank could offer Saudi exporters:

- A program to guarantee working capital loans needed before actual export delivery occurs. These loans would be made by a commercial bank to a Saudi exporter and the export bank would guarantee repayment of, for example, 80 percent of the principal. Thus, the commercial banks would retain only a 20 percent risk on the loan.

- Credit insurance to fully cover export losses resulting from war, expropriation, currency inconvertibility and to partially cover commercial losses arising from nonpayment by the buyer because of insolvency or default.

Development of a More Effective Stock Exchange

The Saudi corporate securities market has expanded significantly in recent years. The value of shares traded through the commercial banks reached SR 1.9 billion in 1408/09 (see Table 8.3). However, the percentage of the value traded each year relative to the total value of the shares listed, has decreased.

A properly regulated active stock exchange could play a critical part in the Kingdom's economic development, through:

- stimulating the supply of stock capital to business enterprises;

- creating opportunities for the public to participate in the ownership of companies, thus leading to a more broadly based contribution in support of private sector development;

- greater use of financial vehicles whereby an adequate range of risk/profit opportunities is made available to private investors, thereby also helping to expand domestic savings and investment;

- establishing fair prices for securities and minimum trading costs, thus leading to a more efficient distribution of capital.

TABLE 8.3

Shares Traded through Commercial Banks and Joint Stock Companies Listed

	1408/09
Shares Listed (SR billion)	80.6
Shares Traded (SR billion)	1.9
Value Traded as Percent of Listed Value	2 %
Number of Shares Traded (millions)	14.6
Number of Joint Stock Companies Listed	52

The current stock exchange mechanism is rather slow and very complicated, as the processing of a stock issue can take up to two years. Individual stock transactions require between one week and two months to complete and, more often than not, the buyer must reach the seller by his own means. Thus, blocks of shares may not be broken up to match the needs of buyers. These obstacles result in significant gaps between bid and asking prices, thus indicating that the price mechanism is not working efficiently. Therefore, consideration will be given to the establishment of a more effective stock exchange, with appropriate state regulation and control to avoid detrimental speculation. Given rapid technology improvements in computer based stock transactions, there is an excellent opportunity to introduce state-of-the-art systems that would be compatible with other GCC stock exchanges.

Prerequisites for an effective stock exchange are the uninterrupted availability of comprehensive financial data and the assurance of equal opportunities for all investors. An efficiently functioning stock exchange, operating under state regulatory controls, will have important developmental impacts on the entire financial sector. It would endeavor to improve financial and legal procedures, induce the establishment of intermediary institutions, and improve the availability of business and financial information. It would constitute an important vehicle for acquiring practical knowledge of finance, industry, technology and economics in general. Furthermore, it would lead to the creation of employment opportunities for Saudi citizens in the financial sector.

Leasing Companies

The lack of finance needed for the direct purchase of plant and equipment can be a major obstacle facing new companies, particularly smaller ones. In this regard, capital equipment and plant leasing companies can be an important source of long-term finance for enterprises. By leasing plant and equipment, enterprises can obtain the immediate benefits from its use without the need to raise the required capital. Therefore, plant and equipment leasing can promote rapid growth in private investment. The success of this form of finance depends on the availability of a legal framework that will enable the leasing company to repossess its equipment in the event of a leaseholder defaulting on repayments. Such a framework requires modifications and clarifications to some existing regulations.

Leasing could also provide an effective mechanism for private sector participation in financing the construction of school buildings and other public facilities, to be leased subsequently to the government. A part of the annual installment payment would constitute the rental equity, and when all payments had been completed, ownership of the facility would be transferred to the government.

Insurance Companies

In the developed countries insurance companies extend direct loans and mortgages to their policyholders and are a major source of long term finance. In the Kingdom, the insurance sector makes an important contribution to the development of the financial sector. However, the role of the insurance companies in development could be greatly expanded if they were to invest a greater proportion of their premium income domestically, instead of overseas where the bulk of collected premiums are currently invested. Furthermore, reinsurance operations are mostly located in the main international insurance centers. To rectify this situation and to develop the domestic insurance market, the government established the National Company for Cooperative Insurance as a Saudi joint stock company (paid up capital SR 250 million).

The insurance sector should be developed by consolidating through mergers the smaller private sector insurance companies into a larger cooperative insurance company to operate according to Sharia principles, and by the creation of a reinsurance industry composed of large joint stock companies with adequate capital, reserves and technical trained staff.

Venture Capital Companies

Venture capital is temporary start-up financing in the form of equity capital or loans, with returns linked to profits and with some measure of managerial control. Venture capital is ideally suited to projects involving uncertainty, poor information, and lack of collateral on the part of the owners. The operations of venture capital companies require a pool of entrepreneurs and an environment conducive to private sector initiatives. In addition, an active stock exchange or an adequate network of business investors is essential, so that stocks and shares can be traded.

During the Fourth Plan, a number of venture capital companies came into being to establish new manufacturing enterprises. In the Fifth Plan period, non-bank financial enterprises could offer attractive investment opportunities for new specialized venture capital companies.