Muhammad Al-Jasser: Diversifying sources of finance

Remarks by His Excellency Dr Muhammad Al-Jasser, Governor of the Saudi Arabian Monetary Agency (SAMA), at the Euromoney Saudi Arabia Conference, Riyadh, 17 May 2011.

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Thank you Padraic for inviting me again to this yearly event entitled this time “Diversifying Sources of Finance.”

It is a fact that finance and the financial sector have been at the centre of global attention since the financial market crisis in 2008. That crisis involved a temporary breakdown in the credit system which produced a global recession, and this example shows the critical role that finance plays in generating or undermining economic growth.

This morning, I would like to address the role of government, including SAMA, in enabling the environment for private enterprises including the SMEs, and then describe the current situation in terms of local and global sources of finance for economic development. I will conclude with some lessons from the recent global financial crisis.

The first source of finance is internal to the Saudi economy, and the second is external. Domestically there is credit intermediation by channeling local savings into productive investments. Externally savings are allocated between economies, where Saudi Arabia competes with others for the global pool of savings.

1. Role of government

The government targets investment in social infrastructure (education, health, housing, etc.) to promote the wellbeing of the people, and is also pursuing diversification of the economy to create work opportunities for its young population. Fiscal and monetary policies are but tools to achieve these goals. Government policies can play a vital role in providing a stable and predictable macroeconomic environment for investors, which is why the policy horizon is long-term.

Monetary policy is anchored on the pegged exchange rate to the Dollar, so interest rate risk premia over the Dollar can be kept low and investors have confidence to commit long-term funds. The result of this long-term success is that Riyal financing is available with no currency risk and at attractive interest rates.

Saudi Arabia’s fiscal policy provides a stable background for investment. It works on counter-cyclical basis, so that it runs budget surpluses when times are good, as at present, so as to allow for deficit spending to keep the economy on a steady growth track when global demand for oil weakens. The result is that Saudi Arabia currently has a very low debt/GDP ratio (less than 10%).

Saudi Arabia also has favourable tax rates for businesses (such as a maximum 20% rate on foreign enterprises) with no capital controls on remittances abroad. The government provides support for investment projects besides developing a supportive legal and arbitration structure. In summary, Saudi Arabia’s economic policy remains cautious and long-term and provides global investors with an ideal backdrop for allocating their capital to the different sectors of the Saudi economy.

2. Financial stability

A sound financial system is the backbone of an economy. Indeed, banking crises tend to be very costly to the exchequer and taxpayers. Our recent experiences revealed that sovereign and banking crises are highly and tightly intertwined. In this context, SAMA as the commercial bank and insurance regulator will continue its conservative policy on banking and insurance supervision, and will fully implement the recommendations of the Basel Committee on capital requirements.

3. Sources of finance: domestic

In emerging/developing economies, banks are the most important source of finance. As is the case in most emerging markets, bank intermediation is still a favoured option in Saudi Arabia, with bank credit/GDP at about 50%. The economy, in common with other developing economies, is relatively under banked, but bank penetration is increasing. Similarly, borrowing by individuals is relatively conservative (consumer loans/GDP is about 12%). The eventual passage of a mortgage law, along with increased lending to SMEs, should help to encourage responsible borrowing in these areas and improve banking penetration in the economy.

The problem in the advanced economies is that banks are forced to retrench from an over-leveraged position; but that is not the situation here. The domestic banks have strong capital adequacy and liquidity ratios. This means they are well-placed to extend credit to the private sector (corporates, households & SMEs) without burdening their balance sheets. Banks are now diversifying their revenue stream by widening their focus to include SMEs and households.

In addition to bank lending, Saudi businesses have access to funds through the Tadawul stock market. The infrastructure of the market is at a high level in terms of listing requirements, ongoing supervision, as well as settlement and custody arrangements. IPOs and capital raisings by local companies have been gaining pace, and this augurs well for corporate governance and operational efficiency.

Government specialized credit institutions (such as the Public Investment Fund, the Real Estate Development Fund, the Saudi Industrial Development Fund, the Saudi Credit & Saving Bank and the Saudi Agricultural Development Fund) play an important role in providing long-term credit to productive sectors of the economy. Their outstanding loans as at the end of 2010 totalled SAR 178 billion. Moreover, government partnership in investments is an important factor in Saudi Arabia. For instance, the Saudi Electricity Company has a programme of public-private partnership projects in the power industry.

The third source of local funds for businesses after banks and equity market should be corporate bonds. The corporate debt market is in the process of emerging, with outstanding corporate bonds to GDP at about 3%. The first corporate bond issue in Saudi Arabia took place in 2003 and in 2009 a corporate bond trading platform was launched. A number of bond issues have taken place, but so far no active secondary trading in debt has developed. Nevertheless, I am confident that this will develop in due course, both in conventional and sukuk form, as it has done in other markets.

4. Sources of finance: external

Businesses in Saudi Arabia also have access to external capital markets. These funds can either come into the economy indirectly via the local banks accessing wholesale funds abroad, or directly through equity investment and FDI. FDI is the most attractive form because it is long-term. Banking flows are highly volatile and can reverse as they did during the 2008 crisis. The CMA (Capital Markets Authority) has been gradually opening up the stock market to investment by non-residents in a series of steps. The latest one was when the CMA allowed foreigners effectively to buy shares through swap arrangements with licensed intermediaries.

Saudi Arabia has a very strong record in inward FDI flows. Last year, UNCTAD ranked Saudi Arabia among the top ten recipients of FDI worldwide (ranked no. 8) and 17th in the world in terms of the performance returns on inward FDI.

5. Lessons from the global financial crisis and update

When complacency takes precedence over prudence, it becomes a recipe for ultimate financial breakdown. This was precisely the case behind the recent global financial markets meltdown. In hindsight, regulatory lapses, unrestrained balance sheet leverage, explosive growth of complex structured products and risk-taking incentives through fat compensation were the main drivers of the crisis. Even countries which had been tightly regulated and supervised, such as Saudi Arabia, were not immune from the contagion. When the big global banks reversed their funding policy towards developing markets in 2008 and very rapidly withdrew funds, the banking system was impacted despite the conservative posture of our banks with prudent loan/deposit ratios.

Saudi Arabia has always been cognizant of risks inherent in the leveraged and leniently regulated model. A sustainable model is one which supports resiliency of the financial system in a crisis. In particular, the crisis made clear that regulators need to have a macroprudential framework for the system as a whole, as well as focusing on the microprudential risk management of each individual bank.

6. Regulatory challenges

Recent efforts by the G20 and other global entities (Basel Committee, FSB, G20 & IMF) in addressing system pitfalls and weaknesses show the seriousness of the problem as well as the need for remedial action. It is well-known that crises are a recurring phenomenon, warranting appropriate countermeasures to contain systemic risks of the scale seen in 2007/2008. Some big challenges in reforming the world's financial system still remain, however. Allow me to say a few words on this point.

In the past two years or so, the G20 has issued calls for coordinating financial regulations and their reforms across multiple issues, such as capital and liquidity requirements, derivative instruments, and orderly resolution of failing banks. However, the G20 process is facing increasing resistance within some member countries on these measures for reasons of domestic politics and practicality of the proposed reforms in some G20 economies. For example, it is agreed that a sound macroprudential framework needs to be in place. The regulators will be expected to decide when the pace of credit expansion is unhealthy. Similarly, SIFI's definition has proven to be contentious.

On bank capital adequacy, some countries (such as the UK and Switzerland) have indicated that the standards they apply will be tighter than the minimum set out in Basel III. This represents a cross-border challenge to regulators because banks from relatively lightly-regulated countries will have a competitive advantage. It was this sort of problem that led to a "race to the bottom" in regulatory standards in the pre-crisis years, and we must strive to avoid this happening again. Regulatory arbitrage is a serious threat.

For financial institutions, which are systemically important to the world economy (and that therefore are practically "too big to fail"), there needs to be additional rules. The FSB will report to the G20 Summit in November on which banks and insurance companies qualify, and what additional capital requirements they need to have. Some banks are resisting this strongly. They argue that tighter regulations will drive financial transactions into the world of "shadow banking" where the activities will be regulated lightly. In my view, international banks need to accept tighter regulation, which will mean lower returns on capital in good years due to lower leverage. In return, this approach should help them avoid the frequent crises and losses of bank capital which have been seen in the last two decades or so. Hence, in the long-term, bank shareholders should be no worse off as a result.

Finally, emerging/developing economies have been subject to wide swings in financing from abrupt withdrawal of funds in 2008 to significant inflows recently, and as a result they are starting to implement capital controls. The risk is that these may spread unless financial flows become less erratic and more long-term and stable.

7. Concern about commodity bubble and high-yielding products

Over the past several decades, the world financial system has produced a seemingly endless series of bubbles (e.g. the dotcom bubble, the housing bubble and the Yen carry trade). Each bubble had its apologists before it burst, who argued that it was rational and that "this time is different." Historically, commodities (apart from oil) were in a downward trend for over 100 years until 2002. Since then the entire decline has been reversed and commentators are talking about a "Paradigm Shift." Compared to historical trends, commodities are as over-priced as the US stock market during the "tech bubble" of 2000. The parabolic rise in commodity prices has serious consequences and it is open to question whether the world economy is strong enough to support their continued gains. It is particularly damaging to inflation and growth in emerging market economies which are relatively heavy users of commodities.

With interest rates at current low levels, investors are looking for high-yield products; but high yield brings high risks as well. For example, some banks are marketing synthetic ETFs tracking an index which are not collateralised by the underlying investment in the index but by other assets with the return guaranteed by a swap with a counterparty which involves counterparty risk. Some ETFs are offering a leveraged return up to 3x that on the index. The IMF, among others, has expressed its concerns (in the Financial Stability Report April 2011) and pointed out that the computer-driven trading used by these products could lead to another "flash-crash" like that of April 2010.

8. Conclusion

In conclusion, a supportive macro and regulatory environment is critical to attracting domestic and global sources of capital. Saudi Arabia has been going about this process for many years, backed up by a prudent monetary and fiscal track record. We welcome long-term capital inflows in various sectors of the economy to gain mutual benefits from the economic potential of Saudi Arabia. To promote this, the government has adopted an "open door" policy towards foreign capital which has provided excellent returns to FDI investors. Saudi Arabia has opened up the financial sector to foreign financial institutions by granting licenses to foreign commercial & investment banks as well as asset management & insurance companies to optimize the level of competence and coverage in different financial disciplines. In terms of regulation of financial institutions, we will continue with the prudent policy which has served us well in the past. As for the G20 agenda, the challenge is to transform its broad vision into detailed rules that prevent regulatory arbitrage of which banks took advantage of in the run up to the crisis.

In closing, I am reminded of an old saying: "Money is a good servant but a bad master." In the last crisis, excesses in the financial system came close to driving the world economy into the abyss and a repeat of the Depression of the 1930s; and it is my belief that nobody wants to see that happen again.

I wish you a productive and successful conference.

Thank you.