Gulf Research Center

Knowledge for All

Financial Aspects of GCC Unification Efforts

Eckart Woertz

August 2014

GRC GULF PAPERS

Financial Aspects of GCC Unification Efforts

Eckart Woertz

Introduction

GCC economic integration has a distinct financial aspect. Economic growth in the GCC countries has been high over the last decade. It has been comparable to growth in the emerging markets and considerably higher than in the world at large. Petrochemical plants, aluminum smelters, power plants, railway lines, housing programs, roads and airports – all these projects are in need of finance. So too the rapidly growing population in the GCC countries that has provided business for a substantial retail banking market. These financing needs have met a relatively underdeveloped financial sector with only nascent regulatory institutions. The GCC financial sector is characterized by a lack of bond and derivative markets, difficult access to credit for small and middle enterprises (SMEs), dominance of international banks in the project finance market, and heavily concentrated equity markets in terms of sectors and ownership.

Sovereign Wealth Funds (SWFs) in the GCC own large foreign assets which they regard as a tool to safeguard economic diversification in the long term. Funneling part of these offshore-based savings into domestic economies requires capacity building and absorption capacity in the real economy, but also diversified financial markets for the allocation of resources. They can also provide a base for the attraction of foreign capital, know-how, and business, while opening up new channels for local funds to invest abroad.

The GCC countries have tried to cater to these needs by building financial center projects. Five of them vie now for the attention of investors: The Dubai International Financial Center (DIFC), the Abu Dhabi Global Market, the Bahrain Financial Harbour (BFH), the Qatar Financial Center (QFC) and the King Abdullah Financial District. Some of them, like DIFC and BFH, have a more international profile, others like QFC focus more on the domestic market, but besides complementarities possible areas of competition have emerged, not only between the centers but also with their respective national capital markets that are under a different jurisdiction. The GCC countries are also trying to establish themselves as a global hub for the growing Islamic banking market amidst lingering questions about regulatory environment and international standards in the industry. In order to overcome such present shortcomings in the GCC financial sector and to fully capitalize on the benefits of greater integration, the GCC states need to increase liquidity and diversity of their capital markets, facilitate cross-border trading of securities, foster a nascent institutional investor class and, above all, strengthen and unify regulatory frameworks.

The Structure of GCC Financial Markets

Banks dominate the capital structure of the GCC financial sector with 60 percent. The huge credit growth in the region has been mainly directed towards a selected minority of large companies and consumer financing. Like elsewhere in the MENA, there is a certain disconnect between the financial sectors and the real private economy. Small and medium sized enterprises (SMEs) in family ownership are reluctant to enter the stock market, but they also have limited access to bank loans and rely heavily on retained earnings. In Saudi Arabia, for example, less than 40 percent of companies had an overdraft facility with a bank in the mid-2000s and only slightly more than 20 percent had a loan from a bank, according to the World Bank.

The absence of SMEs is even more striking on capital markets, where equities dominate while bond markets are under-represented as a means of finance. There is also a nearly complete lack of derivative markets and related hedging services. Derivatives are only traded on some commodities at the Dubai Multi Commodities Centre (DMCC), but not on stocks and bonds, and for currency hedging, investors need to rely mostly on foreign markets. Excessive dispersal of opaque derivative structures like collateralized debt obligations (CDO) contributed to the global financial crisis in 2008 and GCC countries were shielded to a certain extent because of their relative absence from such markets, but there is no doubt that well regulated derivatives are part and parcel of a functioning capital market. They help companies to manage price risks of foreign exchange and vital input commodities, contribute to more liquid capital markets, and temper speculative excesses via short selling.

An increase in the relative importance of bond markets in the overall capital structure of the GCC is warranted. Governments in Qatar and Abu Dhabi have indicated their intention to develop such markets by increasing the issuance of government bonds in order to provide a benchmark yield curve for the corporate bond sector. An improved bond market could lead to better capital access, efficiency gains, and improved price discovery and risk assessment.

The limited number of listings and lack of free float of existing listings are a problem in the young GCC stock markets. They are dominated by a few big companies, which have the state as a majority shareholder. Most of the larger private enterprises are family-owned and not even listed, apart from a few exceptions (e.g., Al Rajhi Bank or Al Abdullatif Industrial Investments). The same is true for the biggest state companies, namely in the oil sector.

The largest twenty or so companies in each of the GCC countries are not listed at all (e.g., Saudi Aramco and other national oil companies, Dubai Holding, Alba, DUBAL, national airlines, ADIA, KIA and other investment bodies). On the other hand, among the listed companies, the largest ten companies in each country make up between 50 percent and 80 percent of market capitalization. The GCC stock market bubble of 2005-06 would probably not have reached such huge proportions if too much money had not chased so few stocks.

Hence, it has been argued that increased privatization on the one hand and going public of family enterprises on the other could lead to broader markets, higher free floats and increased transparency, which would be beneficial for the further development of GCC stock markets. This could also help to facilitate internationalization and increased specialization of conglomerate-like family enterprises by increasing their access to new sources of capital and widening their available talent pool beyond immediate family members. Elsewhere in the world such transformations of family enterprises have already occurred (e.g., Wal Mart, Ford, BMW). In these companies family members do not have an exclusive grip on executive positions and do not rank as prominently on the boards anymore. Instead, they usually prefer a controlling role in the background.

Any such development would involve a significant change in the company culture and will likely only come gradually. The advantage of trust within established family relationships is valued higher than the advantages of increased corporatization and going public such as enhancement of the available talent pool and accountability and easier access to financing from the capital markets. Instead, financing via retained earnings, and sometimes banks, still remains the rule. GCC family enterprises are reluctant to give up unlimited control and succumb to the increased accountability standards that come with a public listing, like quarterly reports and the appointment of independent directors to the supervisory board.

The GCC countries have by far the largest financial markets in the MENA and GCC peculiarities are reflected in the wider region. Bond markets and, to a lesser extent, equity markets have relatively small shares in the overall finance structure and also compared to GDP. This hints at the growth potential of the financial sector as a whole and of bond markets in particular.

Table 1: Comparative structure of global capital markets

Stock Market Capitalization	US$ BN	% of GDP
Middle East and North Africa	895	29
Latin America and the Caribbean	2,476	44
Emerging Market sAsia	5,853	47
North America	18,883	105
European Union	10,086	65
World	**52,848**	73
Total Debt Securities		
Middle East and North Africa	221	7
Latin America and the Caribbean	3,590	64
Emerging Markets Asia	5,492	44
North America	37,292	206
European Union	29,297	189
World	**98,974**	137

The data includes total debt securities, all issuers, and amounts outstanding by residence of issuer.

Bank Assets		
Middle East and North Africa	1,921	62
Latin America and the Caribbean	3,948	70
Emerging Markets Asia	21,081	170
North America	18,679	103
European Union	47,856	308
World	**121,947**	169

Includes total assets of domestic commercial banks, including foreign banks' subsidiaries operated domestically.

Source: IMF Global Financial Stability Review, 2014

Internationally, GCC financial markets are not a force to reckon with yet. They, in particular Saudi Arabia, still put considerable barriers of entry for foreign institutional investors. Only recently Dubai and Qatar were upgraded from frontier market to emerging market status by international index provider MISC. Disparate initiatives on a local level without GCC-wide coordination are unlike to gather the critical mass necessary in international comparison. Increased GCC unification and harmonization of regulatory standards would greatly help necessary reforms like bond market growth and more liquid and broader based stock markets.

Structure of the GCC Banking Sector

The banking universe of the GCC countries is diverse. Domestic retail markets are mostly served by national banks that often have the state as a major shareholder and are still considerably shielded from regional and international competition (e.g., Emirates Bank/National Bank of Dubai, National Bank of Abu Dhabi, and National Commercial Bank). One challenge for these banks will be to define areas of specialization and venture into new fields like project finance and private banking as the environment they are operating in becomes more competitive.

International banks are more present in the corporate and project finance market, and only in some cases do they have a large branch network like HSBC or Citigroup in the UAE. Other banks focus more on local investment and corporate banking services as well as private banking for high net worth individuals, while still others restrict themselves to representative offices, trade finance, and occasional participation in syndicated loans.

There is an apparent lack of an institutional investor base in the country as the market for mutual funds and life insurance products is underdeveloped. There are some locally based private equity funds (e.g., Al Abraj, Injazat, Investcorp), and some banks have been offering mutual fund products that invest in the local market (e.g., Mashreqbank, NCB), but overall the market is in a very nascent stage and could profit from an increased offering of pension schemes.

Government pension funds, as far they exist (e.g., in Saudi Arabia), are usually not very active long-term investors but can occasionally play an important role as provider of liquidity for markets if ordered by the government. There are sales teams of foreign funds (mutual, closed end, private equity, and hedge funds), but these funds mostly invest in international markets, not in those of the region. Finally, the large

SWFs of the Gulf like the investment authorities of Abu Dhabi, Qatar, and Kuwait (ADIA, QIA, and KIA) also manage mostly offshore assets and do not directly affect the local capital markets and their development.

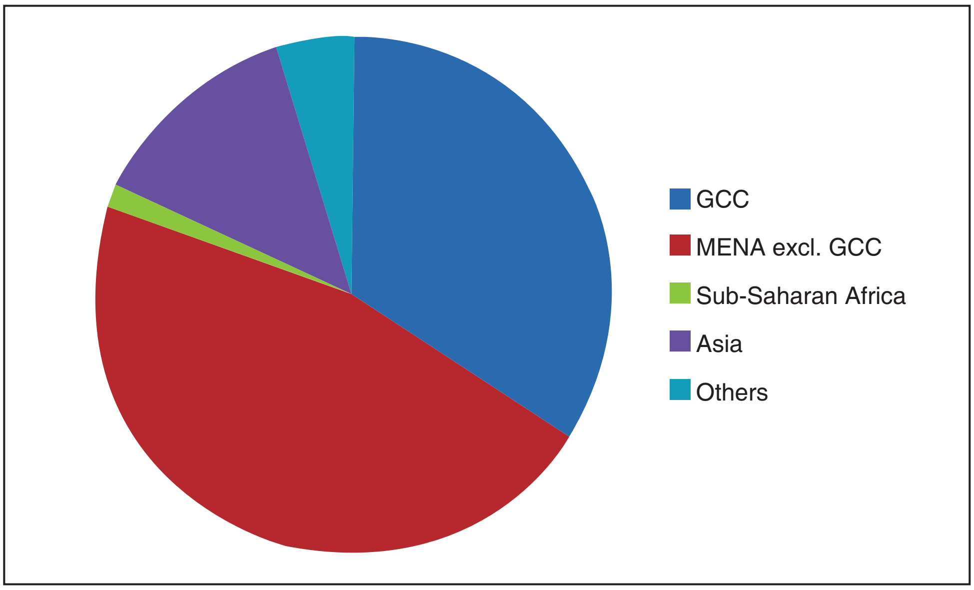
Islamic Banking as a Growth Sector

An important growth segment in the GCC is Islamic banking, which has been growing 15 percent on average in recent years. These growth rates are considerably higher than those for the conventional banking market, although it has to be taken into consideration that it is a young market that has started from a low statistical base. Revenue growth rates will trend lower going ahead, and improved profitability will have increased importance for the growth story of Islamic banks.

Globally, Islamic banking assets are well below 2 percent of the total at the top 1,000 banks, but in the Gulf their relative importance is much higher. Islamic banking musters about a quarter of total GCC bank assets, a steep increase from 10 percent in 2003, according to S&P.

Although some Gulf Islamic banks like Al Rajhi, Kuwait Finance House, or Dubai Islamic Bank have begun to expand internationally to countries such as Malaysia and Pakistan, the Islamic banking market is still segmented along regional and national lines. Gulf countries hold about a third of global Islamic banking assets. Along with other countries in the Middle East and North Africa (MENA), most notably Iran, they are a dominating force in the global Islamic banking market and would be well placed to expand globally into untapped markets in Asia andEurope. Muslims represent about 20 percent of the world population, but only 4 percent of world GDP. Muslims of the MENA region command approximately the same purchasing power as the smaller number of Muslims in Europe and the larger number of Muslims in South Asia.

Figure 1: Islamic banking - Regional market shares, 2012 (in %)



Source: KFH

Islamic banks in the Gulf can be divided into independent Islamic banks (e.g., Dubai Islamic, Al Rajhi) and Islamic banking subsidiaries of conventional banking parent companies (e.g., Emirates Islamic, HSBC Amanah). Domestic Islamic banks from the region have not yet tried to establish a global brand like HSBC Amanah.

The most important segments of the Islamic banking market have been consumer financing, car and mortgage financing, and Islamic credit cards. In the fields of debt securities, Islamic bonds (sukuks) have enjoyed increasing popularity, trumping conventional bond issuance in the GCC.

It is conceivable that Islamic banking will become a more unified market on a global scale. This would require a harmonization of standards to increase tradability of Islamic banking assets between the Gulf countries and Malaysia, which dominates the Asian Islamic banking markets. Considerable disagreements exist on what qualifies as Sharia-compliant and what does not.

The Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) in Bahrain, for example, damaged market sentiment for sukuks in 2008 when it argued that they were not Sharia-compliant as they did not constitute real risk sharing on the part of the investor but rather were some form of disguised fixed income. During the financial crisis of 2008/09, when large issuers like Nakheel faced difficulties, it was unclear whether sukuk holders would have recourse to the underlying basket of physical securities. Disagreement related to the question of whether sukuks are "asset-backed" or only "asset-based" (i.e., that they have been only identified in the sales contract to serve cash flow payments in order to satisfy the legal requirements of Sharia law, but are not subject to some form of privileged recourse by creditors in case of a credit event).

Issuance of sukuks declined more than conventional issuance and came to a virtual standstill in early 2009, as there were increasing doubts about their legal structure. Even though issuance recovered afterwards, regulatory clarifications and legal certainty are needed. There has been a shift of the sukuk investor base from international investors to more domestic players. Because of a lacking institutional investor base, many sukuk issues of the Gulf have paradoxically been bought by investors in OECD countries and have not remained in the region.

Given the strong market share of the Gulf, its banks would be well positioned to capitalize on its competitive advantage and use it for expansion not only in the region but also abroad. As rival financial centers like London are also eyeing the Islamic banking market as an important growth segment, the region needs to match up to this competition.

Regulatory Issues

Rising oil prices and massively increased bank lending led to abundant liquidity in the GCC countries and an unprecedented stock market rally in 2004 and 2005. However, the resulting overvaluations could not be maintained and the stock markets collapsed at the beginning of 2006. Small investors were hurt especially as they had often speculated on margin at the height of the market. Though lack of corporate governance did not directly cause the GCC stock market corrections in 2006, better regulations and more transparency are badly needed. Clear and reliable reporting and investor relations, enforcement of margin requirements, and prevention of insider trading are cases in point.

The improvement of corporate governance in the Arab financial markets is the mission of Hawkamah, a non-profit institute located in the Dubai International Financial Center (DIFC). It has initiated a host of activities since 2006 and increased awareness of the problem considerably. It also published the first Corporate Governance Survey of the GCC in cooperation with the Institute of International Finance (IIF). The IIF, an association of worldwide banks, focuses on five broad areas in its reports: a) Minority shareholder rights, b) Structure and responsibilities of the Board of Directors, c) Accounting and auditing, d) Transparency of ownership and control, and e) Regulatory environment.

The GCC region still shows ample potential for improvement in these areas. Even the better positioned countries like Kuwait and Oman show a compliance rate of only 70 percent with IIF standards, while the UAE and Qatar at the lower end only attain 40 and 35 percent, respectively. The dominance of state ownership in most of the big companies is usually not helpful for the rights of minority shareholders. There is a lack of independent directors on the board– in the case of government companies, it is mainly government representatives, and in family enterprises, it is the family and close friends. In both cases, there is insufficient disclosure of potentially conflicting interests. Insider trading and decision making detrimental to minority shareholders are a frequent occurrence.

As books are often kept for the taxman who is enforcing accounting principles, and as the GCC states rarely tax enterprises, the standards of accounting and auditing are equally underdeveloped in the GCC countries with their young stock markets. Finally, with the exception of Oman, regulatory authorities in the GCC often lack sufficient power to ensure actual enforcement of rules and regulations. Many of the GCC regulatory authorities also still lack full independence from third parties like the state or the respective stock markets.

However, notable progress has been made. Many GCC countries have drafted corporate governance codes or have included such requirements in capital market and commercial company legislations. Enforcement of rules and ad-hoc regulations has also seen some improvement. In the UAE, for example, regulators suspended IPOs of companies that had just been founded and did not have a history of at least two years of successful operations. Thus, a potential flooding of the market with shell companies, as witnessed in the Kuwaiti Souk Al Manakh crash in 1982, was avoided.

The Way Forward: Links between Growth, Regulation and Unification

The Gulf region has the potential to develop into an important niche player in the international financial system. Awash in petrodollars, its SWFs look for foreign investment opportunities, while domestic companies are modernizing themselves and increasingly engaging in mergers and acquisitions. Multi-billion projects in the Gulf are in need of project finance, while the banking retail market in many fields, such as mortgage financing or insurance, is still undeveloped. In commodity trading, the region has obvious advantages in energy-related items and precious metals, and some of the Dubai-related initiatives have good chances to grab more international market shares going forward – the trading in Omani sour crude and gold would come to mind. The region is also in an advantageous position to profit from an expansion of Islamic banking, although the Dubai debt crisis and contradictory statements of Sharia scholars about the legal viability of sukuk contracts have marred sentiment.

Given the burgeoning economic development in the region and its increased need for focused financial services, the following fields may witness the most development:

- Growing investment banking and corporate banking services for domestic companies and venturing of national banks into the project finance market, which is thus far dominated by international banks
- Increased M & A of GCC companies and increased FDI of foreign companies in the GCC
- Development of capital markets, notably bond and derivative markets; this includes a nascent fund industry ranging from mutual funds to pension schemes and private equity funds. Tackling of associated regulatory issues
- Increased role of insurance companies. So far there is a predominance of non-life insurance, a reliance on international reinsurance companies, and low ratios of insurance to GDP. Growth for Shariah-compliant takaful insurance could be particularly brisk
- Private banking services for a growing number of high net worth individuals, who have become more sophisticated investors, could increase
- Advanced asset management solutions for SWFs, which manage the increasing oil wealth. Trend towards strategic equity stakes that can help diversification of the local economy instead of mere portfolio investments
- White labeling of products (e.g., funds, structured products) and know-how acquisition by national banks
- Back office and custodian solutions for GCC capital markets, which have growing intersections with international markets. While a tendency towards unification has not been seen yet, it would be highly desirable and could lead to cross-country trading platforms
- Growing role of Islamic banking, although growth rates are likely to level out as we approach a higher statistical base. There is potential for local banks acquiring international status via this niche market (e.g., cooperation with Asia including Malaysia). Specific requirements in regulation (Basel II), customer care and risk management solutions, as well as controversial discussions about Shariah compliance of various products have to be taken into consideration.

- Growing credit for SMEs and microcredit. The disconnect between SMEs and the banking system in the GCC has to be tackled; there have also been some initiatives for microcredit in the GCC (Al Jameel Group, PlaNet Finance, IFC).
- More access to capital markets could certainly facilitate the expansion and modernization drive of many companies in light of increased liberalization and competition in the wake of the WTO process. But before thinking about family enterprises going public or issuing bonds, the natural first step would be to improve cooperation with the financial sector on the very basic level of loan facilities.

All these steps will require a concerted effort at the GCC level to pool strategies, harmonize regulations and coordinate central banking policies. Even if fully developed isolated GCC markets would not be big enough to seriously compete on an international level. Hence joint political initiatives and cross border commercial cooperation will be of the essence.

About the Author

Eckart Woertz is a senior research fellow at the Barcelona Centre for International Affairs (CIDOB). Formerly he was a visiting fellow at Princeton University, director of economic studies at the Gulf Research Center (GRC), and worked for banks in Germany and the United Arab Emirates. He teaches at the Barcelona Institute of International Studies (IBEI) and was KSP visiting professor at the Paris School of International Affairs (PSIA) at SciencesPo. He is author of Oil for Food. The Global Food Crisis and the Middle East (Oxford University Press, 2013) and can be followed on Twitter @eckartwoertz and at www.oiforfood.info.

Gulf Research Center
Knowledge for All

www.grc.net