

Chapter One:
Banking Financial Institutions

Preview

Financial institutions, including banks, play a crucial role in the overall financial system, influencing economic development by collecting savings and converting them into productive loans. As the oldest financial institutions, they have accumulated experience, adapting, growing, and providing innovative services to meet economic organizations' needs. This chapter sheds light on the most prominent financial institutions that exist.

1. Types of banks

Unquestionably, the most significant financial institutions are banks, which fall into the following categories:

1.1. Central banks (bank of banks)

A central bank is an extraordinary public monetary institution with the ability to create and control legal money through its monopoly on the power to issue banknotes. It is also exclusively competent to monitor, intervene, and direct the various components of the banking and financial apparatus. The meeting of these characteristics makes the central bank the real designer of monetary policy and the only qualification for its activation and correction if it is necessary.

To ensure the effective implementation of their policies in order to contribute to financial and economic stability and improve the welfare of citizens, central banks have been given wide independence¹ to achieve their objectives represented in:

- Designing, implementing, and managing the monetary policy.²
- Managing the countries' foreign reserves.³
- Issuing the banknotes (paper money).
- Determining the legal reserve that other banks must keep with the central bank and its administration, where the offending banks are subject to penalties ranging from payment of additional interest to denial of loans leading to a temporary or final stop (close).
- Lending to banks operating in the form of discounts on commercial papers or loans at a discount rate against the mortgage of government bonds or real estate, and sometimes in the form of a pledge to buy government bonds. The discount rate and the purchase and sale of government bonds (open market operations), as well as the legal reserve ratio and the mandatory additional deposits whose counterpart pays interest, are the main tools used by central banks to control the

¹ Samir Hassoun, *Political Economy of Money and Banking*, Second Edition, Edition Majd, Lebanon, 2004, p.169.

² The main objectives of monetary policy are: (1) increase the level of employment, (2) improving the economic growth rate, (3) maintaining price stability, (4) stabilizing interest rates, (5) stabilizing financial markets, and (6) stabilizing exchange rate.

³ Salah al-Din Hassan El-Sissi, *Scientific and Practical Banking Encyclopedia*, Volume2, Arab Nile Group, Egypt, 2011, p.29.

supply of money in case the banks do not respond to the friendly persuasion method.

- Facilitating and encouraging interbank borrowing (for one night) for interest below the central banks' discount rate. The interbank lending mechanism optimizes the utilization of unemployed resources and increases the turnover of cash to the benefit of the economy.
- Collecting the outstanding checks from banks to other ones; the process is done by deducting amounts due from bank balances at the central bank (clearing) without the need to transfer money or the costs and time involved.⁴
- Supervising the banks in the field of credit (size, type, price, and destination) and controlling their responsiveness to laws and regulations are necessary to achieve the integrity of their financial position, protect depositors' funds, and ensure the continued flow of financing for development.
- Managing governments' deposits and regulating their bond issuances.
- Providing advice and suggestions to the governments on financial and economic matters.
- Participating in economic planning, representing financial institutions, and defending their interests.⁵

1.2. Commercial banks (deposit banks)

A bank is a financial institution that is licensed to accept checking and savings deposits and make loans. Commercial banks intermediate between surplus holders (savers) who do not have any investment opportunities and deficit holders (investors) who are in need of financing investment opportunities they have, using deposits deposited with them on investment aspects that yield an appropriate return that ensures acceptable profits. However, what differentiates commercial banks from other banks is the general nature of their activities and the absence of specialization in a particular activity or sector⁶.

1.3. Non-commercial banks

Non-commercial banks include:

1.3.1. Specialized banks: These banks specialize in servicing a particular sector in order to develop it and accelerate its growth by providing it with different-term services and loans at competitive interest rates.⁷ Notably, specialized banks include:

➤ **Agricultural banks:** These types of banks specialize in the provision of loans and banking services to enable the agricultural activities to expand and increase productivity.⁸ The agricultural banks' loans include:

- Consumer loans.
- Short-term loans.

⁴ Munir Ibrahim Hindi, *Commercial Bank Management: An Entry for Decision Making*, op.cit., p.79.

⁵ Salah al-Din Hassan El-Sissi, *Scientific and Practical Banking Encyclopedia*, Volume1, op.cit., pp.29, 35.

⁶ Ibid, p.35

⁷ Ibid.

⁸ Samir Hassoun, op.cit., p.153.

- Medium-term loans.
- Long-term loans.⁹

➤ **Industrial banks:** Industrial banks aim to meet the financing needs of industrial businesses by providing various services and loans,¹⁰ and:

- Participation in the capital of industrial enterprises.
- Provide all available banking services.
- Feasibility studies for projects are expected to be completed.
- Technical and administrative assistance by placing experts and specialists at the disposal of industrial enterprises and providing for their expenses.
- Develop and introduce new production methods.
- Financing workers' training programs.

➤ **Real estate banks:** Real estate banks are established to provide loans for the purchase of land and real estate and finance various construction projects with mortgages. Due to the characteristics of the real estate sector, the majority of the loans provided are medium- and long-term (ranging from ten to thirty years).¹¹

➤ **Foreign trade banks:** These banks provide exporters and importers with loans of different maturities and open documentary credits for export and import to enable businesses to export their outputs and import their inputs.¹²

1.3.2. Business and investment banks: These banks have been established to serve investment by providing financing and contributing to investment management, pooling resources from clients' deposits to employ them in different investment aspects. To stimulate investment, these banks contribute to the establishment of different companies and continue to support them by providing loans and issuing bonds for them. Like other commercial banks, business and investment banks rely on deposits in their activities, but their deposits are usually long-term and significant, enabling them to set up companies in different economic sectors.¹³

1.3.3. Savings banks: These banks are distinct from commercial banks in that they issue low minimum deposit investment certificates, which qualify them to attract small savers and gain immense popularity. They depend on their attraction of savings on investment certificates issued in different values that give their owners several benefits, such as earning interest for the savers from the month of purchase, while counting from the month following in other banks. In addition, investment certificates also give their owners the right to borrow on concessional terms by guaranteeing them. Savings banks may also invest in the establishment of investment funds, the purchase of first-class securities, and deposits with other banks with special interest.¹⁴

1.3.4. Internet banks: Internet or electronic banks began to emerge in 1995, offering their various services to their customers anywhere via a specialized website

⁹ Nadia Abu Fakhra & Mahmoud Sobh & Shamel Al-Hamoui, *Financial Markets and Institutions*, Hariry Print, Egypt, 2006, p.332.

¹⁰ Salah al-Din Hassan El-Sissi, *Scientific and Practical Banking Encyclopedia*, Volume1, op.cit., p.38.

¹¹ Nadia Abu Fakhra & Mahmoud Sobh & Shamel Al-Hamoui, op.cit., p.333.

¹² Samir Hassoun, op.cit., p.154.

¹³ Salah al-Din Hassan El-Sissi, *Scientific and Practical Banking Encyclopedia*, Volume1, op.cit., p.39.

¹⁴ Nadia Abu Fakhra & Mahmoud Sobh & Shamel Al-Hamoui, op.cit., p.342.

and then evolving to make the services provided through the network compete with the services provided by other banks.¹⁵

1.3.5. Islamic banks: The philosophy of Islamic banks is based on avoiding dealing with interest (Reba) on lending and borrowing and replacing them with what accords with the principles of the *Islamic Shariah* by entering into processes of murabahat, mudarabat (speculation), mucharakat (participation), Istisna'a, Salam, Muzara, Musaka, and Mugharasa instead of lending.¹⁶ The sources of Islamic banks come from paid capital, retained profits, current and savings accounts, deposits of various timings, zakat, and funds deposited to invest with the authorization of their owners. The Islamic banks employ funds available in various areas of direct investment by establishing projects, contributing to the capital of enterprises (buying shares), and providing interest-free lending, in addition to using *zakat* funds to achieve social solidarity (*Takaful*). In their activities, Islamic banks avoid anything contrary to Islamic sharia.¹⁷

1.3.6. Universal or all-purpose banks: Universal or all-purpose banks are keen to do all the traditional and non-traditional functions of banks; they combine the functions of commercial banks, investment banks, businesses, and specialized banks at the same time, relying on diversification as a strategy by which to diversify their resources and investment channels. Universal banks seek to develop their deposits by launching a range of diversified and innovative services that have the effect of attracting new age groups. They also attempt as much as possible to maintain the stability of deposits by installing deposits, securing deposits, launching investment certificates and negotiable deposits, and establishing investment funds to allow small savers to subscribe to them. In order to raise sources of financing, universal banks may resort to securitizing their loans and long-term borrowing from banks and financial institutions, and they may take the form of a holding company that manages a group of companies in all fields to obtain more financial resources.

Besides banking fields, universal banks attempt to diversify their activities as much as possible. This can be reached by breaking into non-banking areas that achieve profitability and the desired return with low liquidity risk, such as carrying out leasing financing activities, trading currencies to complete international deals for some companies in exchange for commissions, ensuring equity and bond issuance, providing insurance services, establishing investment funds, and others. To reach as many clients as possible, some universal banks offer some activities at major malls and shops and offer ATM service anywhere, 24/7.¹⁸ Figure 1 depicts the structure of the banking system, which may vary from one country to another.

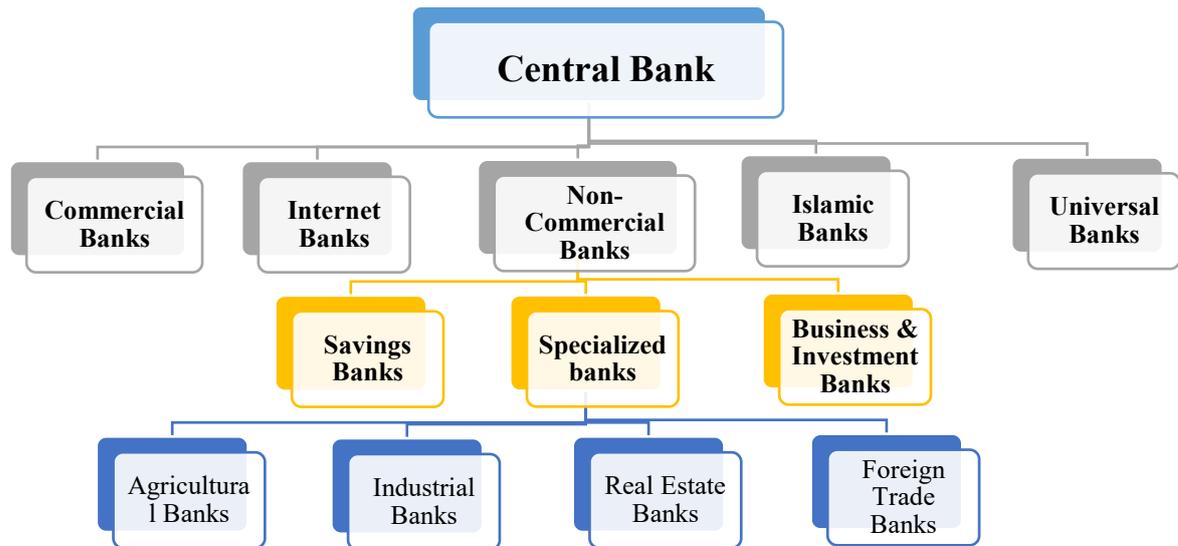
¹⁵ Samir Hassoun, op.cit., p.159.

¹⁶ Ibid.

¹⁷ Salah al-Din Hassan El-Sissi, *Scientific and Practical Banking Encyclopedia*, Volume1, op.cit., p.41.

¹⁸ Abdulmutalib Abdulhamid, *Universal Banks: Their Operations and Management*, Eldar El Gamaya, Alexandria, Egypt, 2000, p.17.

Figure 1: Banking System Structure



Source: Author's preparation

2. Roles of banks

Banks have received significant attention from specialists and decision-makers due to the roles that they can play in achieving the social and economic development, including:

2.1. Savings mobilization

Banks offer a variety of deposits consistent with the preferences and desires of their target clients, and for this reason, banks are known as depository institutions. In this regard, the most prominent deposit type is current and non-current deposits. Current deposits (call deposits) are deposits that give their owners (depositors) the right to withdraw or transfer them at any time and from anywhere without having to notify the bank in advance. However, some banks may offer the possibility of withdrawing additional amounts, resulting in the generation of a debit balance that their clients are required to settle with interest and commissions. Non-current deposits (time deposits) are amounts of cash deposited by their owners, in advance agreement with the bank, that are not withdrawn before a specified date (maturity date). Unlike current deposits, which are considered inexpensive resources due to the absence of an obligation to pay any interest on them, banks pay interest on term deposits that vary in proportion to their maturity.¹⁹

To better manage their deposits, banks take into account two primary considerations:

¹⁹ Salah al-Din Hassan El-Sissi, *Scientific and Practical Banking Encyclopedia*, Volume1, op.cit., p.122

- Improving the liquidity and diversification of deposits.
- Lowering the costs of deposits.²⁰

2.2. Meeting the financing needs of different economic sectors

By collecting as many deposits as possible, banks have the potential to finance individuals and economic firms with a wide range of services through three primary forms, namely:

- Contribution to project capital.²¹
- Providing loans to finance projects that serve the economic and social development plans and achieve the established objectives.²²
- Providing guarantees for the benefit of projects. Banks issue, at the request of the contractor client, an initial or final letter of guarantee in which they undertake to refund the cash insurance.²³ Banks also issue a letter of guarantee of items loaned to the contractor in case the project owner lends the contractor machinery, equipment, or forms for the completion of the operation. Thus, the letters of guarantee contribute to the completion of many large projects thanks to the significant financial liquidity they provide, instead of depositing it with the owner of the project.²⁴

2.3. Financing foreign trade

Financing foreign trade contributes to meeting the economic development requirements for capital goods needed to start production, intermediate goods that enhance the volume and quality of production, and other consumer goods. On the other hand, the provision of export facilities stimulates the development of domestic industries by creating external channels for the discharge of production and the provision of foreign exchange resources to the country. Banks exercise their role in financing foreign trade by issuing letters of guarantee and documentary credits using their existing network of relationships with their external branches or correspondents (foreign banks) in other countries.²⁵

2.4. Contributing to establishing financial markets and developing their performance

²⁰ Mahmoud Younes & Kamel Amine El-Wassal, *The Economics of Money, Banking, and Financial Markets*, Eldar El Gamaya, Alexandria, Egypt, 2005, pp.239, 250.

²¹ Abdul Hamid Mohammed Al-Sharbi & Mohammed Abdul Hamid Al-Sharbi, *Banking Risks Management from Banking and Legal Viewpoints*, Monchaat Almaref, Egypt, 2002, p.387.

²² Salah al-Din Hassan El-Sissi, *Scientific and Practical Banking Encyclopedia*, Volume1, op.cit., pp.16, 140.

²³ Government departments and companies require contractors wishing to implement the projects tendered to provide cash deposit as a guarantee to be confiscated if the contractor decides to retreat from the completion of the project for any reason.

²⁴ Salah al-Din Hassan El-Sissi, *Theoretical and Applied Studies: Documentary Credits and Bank Guarantees in Economic, Accounting and Legal Terms*, Dar El-Wesad, Lebanon, 1998, p.75.

²⁵ Salah al-Din Hassan El-Sissi, *Theoretical and Applied Studies: Documentary Credits and Bank Guarantees in Economic, Accounting and Legal Terms*, op.cit., p.4.

Banks play a pivotal role in the establishment and development of financial markets by establishing investment funds,²⁶ establishing deposit funds, providing loans to brokers and securities dealers, issuing and promoting government and private securities,²⁷ investing in securities,²⁸ and establishing mutual debt funds.²⁹

2.5. Contribution to public expenditure

Banks contribute to finance the public expenditure by paying taxes, direct lending to governments, or investing in buying government bonds.³⁰

2.6. Implementing the privatization programs

Contributing to the implementation of privatization programs by providing consultancy, investing in buying some or all of the shares offered, and including them in their investment portfolio.³¹

2.7. Attracting foreign direct investments

Banks have a crucial role in attracting foreign direct investments by providing loans for investments at low interest rates and harnessing their technical and advisory capabilities to accompany them.³²

2.8. Combating money laundering

Banks play a pivotal role in combatting the phenomenon of money laundering by checking the selection of their clients and monitoring their behaviors, processes, and activities related to them.³³ It should be noted that due to the banking position on money laundering operations, the Basel Committee and the United Nations have provided a set of guidelines to banks and financial institutions to address them. In addition, the Vienna Treaty, which was concluded on December 19, 1989, urges countries to take effective action against such operations; one of the most important is the abolishing of the banking secrecy system for any operations related to illicit business. Financial institutions should contribute to efforts to combat the phenomenon by scrutinizing their clients' operations and reporting suspicious and other transactions.³⁴

²⁶ Safwat Abdulsalam Awadallah, *Investment Funds: Study and Analysis from the Perspective of the Islamic Economy*, Dar Alnahda, Egypt, 2005, p.41.

²⁷ Abdulghafar Hanafi, *Investing in Securities: Stocks-Bonds-Investment Documents-Options*, Elder Elgamaya, Egypt, 2000, p.43.

²⁸ Munir Ibrahim Hindi, *Commercial Bank Management: An Entry for Decision Making*, third Edition, Modern Arab Office, Egypt, 1996, p.143.

²⁹ Shakir Atallah, *Financial Market: Tunisian Experience*, Imprimerie Cartage Tunis, Tunisia, 2007, p.54.

³⁰ Said Abdullaziz Atman, *Introduction to the Public Economy (Public Finances)*, Eldar Elgamaya, Egypt, 2003, p.351.

³¹ Zidan Mohamed, *FDI in Countries in Transition - An Analytical View of Gains and Risks*, *Journal of North African Economies*, Chlef University, Algeria, N°01, 2004, p.120.

³² Ibid.

³³ Mahmoud Mohamed Saif, *Analysis and Evaluation of Banks' Role in Combating Money Laundering*, Dar Athaqafa, Jordan, 2008, p.134.

³⁴ Abdelbaset Wafa, *The Private Banking Industry and Its Role in Savings Mobilization*, Dar Alnahda, Egypt, 2005, p.111.

3. Banking risks

The notion of risk intrinsically links the characteristics of the banking sector, particularly in the context of growing competition, financial liberalization, and technological advancements. It is essential to monitor the risk levels associated with the banking sector and to manage them systematically to ensure the bank's success in achieving its strategic objectives, including profitability and returns. We can classify the risks that banks face into:

3.1. Financial risks

Liquidity risks include withdrawal of deposits and market risks (fluctuation of revenues as a result of changing interest rates, securities prices, and prices of goods and services), as well as credit risks (debtors' default), which, if not managed, can lead the bank to bankruptcy.³⁵

3.2. Operational risks (activity risks)

These risks arise from defects and inefficiencies in the bank's internal and information systems, or from external events (including legal risks), which can lead to management being unaware of current events at the bank and a loss of control. Then, operational risks open the way for the spread of financial fraud, mismanagement, embezzlement, cybercrime, interference, the overreach of powers, and delays in the timely preparation and submission of reports.³⁶

3.3. Business risks

Business risks include all external risks that the bank has no capacity to control, such as economic conditions, financial sector structure, changing legislation, etc.³⁷

3.4. The risks of events

This includes political risks, financial crises, natural disasters, civil wars, etc.

3.5. Other risks

Banks face other risks, including country risks (international lending), reputational risks (decreasing client confidence), and compliance risks (financial penalties and prohibition from engaging in an activity as a result of wrongdoing).³⁸

Therefore, banks must be ready for all these risks by establishing policies and procedures for risk management that ensure that risks are identified, measured, and tracked to avoid or reduce them to a minimum so that they do not affect money flows and disposal (trade-offs between return and risk).

³⁵ Zitouni Kamel, *Impact of Economic Shocks on the Analysis of Indicators of Banking Crises during 1980-2015: A Comparative Study between Algeria and Saudi Arabia*, Ph.D diss in Economics, M'Sila University, Algeria, 2016/2017, pp.69-70.

³⁶ Ibid, p.70.

³⁷ Salah al-Din Hassan El-Sissi, *Scientific and Practical Banking Encyclopedia*, Volume1, op.cit., p.621.

³⁸ Ibid.

To ensure the banks' sustainability, monetary authorities, including central banks, have paid great importance to managing bank risks by subjecting banks operating under their tutelage to strict and continuous supervision to ensure their efficiency, integrity, and respect for banking laws and legislation. This can be achieved by enhancing control over the banking system to ensure the integrity of banks' financial positions and the funds of depositors and creditors, while also increasing predictability regarding deviations and preparing various potential solutions. In this regard, countries have sought to improve banking control systems to prevent crises. Among the most acceptable and used systems by bank supervisory authorities, the CAMELS system, which is an American early warning system, permits the evaluation of the performance and health of banks. It consists of six criteria that allow the assessment of banks' financial situation quickly and continuously, which are (1) adequacy of capital, (2) asset quality, (3) management risk for day-to-day activities, (4) earnings, (5) liquidity, and (6) sensitivity to market risks.

As countries strive to accelerate financial liberalization and enhance interconnectedness in financial relations, coupled with the financial crises affecting many systems, the effectiveness and efficiency of banking controls have become dependent on coordination among various regulatory authorities. Accordingly, the governors of 10 central banks in developed countries agreed to establish the Basel Committee in 1975. Since 1988, the Basel Committee has been working on the development of norms and standards aimed at strengthening the supervision of banks and ensuring their financial integrity and has urged monetary authorities to apply them to avoid the possible impact of different levels of bank control on some banks' competitive advantage over others. The Basel 1 Criteria dealt with credit risk by focusing on the adequacy criterion (basic and supplementary), so the size of the standard (capital to assets) has been set at 8% (COOKE ratio). It was recommended for its application at the end of 1992.³⁹ Owing to the failure of this standard to capture all risks as well as the prevalence of innovative financial instruments, especially after the 1997 Southeast Asian crisis, the Basel 2 Convention expanded in 2004 the standard of capital adequacy to include credit, market, and operating risks. Thereby, the amount of capital is linked to those risks while maintaining the same ratio and allowing the issuance of short-term, unsubordinated debt. Overall, the new criteria are based on three main themes:

- Adequacy of the capital. This includes minimum capital requirements, various types of credit risk such as those from standard entry applications, internal classification inputs, and securitization, as well as operational risk and banking book risk related to fluctuations in investment prices.
- Supervisory audit of banks.
- Market discipline by publishing information and providing transparency to alleviate the problem of asymmetric information.

³⁹Zitouni Kamel, op.cit., pp.74-99.

Basel II has tried to provide a set of criteria by which to measure different risks, but it is noticeable that it focuses on credit risks, providing three methods for measuring them:

- The standard method focuses on giving different hazard weights depending on the class of customers (governments, banks, companies, etc.).
- The basic internal classification method assesses the risk of customers failing to pay their debts (default risk), while the rest of the credit risk remains covered by the central bank.
- Advanced internal classification method based on the assessment of all credit risks without central bank intervention.⁴⁰

The minimum adequacy of the capital ratios is comprised of three segments: the seed capital (the paid-up capital, reported reserves, and retained earnings), supplementary (unreported reserves and recalibration reserves), and short-term, unsubordinated debt (less than two years and not more than 250% of the seed capital). As soon as the 2008 global financial crisis erupted, Basel II failed to maintain the financial position of banks in the face of external risks and shocks that emerged, paving the way to launch Basel III in September 2010, with a timeline for the application up to 2019. The concept of liquidity and private funds has been readjusted to include ordinary shares. The risk was expanded to include derivative contracts and pressure tests, and leverage ratios were introduced to raise the adequacy of the capital to absorb losses and shocks; the capital's adequacy rate was raised to 10.5%.⁴¹

Developments in financial markets recently that have generated multiple risks and increased their seriousness and spread have led to an increase in the importance of paying attention to applying the principles of governance in banks. This step is to ensure the commitment of governing councils (boards of directors) to achieving the prevailing goals and safeguarding the rights of stakeholders, including shareholders and depositors.⁴²

⁴⁰Salah al-Din Hassan El-Sissi, *Scientific and Practical Banking Encyclopedia*, Volume2, Arab Nile Group, Egypt, 2011, p.188.

⁴¹ Hayat Nedjar, *The Basel 3 Convention and its Possible Implications for the Algerian Banking System*, Journal of Economics and Management, Setif1 University, Algeria, N°13, 2013, p.280.

⁴²Zitouni Kamel, op.cit., pp.105-108.