Chapter two:
Non-banking financial institutions

Preview

Financial institutions, including banks, play a crucial role in directing financial resources from savings lenders to investor borrowers. However, they do not have a monopoly over financial intermediation functions or markets. This chapter sheds light on the most prominent non-banking financial institutions.

1. Insurance companies

Insurance is one of the most important and renowned tools of risk management because it can transfer the risks from one party to another who is willing to bear the burden of losses if they are realized. Thus, insurance is one of the effective systems that reduces the insured person's uncertainty about all or part of the financial losses that can occur. Insurance is an economic tool that can replace a significant potential loss with a confirmed small one. Insurance is a process that allows individuals and businesses (insured) the possibility of protecting themselves from potential losses by paying periodic installments to the insurer, who is willing to bear the consequences of the risk by means of the large numbers law, which requires a large number of similar risks to be pooled and cleared. The law helps to improve the accuracy of the estimate between actual and expected losses and helps to determine the value of the advance fixed premium.[1]

1.1. Insurance contract information:

In order to establish both parties' obligations, they are required to sign a contract called an insurance policy, which includes the following information:

1.1.1. Contracting parties: To be valid, an insurance contract usually includes different parties, who are:

- **The insurer (insurance company)**: The first party to the contract is the insurer, who agrees to indemnify another upon the occurrence of a specified contingency and is often the insurance company.
- **The insured**: It is the second party in the contract. The insured is the party to be compensated in case of a loss in exchange for an obligation to pay periodic insurance premiums during a specific period.
- **The beneficiary**: Alongside the previously mentioned parties to the contract, the insurance contract may encompass additional parties, including the beneficiary. The latter refers to the individual who obtains the advantages of an insurance policy upon its maturity. The individual for whom the insurance contract is established and who receives compensation upon the determination of the insured risk. The beneficiary may be the insured individual or another party, such as an employer insuring employees against labor injury risks. In this scenario, the employer is the insured party, while the beneficiaries are the workers. In specific life insurance contracts, the insured individual may differ from the policyholder; for instance, a

[1] Falag Saliha, The ***Requirements for the Development of the Takaful Insurance System - Arab Experiences***, Ph.D diss in Economics, Chlef University, Algeria, 2014/2015, pp.16-17.

husband may insure his wife's life for the benefit of their children. In this scenario, the husband is the insured, while the children serve as beneficiaries.

1.1.2. Parties' obligations: The obligations of the parties to the insurance contract are represented in the amount of insurance or premium paid by the insured person. Concerning the obligations of the insurer, the amount of the insurance shall be determined in advance and confirmed in the insurance policy. In the insurance of the property, the value of the subject matter shall be equal to that of the matter insured, thereby constituting the maximum amount of the insured's obligations. About life insurance, the insured person is obliged to pay the full amount of the insurance without estimating the amount of compensation for the loss in the event of the occurrence of the incident insured against, since the loss cannot be estimated precisely.

For the insured person's obligations, they are the insurance premium or periodic installments that are paid in advance and are determined as a proportion of the amount of the insurance.

1.1.3. The insured incident: The insured incident is the occurrence of the insured risk that causes the insured to lose property or get hurt, which can cause him to lose his life.

1.1.4. Duration of the insurance: The beginning and end of the duration of insurance are usually determined by a specific hour and day, which helps to determine precisely the duration of the insured's responsibility. If the risk is found to occur outside that duration, the insured person's obligation is to pay any compensation for the loss that is outside the coverage. The duration of insurance in the case of property and responsibility is often one year, which may be extended in exceptional cases, such as insurance on cars in the case of sale by installment. Life insurance is always for a period of one year or longer, and not less than five years, sometimes extending to the life of the insured person.[2]

1.2. Importance of insurance companies

Insurance companies have been able to keep such great importance within the financial systems thanks to the economic roles they can play and contribute to the channeling of savings for financing purposes, allowing the implementation of investment projects and increasing the competitiveness of economies to improve the welfare of societies. Therefore, insurance companies can contribute to:

1.2.1. Reduce the financing costs of the project: Lowering financing costs is crucial for economic projects in sectors like agriculture, industry, and services. Insurance companies offer adequate guarantees to protect investors from risks, reducing fears and uncertainty. This encourages capital attraction and employment at lower costs, reducing the overall project cost.[3]

1.2.2. Balancing reserves and obligations: Insurance premiums are crucial for managing risks, as they are based on accurate information and statistics. Companies,

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[2] Alaa Farhan Talab & Hader Younes Al-Moussaoui & Mohamed Fayez Hassan, ***Management of Financial Institutions***, Dar Alayam, Jordan, 2015, p.135.

[3] Raid Abdulkhalek Abdullah al-Obaid & Khaled Ahmed Farhan al-Mashhadani, ***Management of Financial and Banking Institutions***, Dar Alayam, Jordan, 2013, p.105.

with their extensive experience and knowledge, ensure that these premiums are appropriate and affordable. Without insurance, project owners may underestimate risks, leading to unnecessary cash reserves and potential employment in other areas.[4]

1.2.3. Providing safety, economic stability, and increasing production: Insurance companies play a crucial role in providing economic stability and safety for businesses and workers. They offer stability, allowing for full-time production, increased productivity, and investment opportunities without wasting time in risk assessment. Insurance companies also provide advice and compensation for losses, allowing businesses to continue operating without disruption. They also prevent sudden losses, reducing the need for increased prices and affecting competitiveness. The stability of production also encourages consumers to avoid storing goods that may be damaged, reducing income loss rather than saving or investing.

1.2.4. Developing national savings and revitalizing investments: Life insurance is a unique savings device that attracts savers from all categories due to its unique advantages. It provides immediate access to large amounts payable in the event of death, enabling immediate investment in the early years. Insurance companies invest a significant portion of the combined premium returns in various investment aspects, including stocks and bonds, contributing to the revitalization of financial markets and the national economy.[5]

1.2.5. Curbing inflationary pressures: Insurance plays a crucial role in reducing inflationary pressures by allowing insurance companies to withdraw cash from trading, which would have increased demand for consumer goods and services. Insurance premiums are then used to finance productive investment projects, ensuring a balance of supply and demand.[6]

1.2.6. Developing the international trade: Insurance plays a crucial role in facilitating international trade by covering risks during goods transport, both within and between countries. It catalyzes commercial transactions, increasing their size and demand. Marine or aviation insurance policies for import and export ensure traders can meet obligations easily, even in the face of sudden events. Export insurance protects importers from default due to political turmoil, preventing non-performance of contracts. Insurance documents provide a guarantee to banks when opening documentary credits, thereby stimulating international trade and ensuring goods are available at appropriate prices in markets.[7]

1.2.7. Improving the balance of payments: Improving the balance of payments: Insurance is one of the items of balance of payment, where insurance services provided by residents to non-residents are recorded in export items, in addition to the services of managing the portfolio of assets of insurance companies and the

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[4] Tarfah Shariki & Rafid Mohammed, ***Role of Insurance Sector in the Economic Activity***, Tishreen University Journal- Economic and Legal Sciences Series, Vol 30, N°4, 2008, p.160.

[5] Frederic S. Mishkin, ***The Economics of Money, Banking, and Financial Markets***, Sixth edition, Addison Wesley Longman, USA, 2001, p.318.

[6] Raid Abdulkhalek Abdullah al-Obaid & Khaled Ahmed Farhan al-Mashhadani, op.cit., p.105.

[7] Yousef Masadawi, ***The Role of the Islamic Corporation for the Insurance of Investment and Export Credit (ICIEC) in Promoting Exports and Investments of Member Countries***, Damascus university journal for the economic and legal sciences, Vol 24, N° 01, 2011, p.25.

operations associated with investments made by reinsurance companies abroad, which affect money flows to and from abroad.[8]

1.2.8. Facilitation of the expansion of credit and increased confidence: Insurance documents are crucial for businesses to access credit facilities and increase confidence. They provide adequate coverage for risks to collateral, preventing insolvency risks in case of trouble or bankruptcy. Banks typically require insurance documents for project approval and individual lending, facilitating the expansion of credit and promoting business expansion.

1.2.9. Prevention and loss reduction: Insurance companies play a crucial role in promoting risk prevention methods in production projects. They focus on preventing theft and fire exposure, promoting the use of alarms, automatic fire extinguishers, and labor accident prevention tools. They also recommend accident-proof precautions to reduce car accidents and transport dangerous goods. Insurance companies may refrain from paying compensation if preventive action requirements are inconsistent. They reduce the value of insurance premiums for projects certified to comply with public safety rules and avoid raising the value of insurance premiums for projects failing to follow safety rules.[9]

1.2.10. Attracting investments: Insurance contributes to attracting domestic and foreign capital by opening the way to participate in the establishment of insurance companies or entering into the capital of existing companies.

1.2.11. Contributing to the development of economic sectors: Insurance companies significantly contribute to economic sector development by investing in shares and corporate bonds, introducing modern production methods, and imposing preventive measures. They reduce uncertainty and raise the burden on producers to allocate additional precautions to deal with risks, motivating the introduction of modern and large-scale technology in production projects.[10]

1.2.12. Job creation: The insurance sector significantly contributes to job creation by attracting diverse job applicants, reducing unemployment and poverty, and increasing production rates.[11]

1.2.13. Achieving social stability: Insurance makes an important contribution to achieving social stability by providing compensation for sickness, disability, unemployment, and commercial risks, thereby preventing the insured from falling into poverty and enabling them to resume their activities.

1.2.14. Developing a sense of responsibility and contributing to reducing accidents: Insurance companies play a crucial role in fostering a sense of responsibility and reducing accidents. Their requirements, such as refusing compensation if the insured's will is to achieve the risk insured against, refraining from compensation if the loss does not exceed a certain threshold, and ensuring a pension after death, further contribute to this responsibility.[12]

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[8] Falag Saliha, op.cit., p.25.

[9] Frederic S. Mishkin, op.cit., p.319.

[10] Tarfah Shariki & Rafid Mohammed, op.cit., p.162.

[11] Abdulwahab Yusuf Ahmed, ***Finance and Management of Financial Institutions***, First Edition, Dar Alhamed, Jordan, 2008, p.198.

[12] Falag Saliha, op.cit., pp.25-26.

2. Mutual and pension funds

2.1. Mutual funds

Mutual funds are financial institutions that collect funds from small investors in exchange for stocks, which are used to purchase securities from various financial markets. This allows small savers to invest in financial markets and take advantage of the opportunities and returns they offer. Mutual funds employ small collected funds to hold a large volume of securities, reducing brokerage commissions and creating a diversified investment portfolio. By issuing shares, investors in mutual funds receive shares representing their share in the portfolio, allowing them to participate in the potential for profit and loss. The purpose of establishing mutual funds is to link small savers to financial markets, preventing the flight of national savings abroad and stimulating financial markets.[13]

Sources of mutual funds: Stocks are the primary source of investment for mutual funds, as well as paid-up capital, allowing their shareholders to receive returns in three ways:

- Obtaining periodic returns from dividends and interest on bonds purchased by the funds.
- Capital gains from the sale of securities in which the funds are invested.
- An improvement in the market value of the portfolio leads to a rise in the funds' shares, enabling shareholders to take advantage of this and sell shares at an appropriate price.

2.1.1. The advantages offered by mutual funds, such as the right to transfer funds from one fund to another within the single fund group and tax credits, are what have made these funds an essential savings attraction tool, as in recent years they have occupied an important place within financial systems.[14]

2.1.2. Mutual fund assets: Mutual fund managers use their pool of equity sales to buy and sell securities from various financial markets, creating a diversified investment portfolio. They monitor the portfolio's evolution and modification, balancing return and risk. The constituent assets of the portfolio vary depending on the fund type, with two main distinguishable categories:

- **Short-term securities**: Mutual funds' portfolios include short-term securities such as foreign deposits, local current deposits, currencies, savings, and municipal bonds. Managers must manage risks such as credit, interest rate, exchange rate, and market to maintain asset integrity.

[13] Safwat Abdulsalam Awadallah, op.cit., p.41.

[14] Abdulrahman Mare, ***The Role of Investment Funds in Activating the Securities Market in Syria (Field Study)***, Damascus university journal for the economic and legal sciences, Vol 29, N° 01, 2013, p.290.

- **Long-term securities**: Long-term mutual fund portfolios primarily comprise company shares, followed by credit market instruments like commercial papers, municipal bonds, and government bonds.[15]

2.2. Pension funds

Pension funds, among other financial institutions, play a crucial role in financial intermediation by accumulating savings over time and converting them into long-term investments, particularly in financial markets and the real estate sector.[16]

2.2.1. Pension fund resources: The resources of pension funds are made up of workers' and employers' contributions. Most laws require them to pay periodic contributions according to the pay-as-you-go rule (the contribution deduction from the source) within a retirement program whose laws are designed by the government with the task of managing a government body or agency in order to protect the rights of contributors and the permanence of the program. The program ensures the determination of rights, responsibilities, relationships, and duties for both the fund's managing body, the contributors to the program (workers and employers), and the beneficiaries of the program.[17]

2.2.2. Pension fund investments: Pension systems are undergoing reforms to address successive losses in funds. These funds aim to invest contributions in investments with sufficient returns, ensuring financial balance and program sustainability. Governments are now allowing pension funds to enter new investment areas.[18]

Pension funds invest in long-term financial instruments like bonds, stocks, and mortgages to maintain liquidity and solvency. Management diversifies high-liquidity and low-risk assets. The investment strategy of pension funds underwent dramatic changes after World War I, with the majority of assets consisting of government bonds. The ratio of assets decreased from 77% in 1960 to 47% in 1974.[19]

Pension funds have increasingly invested in municipal bonds due to their tax advantage and increased share in their portfolio. However, their importance has not been equally significant. The boom in equity markets in the 1950s and higher returns led pension funds to enter the promising market, with their share reaching 39% for private and 34% for public funds. In the 1980s, pension funds diversified their investments in the real estate market, but their demand was not as high as that of insurance companies, acquiring only 4% of total assets in 1994.[20]

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[15] Anthony Saunders and Marcia Million Cornett, ***Financial Institutions Management: A Risk Management Approach***, Sixth Edition, McGraw-Hill/Irwin, 2008, p.134.
[16] Frederic S. Mishkin, op.cit., p.321.
[17] Max Horlick, ***The Relationship between Public and Private Pension Schemes: an Introductory Overview,*** Social security bulletin, Social Security Administration, USA, Vol 50, N°07, July 1987, p.20.
[18] Ayman El Mahgoub, ***New Strategies for Trusteed pension Funds (One Global Macro-Approach),*** Arab Economic journal, Egypt, N° 23, 2001, p. 50.
[19] Frederic S. Mishkin, op.cit., p.322.
[20] Ayman El Mahgoub, op.cit., p.51.

3. Finance companies

Finance companies are non-depository financial institutions that offer lending to small businesses and consumers who lack good credit or sufficient guarantees for bank loans. These institutions help new businesses overcome difficulties in obtaining funding from traditional channels and financial markets. They provide funding at specific interest rates and technical assistance to help them create businesses and make profits. Additionally, finance companies provide consumer loans to finance purchases of furniture, durable goods, and property acquisition and improvement.[21]

Finance companies, originating from automobile corporations in 1900, offer high-yield and high-risk loans to customers, ensuring privacy and reducing interest rates. As non-depositary enterprises, they are less vulnerable to central banks' requirements, allowing them to expand and grow. Their success contributed to the revitalization of the automotive industry, motivating other corporations like General Electric Corp. to finance purchases and eventually expanding to include stores.[22]

3.1.1. Sources of finance companies: Finance companies, unlike banks, do not accept deposits but instead receive funds from various sources, including banks, to manage their financial operations:

- **Commercial papers:** Commercial papers are an important source of financing for short-term finance companies, offering lower interest rates than banks. They are sold directly without intermediaries, avoiding commissions for mutual funds and investment companies. With maturity dates ranging from 30 days to 270 days, commercial papers are the most significant short-term trade issuers.
- **Other sources:** Finance companies may utilize external sources to ensure the smooth operation of their operations and meet the needs of their clients. These sources include:
  - ✓ short- and long-term bonds.
  - ✓ Loans from banks.
  - ✓ Loans and subsidies from the parent company if it exists.[23]

3.1.2. Assets of finance companies: Finance companies can hold various types of assets, such as:

- **Consumer loans:** Finance companies provide consumer loans for car purchases, household appliances, and furniture, putting them in intense competition with commercial banks in the consumer loan market.[24]
- **Mortgages:** Mortgages, including commercial mortgages, have become crucial for finance companies' portfolios, contributing to the recovery of the real estate market. Their contribution to the United States rose from 10.5% in 1977 to 30.3% in 2006, mainly due to high-risk lenders and reduced tax rates on mortgage-secured loans. This has led to the rise in mortgages, concessional loans, and property.

[21] Anthony Saunders and Marcia Million Cornett, op.cit., p.153.
[22] Alaa Farhan Talab & Hader Younes Al-Moussaoui & Mohamed Fayez Hassan, op.cit., p.120.
[23] Anthony Saunders and Marcia Million Cornett, op.cit., p.155.
[24] Alaa Farhan Talab & Hader Younes Al-Moussaoui & Mohamed Fayez Hassan, op.cit., p.120.

- **Loans to businesses:** Finance companies heavily invest in business loans, which constitute the majority of their business portfolio. These loans, including rental and lending, offer the advantage of easy recovery of leased equipment in case of bankruptcy or failure, unlike the more challenging and time-consuming lending options.
  - ✓ Purchase indebted accounts (debts).
  - ✓ Bank deposits.
  - ✓ investing in securities of different duration and liquidity.[25]

4. Hedge funds, credit unions, and Mutual savings banks

4.1. Hedge funds

Hedge funds are financial institutions that raise funds from wealthy individuals and banks to invest on their behalf. They intersect with mutual funds but differ in their long-term investment requirements. In the United States, investors must provide at least $100,000. Hedge funds typically have a limited number of wealthy investors, not exceeding 100, and earn fees of up to 2% of assets managed annually, with a potential 25% profit percentage.[26]

Mutual funds, not subject to monetary authorities' requirements, use a high-risk offensive strategy to generate significant returns through short-selling, electronic trading, arbitrage, derivatives trading, and securitized debts. Hedge funds use a neutral market strategy by acquiring various financial instruments, expecting price increases and exaggerated levels. However, these expectations may not always be accurate, exposing the fund's investments to financial losses.[27]

4.2. Credit unions

Credit unions are financial institutions organized as small cooperative enterprises established by a particular group of workers of a particular enterprise, such as the workers' union of that enterprise. These associations mobilize resources from their founders' contributions in the form of deposits (current and term) for use in providing consumer and real estate loans.

4.3. Mutual savings banks

These institutions interfere with savings banks in that both receive funds from individuals' savings deposits that are subsequently employed in mortgages and consumer loans, but mutual savings banks are characterized by the fact that they take the form of cooperatives owned by their depositors.[28]

Figure 2 illustrates the most important non-financial institutions.

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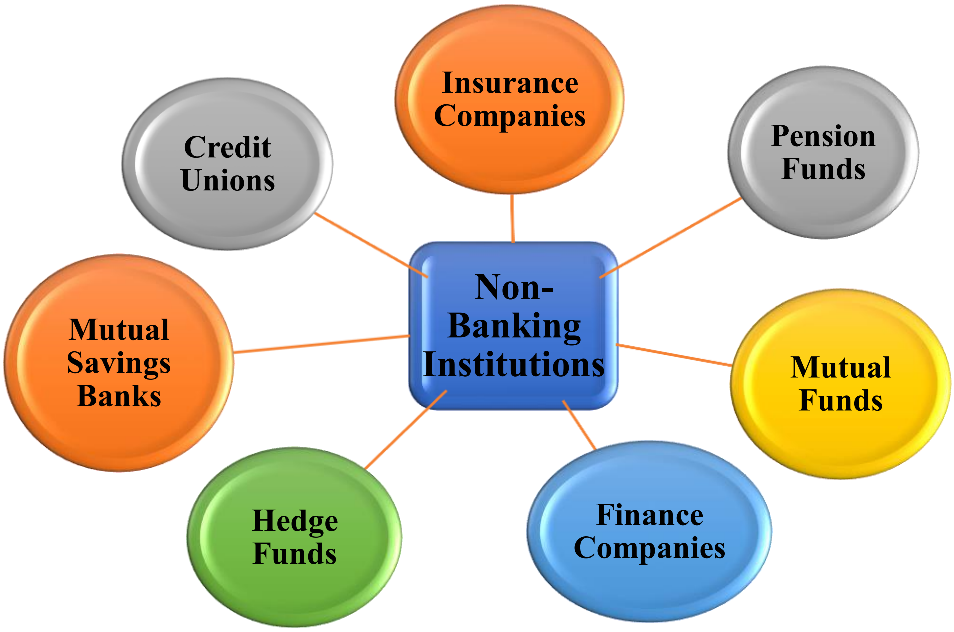
[25] Anthony Saunders and Marcia Million Cornett, op.cit., p.160.
[26] Frederic S. Mishkin, op.cit., p.329.
[27] Anthony Saunders and Marcia Million Cornett, op.cit., p.143.
[28] Mahmoud Younes & Kamel Amine El-Wassal, op.cit., p. 103.

Figure 2: Types of Non-Banking Financial Institution



Source: Author's Preparation