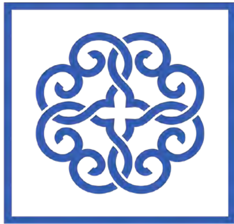

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MEGA-PROJECTS AND SMALL ENTERPRISES: UNDERSTANDING SAUDI ARABIAN BANKS' ROLE IN ECONOMIC DEVELOPMENT

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Vision 2030 promises a transformation of Saudi Arabia's economy, and the financial sector will be crucial to achieving this. The sector will facilitate private investment focusing on small and medium-sized enterprise (SME) financing, fund mega-projects, and be a driver for diversifying away from oil. As a result, banks' role must go from being distributive and largely passive to developmental and active. This article[1] will highlight how the role of the Saudi banking sector has been transformed in the last five years and how its composition is changing to cope. Commercial banks are becoming financial intermediaries between all facets of the Saudi economy, not only the state and large conglomerates. The new banking environment requires updated approaches and since Saudi companies — with a few notable exceptions — do not borrow abroad, the domestic banking system is a critical source of funding for Vision 2030.

This partially explains recent changes, such as the merger between Alawwal and Saudi British Bank (SABB) announced in 2018, the merger between National Commercial Bank (NCB) and Samba announced in 2020, and the granting of two digital licenses in 2021, which show a degree of dynamism that is highly uncharacteristic for the Saudi banking sector. The country's commercial banks have diversified their portfolios from a near-exclusive focus on conglomerates and large-scale investments in industry and infrastructure to now also include mortgages and SME financing. To assist banks in these areas, government-financed funds have been overhauled and have become integral to bank profitability. However, it is important to not be mesmerized by slick brochures and eye-popping price tags, as several structural problems that have hindered banking sector development since the 1970s are still present.

Sector origins and trends

When the flow of oil wealth turned from a trickle to a flood after the sharp rise in prices in 1973, banks from all over the world poured into the country. While Saudi Arabia's built environment was transformed, the structures underpinning its financial sector formed and then remained stubbornly similar for more than half a century. The state was the alpha and omega of investment, the legal system did not modernize concurrently with the economy, the commercial banking sector remained marginal, and the financial system was hostile to small actors, be they small banks, SMEs, or individual borrowers.

The 1973 oil boom led to a spending spree with few historical parallels, and the state's extraordinary financial might made foreign direct investment (FDI) unnecessary and undermined the development of a competitive financial ecosystem. The glut of money meant little attention was given to modernizing the Saudi legal system, which was unfit to handle the needs of modern banking. In courts, the Islamically trained jurists would invariably rule against banks due to the Islamic prohibition on interest-taking economic activities, and borrowing against short-term assets, such as imported cars, was not legally enforceable. The government-induced preference for enormous industrial and infrastructure projects meant that banks preferred to lend

to large conglomerates and government-related enterprises, because of the larger margins and more predictable contracts they brought. As a result of these two factors, banks made few inroads into retail lending, a problem that has only recently been given the attention it deserves.

When the oil price declined during the first half of the 1980s and then crashed in 1986, the high-spending government-centric investment strategy ground to a halt. The inadequate regulatory system, which could be sidestepped in the years leading up to the crash due to the monetary surplus, was now causing headaches. The government, suddenly low on funds, would delay or even cancel payments to contractors, creating a ripple effect of unpaid bills and loans across the economy. Suing the government was a non-starter and contractors would instead appeal to sharia courts, which would deduct paid interest from the principal of the loan. This put enormous pressure on bank balance sheets that were already buckling from the precipitous drop in government investment. The legal and financial troubles banks faced in the late 1980s gave rise to a decades-long trend of risk-averse lending, where the preferred borrowers would be conglomerates, well-connected royals, and the government itself.

The 1990s were the logical conclusion of the trends from the 1970s and 1980s. Low oil prices during the 1990s meant the government could not pay for the infrastructure projects that had become the bread and butter of commercial banks. The lack of trustworthy borrowers in the kingdom in this period caused banks to buy most of the $55 billion in treasury bills and bonds issued by the government because these had better returns and were more reliable than lending to the private sector. Retail financing was still off the table as the legal system was only modernized after the turn of the millennium. The structural advantages for large banks continued as they could buy more government debt, while the woeful economic conditions caused United Saudi Commercial Bank and Saudi Cairo Bank to merge and then become absorbed into Samba. In 1999, NCB came close to becoming insolvent due to the large number of bad loans in its portfolio. The Ministry of Finance — through the Public Investment Fund (PIF) and the General Organization for Social Insurance (GOSI), the kingdom's private sector social insurance authority — bought a 50% stake in NCB.

In each of these periods, a defining feature of the Saudi banking sector was its lack of competition and dynamism. The centrality of the government as an investor stimulated big projects and, together with the opaque legal system, undermined lending to SMEs. A private sector independent of government investment did not emerge, perpetuating the need for continued government investment. Likewise, the absence of small, locally focused banks limited the growth of retail finance. These trends can be traced back to the spending patterns of the boom period and constitute the primary obstacles Vision 2030 will need to overcome.

Preparing banks for Vision 2030

The most eye-catching mega-projects under the Vision 2030 umbrella, including the Red Sea Project and the hypermodern city NEOM, have price tags in the tens and hundreds of billions of dollars. When the Crown Prince Mohammed bin Salman (MbS) came to power, no Saudi bank had the balance sheets nor the experience necessary to make these projects a reality, but following the merger of NCB and Samba, Saudi National Bank (SNB) is one of the 150 largest banks in the world. NCB predicted in 2019 that mega-projects would add to a "positive outlook for the Saudi banking sector" due to the vast amounts of funding involved in making them a reality, calling them "integral to the kingdom's sustainable growth and prosperity." Alawwal and SABB echoed this in their merger presentation, and mentioned that the enlarged balance sheet would create a "capacity to support transformational infrastructure and privatization projects." The dominant credo is therefore "bigger is better." A secondary goal is to ensure that local banks do not become sidelined by foreign banks that might want a significant piece of the action from Vision 2030, which may see profits from ancillary work alone reaching $100 million.

Along with funding mega-projects, mergers are also aimed at increasing synergy and saving on costs. Banks with an extensive retail network, such as NCB, or a very strong corporate bank, in this case Samba, are appealing targets for a merger. Another possible reason can be gleaned from the annual reports of Saudi Arabia's central bank, the Saudi Arabian Monetary Authority (SAMA). The insurance market saw three mergers take place "as a result of SAMA's efforts aiming at maintaining the stability and resilience of the financial system by encouraging insurance companies' mergers." Considering the unpredictability of oil markets, recent tensions between the UAE and Saudi Arabia, the growing impact of environmental policies, and the challenges the Saudi economy

Photo above: Governor of the Saudi Arabian Monetary Authority Ahmed al-Kholifey (L) and Saudi Arabian Finance Minister Mohammed al-Jadaan (C) attend the G20 Finance Ministers and Central Bank Governors Virtual Meeting in Riyadh on March 31, 2020. Photo by Xinhua/Getty Images.

will face in the coming decades, a well-diversified and stable bank is a thoroughly appealing prospect. While it has been difficult to go bankrupt in Saudi Arabia — a bankruptcy law was only introduced in 2018 — there is no longer a bottomless pot of money that the government can use to invest in ailing banks, as it has done with NCB, Samba, and Riyadh Bank in the past.

Overhauling specialized credit institutions

To facilitate bank lending to SMEs and retail customers, several institutions in Saudi Arabia have been revamped. Historically, economic development in the kingdom has been catalyzed by the government and its specialized credit institutions (SCIs), such as the Real Estate Development Fund (REDF), the Saudi Industrial Development Fund (SIDF), and the Agricultural Development Fund. These would supply the capital required for the kingdom's cement plants and petrochemicals industry and gave stipends for housing and agriculture. Commercial banks would focus on lending to big projects, while avoiding retail finance and SME lending. These SCIs filled the gap, with three significant results. First, they cemented the government's central role in important economic sectors; second, and more problematically, they perpetuated commercial bank exclusion from these sectors as they removed any impetus for legal modernization; and third, because SCI terms were more generous than those of banks, there was very little demand for banks to enter these sectors. The government therefore crowded out commercial actors as both an investor and a lender, hindering the creation of a flexible and transparent banking ecosystem.

Vision 2030 has revolutionized the SCIs. Instead of funding projects or homes directly, they now provide guarantees for loans banks make to individuals. This enlarges the role of banks in financial intermediation and increases the number of people that have access to banking services. For example, the SIDF's capital has almost doubled since 2017, with loan disbursements — serving as guarantees for loans made by banks to other businesses — growing by more than 25% between 2017 and 2019. Likewise, the REDF's growth has been stratospheric, driven by a joint REDF-Ministry of Housing initiative to provide suitable and affordable housing to 63.5% of the population by 2020 and 70% by 2030, from a baseline of around 50% in 2016. Samba stated that REDF support ensures access to "top quality finance mechanisms for a very real and genuine need," referring to housing, while NCB reported a 57% increase in residential financing in 2019 alone, "in close cooperation with government initiatives." The results are clear:

Photo above: Customers use ATMs inside the Al Rajhi Bank in Riyadh on December 1, 2016. Photo by Simon Dawson/Bloomberg/Getty Images.

Housing has been the main driver for bank profitability since the program has taken off, and the policy to synergize SCIs and commercial banks is paying dividends, rather than producing the more exclusionary results of earlier policies. The IMF has, however, cautioned that letting these programs grow too large could raise "contingent fiscal risks for the government" if money is given to less-efficient SMEs or if prudential steps are not taken to protect banks from large price fluctuations in the housing market.

Encouraging SMEs and diversification

Core to the economic transformation that Vision 2030 aims to achieve is diversifying the economy away from oil, in large part by encouraging a more vibrant SME sector and small-scale entrepreneurship. This is where the bulk of economic and job growth predicted by the Vision will take place, but also arguably where banks face the most structural obstacles. With SME penetration among commercial banks at an abysmal 6%,[2] meaning that only one in 20 SMEs makes use of commercial banks, a vast amount of work remains to be done. For this reason, improving SME penetration is one of the main goals described in the Financial Sector Development Program and substantial funds are being allocated to achieve this. The SCIs help in two ways: They facilitate funding for a group of companies that face enormous trouble getting access to credit, and they create incentives for banks to change lending patterns in an economy that has historically been dominated by conglomerates and large-scale investments.

In 2019, 77% of loans disbursed by the SIDF went to SMEs via banks, although the total value of these loans was only one-eighth of funds approved by the SIDF that year. The SIDF has launched "specialized financing programs *as incentive solutions* for the private sector [emphasis added]" to facilitate bank investment into strategic sectors. One of the primary beneficiaries was NCB, the largest creditor to the SME sector in Saudi Arabia, which said it considered it a "strategic priority" to support this sector. It is fair to assume that this will continue to be the case after the merger with Samba to create SNB.

However, the media blitz surrounding Vision 2030 and the diversification drive can paint a picture that is excessively positive. There is a drumbeat of "diversify, diversify, diversify" but a substantial percentage of this "diversification" happens in the upstream and downstream petroleum sectors, and companies do not fundamentally move away from oil-based products.[3] This is reflected in bank lending patterns. The SIDF is the putative catalyst for diversification, but in 2019 chemical industries received more funding than the next three sectors (engineering, consumer, and cement industries) combined.

Obstacles and recommendations

Vision 2030 is the industrialization drive of the 1970s and the diversification push of the early 2000s combined but with a more centralized power structure and, more importantly, a leader who is willing to upset the social norms that limited his predecessors' activities. Based on that alone, Vision 2030 has a higher chance of success and promises to be substantially more impactful. However, the breakneck speed of reforms means that goals and methods do not always align.

The economic impact of large banks

The creation of SNB raises several questions about the future of the Saudi financial sector, the first relating to the necessity of large banks. The NCB/Samba merger created a leviathan of the Saudi banking sector, although SNB is still small compared to some international actors (JP Morgan, for example, has almost 15 times more assets under management than SNB). But with well over 40% of sector assets concentrated in one bank, systemic risks increase. There is also no evidence that large banks are better situated to accomplish the structural changes necessary, such as SME financing and greater bank penetration in that sector.[4] Moreover, the lack of bank licenses for local lenders focusing on particular regions further undermines that goal. The U.S. has around one bank license per 60,000 inhabitants, while Saudi Arabia has one bank license per 3 million (excluding foreign licenses due to their miniscule role beyond corporate banking). While NEOM and the Red Sea Project capture headlines, the bulk of jobs come from SMEs, but the Saudi state seems unwilling to create a banking system that is structurally capable of meeting these challenges.
While it would be a revolutionary change for the Saudi banking system to drastically increase its number of licenses, it is hard to argue against such as shift when so much of the success of Vision 2030 regarding employment and economic growth hinges on the sustainable growth of the SME sector. Adding 550 bank licenses (the number required to have a license-per-capita level similar to the U.S.) would be preposterous, but at least doubling the current number of licenses to create banks with a specific regional focus would help establish a system more suited to the needs of SMEs and entrepreneurs. A greater number of banks, leading to more specialized lenders, both geographically and based on economic sectors, would be beneficial, rather than having a dozen banks that all strive to fund the same mega-projects. It is possible that Al Rajhi, thanks to its vast branch network, will become the retail bank of choice while SNB becomes the country's primary corporate bank, but this is at best a band-aid fix made necessary by an institutional unwillingness to open up the sector.

Competition

The creation of SNB allowed NCB to effectively absorb one of its main rivals and, while good for synergies and profit margins, this is not conducive to a competitive banking system. SNB can leverage its large size and benefit more from economies of scale, snowballing its inherent advantages and leading an increasingly non-competitive banking sector at a time when competition and dynamism should be overarching priorities. Relatedly, with the growing focus on fintech — highlighted by two digital-only banks being granted licenses — there is room for innovation, but this normally takes place in smaller, more flexible banks.

It is in the Saudi government's best interest in the long term to develop a vibrant private sector. Encouraging mergers makes sense for the less profitable and impactful banks, for example Bank AlJazira, but concurrently granting more licenses and removing the requirement that banks have their headquarters in the capital will create a banking system that is better situated to promote and thereafter capitalize on Vision 2030. The Vision cannot be successful without some private sector competition. Digital-only banks and e-banking can help banking expand into hard-to-reach places, but as the president for the Gulf Center for Financial Consultancy, Mohammed Alomran, said, "When it comes to banking, personalization is very important." Creating relationships is essential for effective corporate banking, even on a small scale, and the Saudi state cannot allow medium-sized banks to merge without

acknowledging the adverse impacts this can have on small-scale businesses.

The PIF and SCIs

The Saudi state has, for the last six decades, been at the center of the kingdom's economy. Diversification was aimed at reducing the country's dependence on oil while also limiting the role of the state. However, the PIF shows that while the mechanism is different, government money and old spending patterns still dominate. The PIF is either the dominant or only shareholder in all major Vision 2030 projects. Saudi investments go where the PIF leads, and the appetite for large-scale projects that has existed since the 1970s has not abated — if anything, it has increased. Nor are the priorities of the PIF clear: It is a highly opaque organization, and the stated ambition of rapid wealth creation clashes with its economic role as an investor in important sectors. Balancing the quasi-hedge fund behavior necessary to achieve the desired $2 trillion valuation with the stable and predictable spending required to encourage an appealing investment climate domestically will be challenging. Increased clarity on whether the PIF's priority is financing the private sector or reaping returns for the fund itself is essential if the crown prince wants more FDI to flow into the country and to assuage any doubts among investors that their investments will be secure.

While SCIs such as the SIDF and the REDF have altered their funding mechanisms, the inescapable reality is that government funds still undergird economic development. The government remains the primary investor and first mover, as banks are structurally more inclined to do business with large companies such as SABIC and Aramco, due to their higher margins. The profound impact that the joint REDF-Ministry of Housing homeownership program had on bank growth also raises questions as to what will happen once these funding mechanisms are wound down. The last two years have seen mortgage lending and government debt being the profit-makers for Saudi banks, but neither of these will remain at such high levels forever.

An eye to the future

The success of the government's housing initiative is undeniable, and the newfound vitality of a sector that has historically been somewhat passive is a welcome and necessary change. The Saudi government has also identified what is necessary for the successful implementation of Vision 2030, namely energizing the SME sector, increasing bank concentration, and attracting FDI for major projects. MbS and the rest of the Council of Economic and Development Affairs have also shown a willingness to face sensitive topics such as taxation and reduction of benefits head on. The big unanswered question is whether that willingness extends to upending financial structures that have remained unchanged for decades. Saudi Arabia has had roughly a dozen locally incorporated banks for almost half a century and, with substantial PIF shareholding in many of them, can exercise some influence over their strategies. The banking system as it is has served Saudi Arabia well, but with economic growth being driven by small-scale enterprises and ambitious entrepreneurs, a system that was designed to cater to industrial conglomerates and multibillion-dollar projects is no longer fit for purpose.

About the author

Piotr Schulkes is a non-resident scholar at the Middle East Institute. His research concerns the political economy of the Gulf, focusing on the region's financial sectors. Before MEI, Piotr worked in Egypt and Jordan and obtained his graduate degree from the University of Oxford. The views expressed in this piece are his own.

Notes

1. This article's content and research is based on the author's graduate dissertation.
2. Author interview with Saudi banker
3. Author interview with ex-IMF employee
4. Author interview with Gulf financial analyst