Financial Crisis and Regulatory Reform: Implications for the MENA Emerging Markets

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AGENDA

GLOBAL FINANCIAL CRISIS AND ECONOMIC OUTLOOK: ***Heading to Depression***

FINANCIAL CRISES AND THEIR AFTERMATH: ***Turmoil & potential meltdown***

MENA/GCC & EMERGING MARKETS: ***Relatively Resilient***

CORPORATE GOVERNANCE, STRUCTURAL & REGULATORY REFORMS: ***Beware the political backlash***

Analysis of Global Situation

- Despite a historic coordinated intervention of all major central banks and a series of unprecedented, wide ranging and extensive government intervention, the financial sector remains fragile and a return to normality is slow. Damage assessment is still underway and new heavy losses are revealed every quarter.
- Authorities, financial intermediaries and corporations are bracing for at least three quarters of deep recession and widespread weakness until end 2009 as the credit crunch spreads to the real economy. Almost every month forecasts have been corrected sharply downwards. World growth in 2009 is forecast to be barely above zero.
- Lower consumption, cuts in investment projects and corporate downsizing in the wake of sharply reduced credit availability will in all likelihood prevail until the deleveraging comes to an end and trust in financial markets is restored.
- At present nobody can be sure for how long markets will remain dysfunctional, what results the stimulus packages will produce, over what time frame, and what future imbalances might cause.
- There is now a probability of 20% that the US current recession will develop into a depression with a 10% macroeconomic decline of output and consumption. (Barro & Ursua, NBER, Feb. 2009)

Recent IMF Forecasts (WEO 2009)

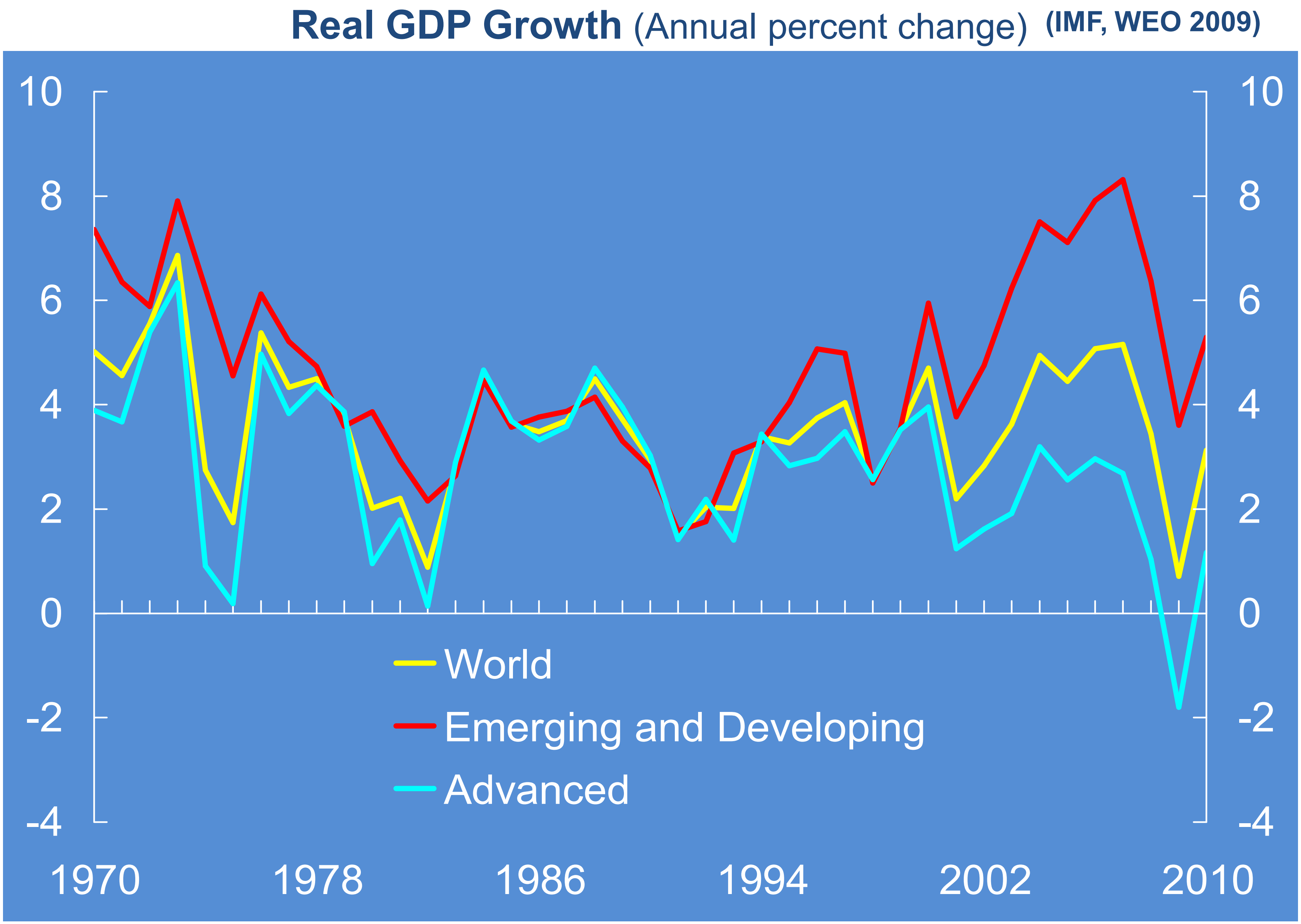
- The **world economy** is coping with the most severe shock to mature financial markets since the 1930s.
- On an annual basis, **global growth** is expected to moderate from 5.0% in 2007 to 3.4% in 2008 and 0.5% in 2009.
- **Advanced economies** will suffer a deep recession, -2.0% in 2009 (a downward revision of 1.7% compared to a month ago).
- **Emerging economies** have thus far been able to hold on, but global trade, on which most of them rely, has suffered one of the most severe quarterly blows in history. Their real GDP growth is expected to slow from around 8% in 2007 to 3.0% in 2009 (revised down from 6.1% in the October WEO) on the optimistic assumption that export push will be replaced by domestic demand.
- These figures essentially indicate that the world is facing a **simultaneous recession never experienced in peace time**

A Severe Global Recession…

Overview of IMF World Economic Outlook Projections (YoY)

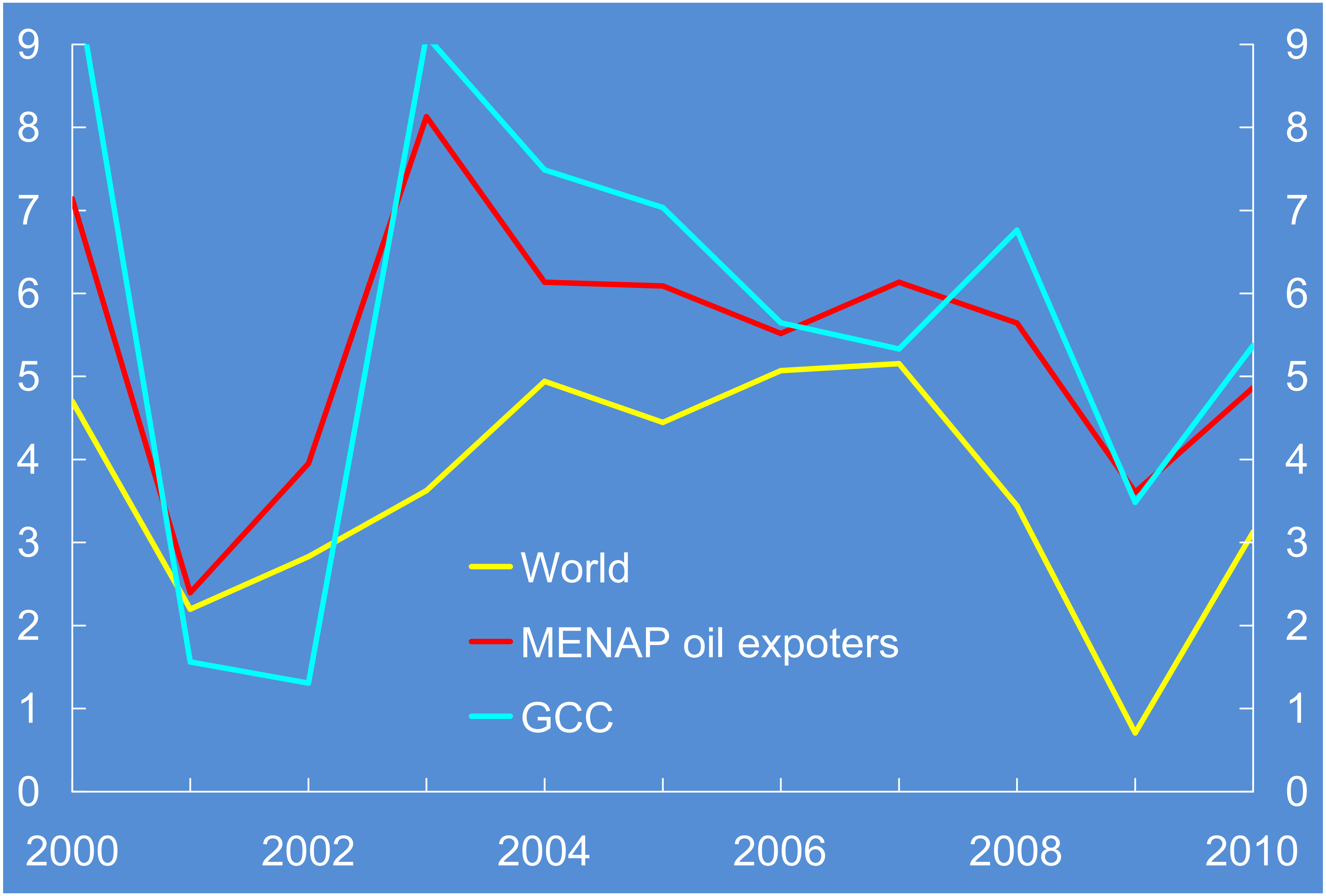
			Projections		Difference from Nov. 2008 WEO Projections	
	2007	2008	2009	2010	2009	2010
World output	5.2	3.4	0.5	3.0	-1.7	-0.8
Advanced Economies	2.7	1.0	-2.0	1.1	-1.7	-0.5
United States	2.0	1.1	-1.6	1.6	-0.9	0.1
Euro Area	2.6	1.0	-2.0	0.2	-1.5	-0.7
Emerging and Developing economies	8.3	6.3	3.3	5.0	-1.8	-1.2

Global economy heading for major recession

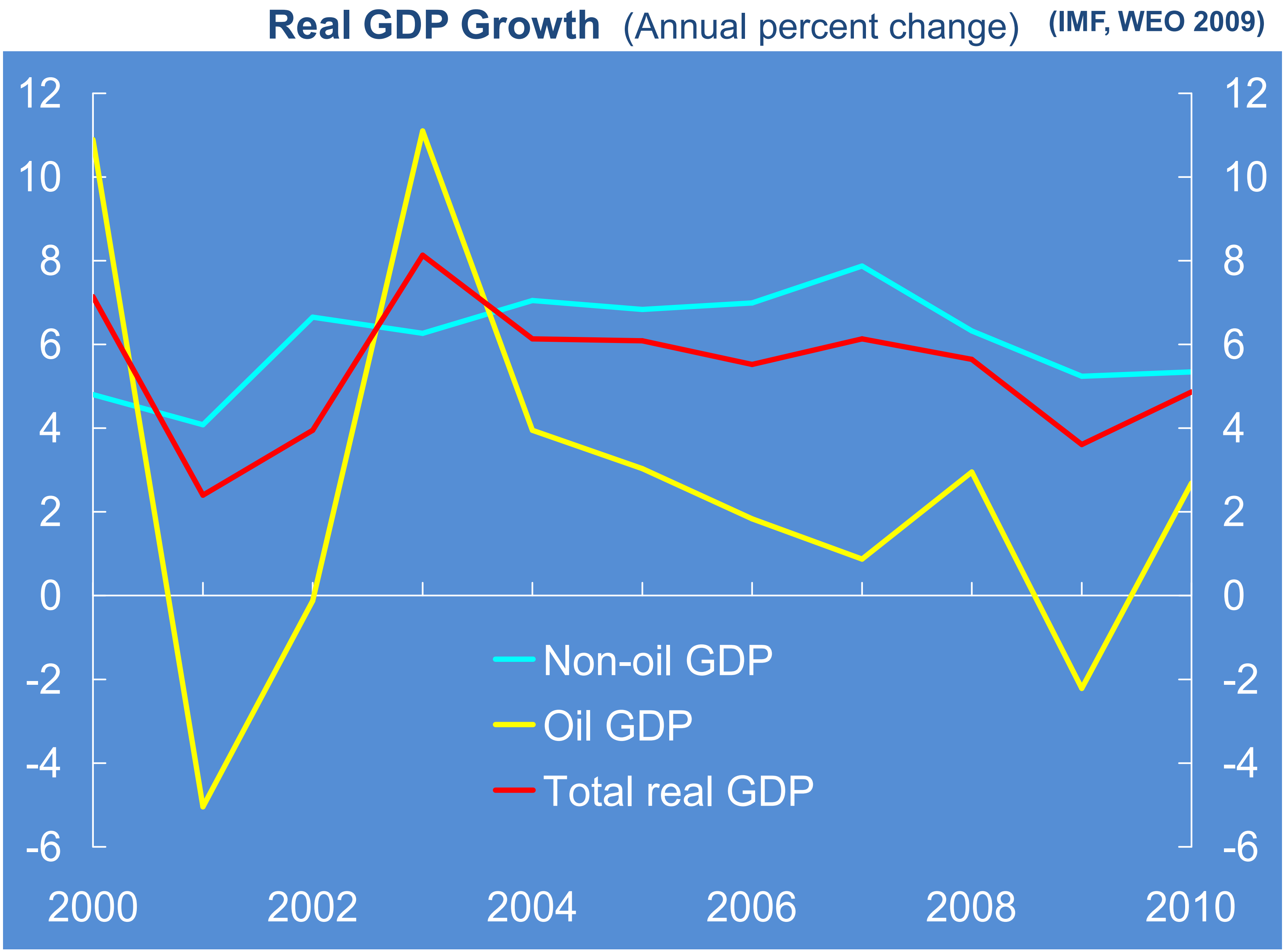


Growth in oil producers is expected to slow...

Real GDP Growth, Oil-Exporting Countries (Annual percent change)

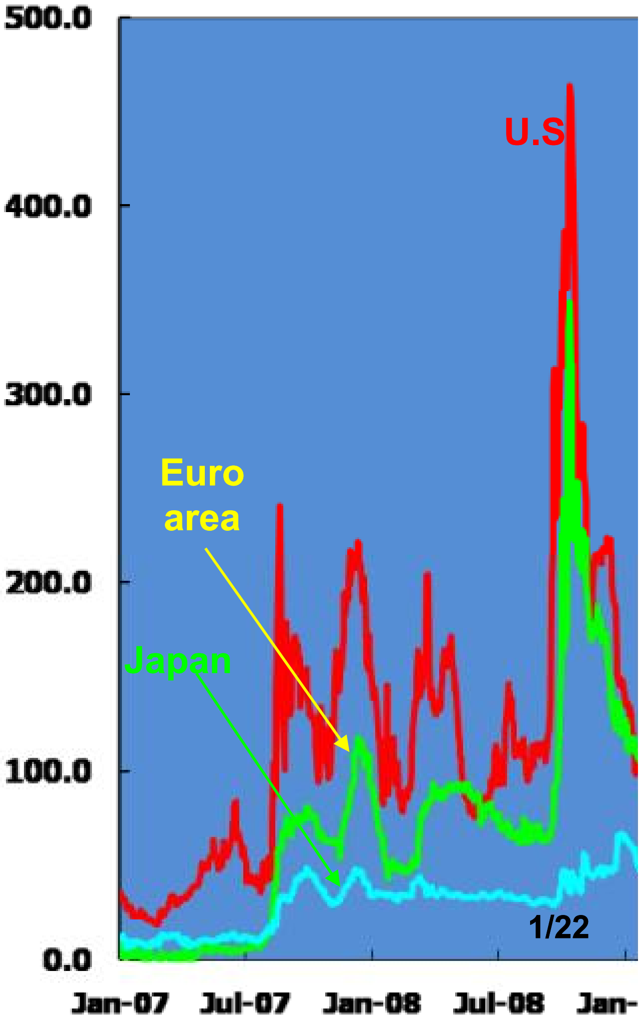


Economic Diversification will help oil producers

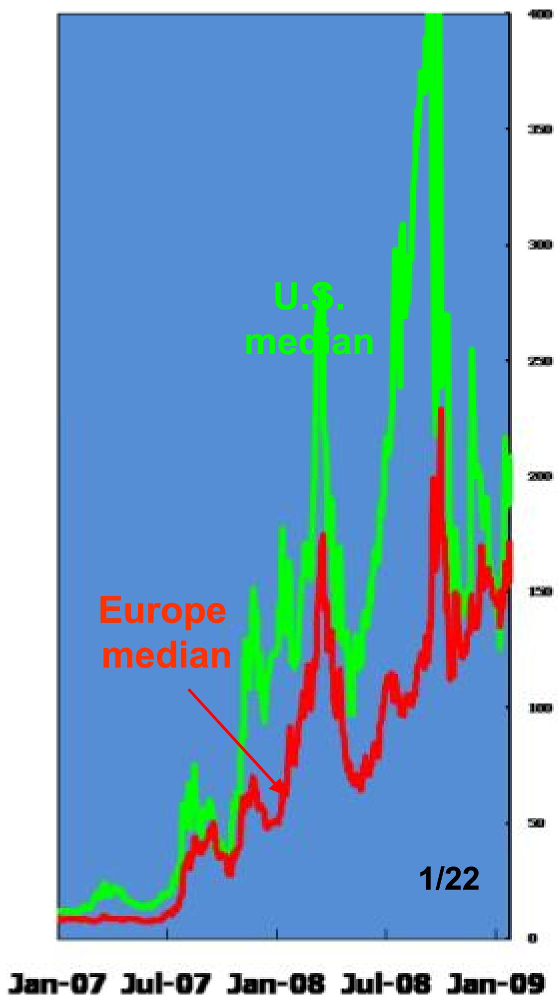


Global financial system slowly coming back from the brink (IMF, WEO 2009)

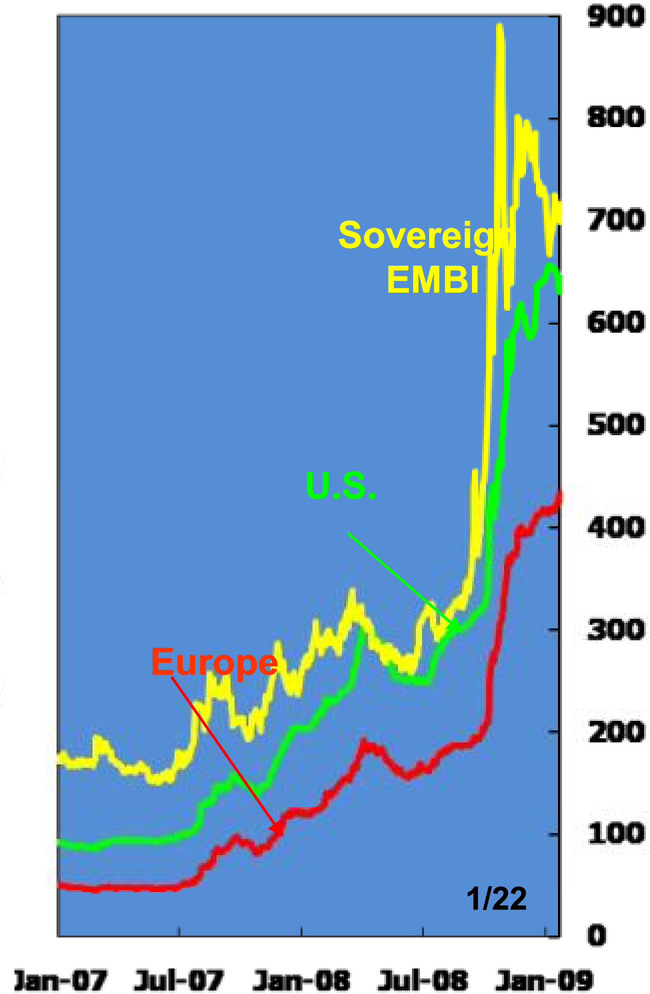
Interbank Markets
(3-month LIBOR minus T-bill rate; in percent)



Bank CDS Spreads
(5-years; basis points)



High-Grade Spreads
(basis points)



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27 Things you may not have known about banking crises

Systemic Banking Crises: A New Database, IMF Working Paper, Nov 2008

1. In 55 per cent of cases, the banking crisis coincides with a currency crisis.

2. Bank runs feature in 62 per cent of the crises.

3. Banking crises are often preceded by credit booms, in 30 per cent of the cases.

4. Non-performing loans average about 25 per cent of loans at the onset of the crisis.

5. Macroeconomic conditions are often weak prior to a banking crisis.

6. Extensive liquidity support is used in 71 per cent of crises.

7. Peak liquidity support tends to be sizeable and averages about 28 per cent of total deposits.

8. Blanket guarantees are used in 29 per cent of crises, often introduced to restore confidence even when previous explicit deposit insurance arrangements are already in place, lasting for an average of 53 months.

9. Prolonged regulatory forbearance - where banks, for example, are allowed to overstate their equity capital in order to avoid the costs of contractions in loan supply - occurs in 67 per cent of crises.

10. In 35 per cent of cases, forbearance takes the form of banks not being intervened despite being technically insolvent, and in 73 per cent of cases prudential regulations are suspended or not fully applied. Existing literature on forbearance shows it is counterproductive, with banks taking on additional risks at the future expense of the gove11. In 86 per cent of cases, government intervention takes place in the form of bank closures, nationalizations, or assisted mergers.

12. 51 per cent of crisis episodes have experienced sales of banks to foreigners.

13. The more bank closures there are, the higher the fiscal costs.

14. A blanket guarantee, however, reduces the instances of bank closures.

15. Bank restructuring agencies are set up in 48 per cent of crises.

16. Asset management companies are set up in 60 per cent of cases to manage distressed assets.

17. In 76 per cent of episodes, banks were recapitalised by the government, mostly with cash, government bonds or subordinated debt.

18. Recapitalisation programs are usually accompanied with some conditionality.

19. To the extent that debt relief schemes are discretionary, they run the risk of moral hazard as debtors stop trying to repay in the hope of being added to the list of scheme beneficiaries.

20. Average net recapitalisation costs to the government amounts to 6 per cent of GDP.

21.On the bright side, recapitalisations tend to be associated with lower output losses.

22. Monetary policy tends to be neutral during crisis episodes, while fiscal policy tends to be expansive.

23. Average fiscal costs, net of recoveries, associated with crisis management average 13.3 per cent of GDP.

24. The average recovery rate is just 18 per cent of gross fiscal costs.

25. Real GDP losses average 20 per cent relative to trend during the first four years of the crisis.

26. There is a negative correlation between output losses and fiscal costs: the higher the fiscal costs, the smaller the loss of output

27. Inflation and currency devaluation help reduce the budgetary burden and thus have been a feature of the resolution of many crises in the past.

Stylised Facts on the Aftermath of Severe Financial Crises

C. Reinhart & K. Rogoff (2008)

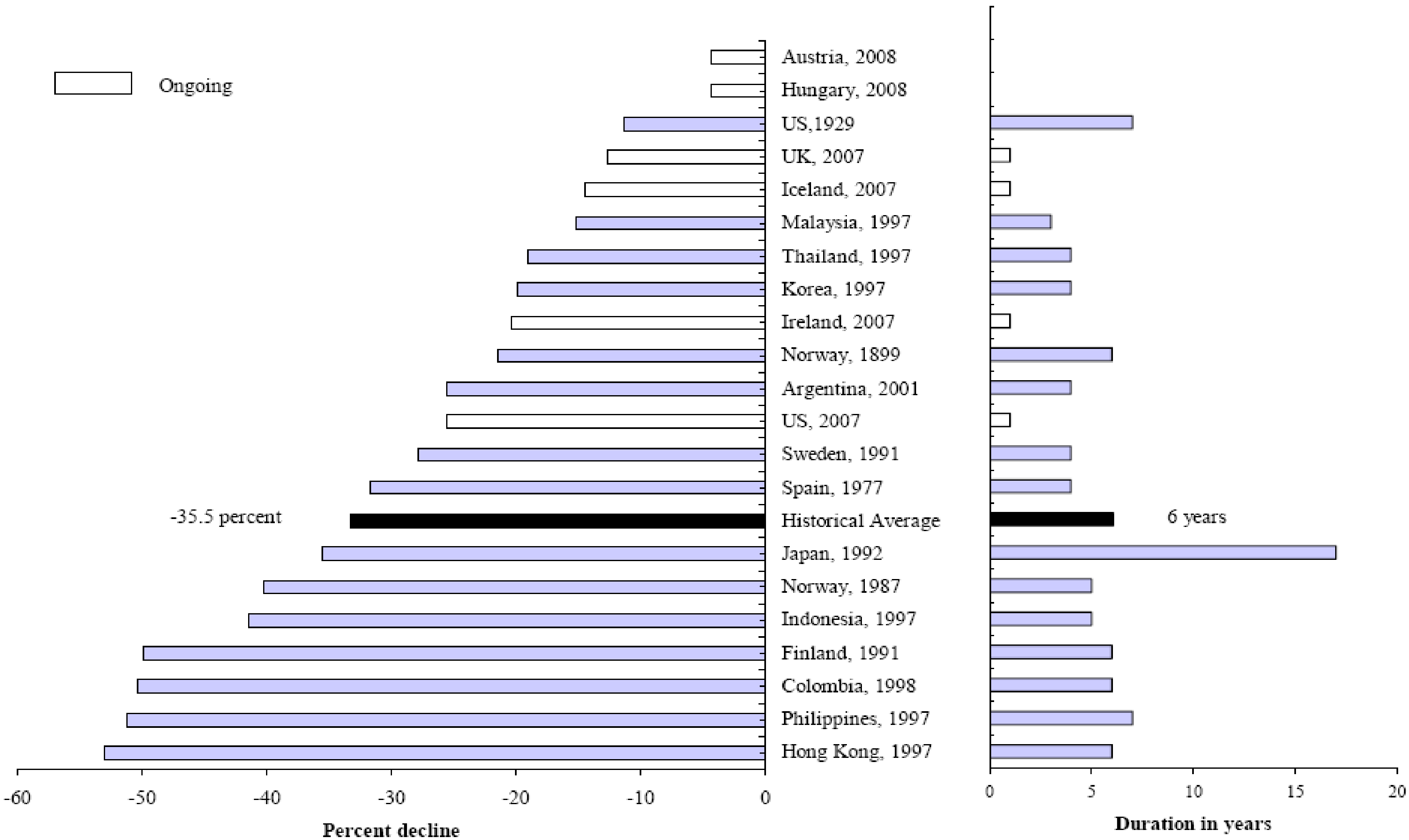
1. ***Asset market collapses are deep and prolonged***. Real housing price declines average 35 percent stretched out over six years. Equity price collapses average 55 percent over a downturn of about three and a half years.

2. ***Aftermath of banking crises is associated with profound declines in output and employment.*** Unemployment rate rises an average of 7 percentage points over the down phase of the cycle, which lasts on average over four years. Output falls (from peak to trough) an average of over 9 percent, although the duration of the downturn, averaging roughly two years, is shorter than for unemployment.

3. ***Real value of government debt tends to explode, rising an average of 86 percent in the major post–World War II episodes***. Main cause of debt explosions is not the costs of bailing; the big drivers of debt increases are the collapse in tax revenues as a result of recession.

Past and Ongoing Real House Price Cycles and Banking Crises:

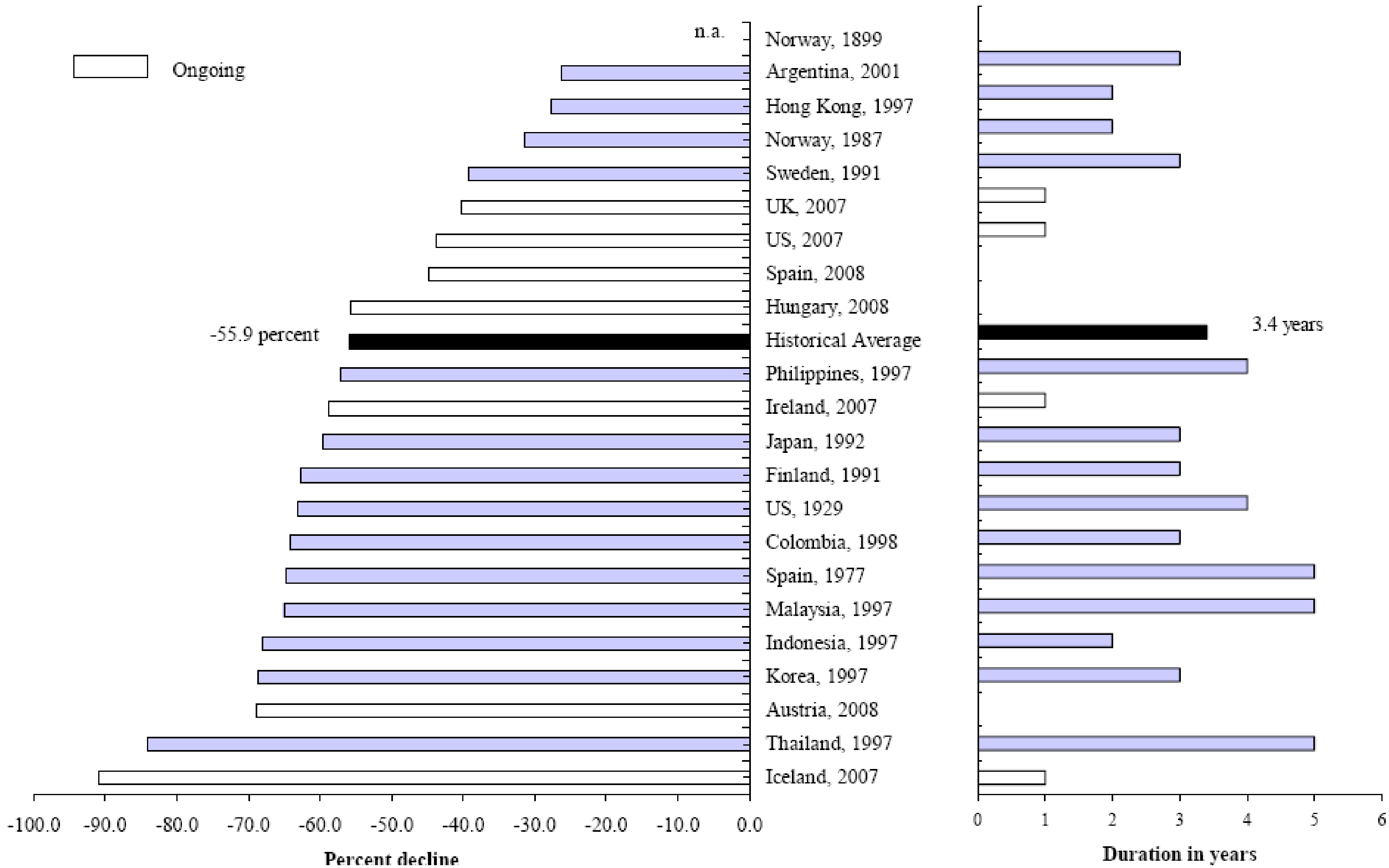
Peak-to-trough Price Declines (left panel) and Years Duration of Downturn (right panel)



Sources: Reinhart and Rogoff (2008b) and sources cited therein.

Past and Ongoing Real Equity Price Cycles and Banking Crises:

Peak-to-trough Price Declines (left panel) and Years Duration of Downturn (right panel)



Sources: Reinhart and Rogoff (2008b) and sources cited therein

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Resilience in Emerging Markets

- A slowdown in external demand will not be enough to force a hard landing in EM growth, but could force a sudden adjustment in the export sector with factory closures and widespread layoffs.
- While hot money inflows have turned to outflows in many EMs, a hard-landing is unlikely unless FDI drops drastically.
- In several EMs, financial markets are clogged, and this will cause growth to fall sharply in the near term. However, if policy actions in the US and Europe help to unfreeze markets, there is a good chance that most EMs will escape a severe contraction.
- The key factor to watch will be large infrastructure projects and the effects of stimulus measures aimed at boosting domestic consumption in the EMs.

MENA - Limited Repercussions

- **MENA, especially the Gulf region, has not been as severely hit by toxic assets and financial turmoil thanks to**
  - Strong growth and profitable domestic markets
  - Small stock of outstanding securitised/structured products
  - Limited expertise in managing structured investment products
  - Regulatory/prudential requirements limited exposure to sub-investment grade investments & instruments
  - Growing importance of Shari'a compliant finance
  - Ample liquidity from the increasing net capital flows (due to high returns) and from oil exports
  - Fiscal discipline and sizeable stock of foreign assets
- **However the drop in oil price will cloud the outlook and put strains on public finances and current accounts**

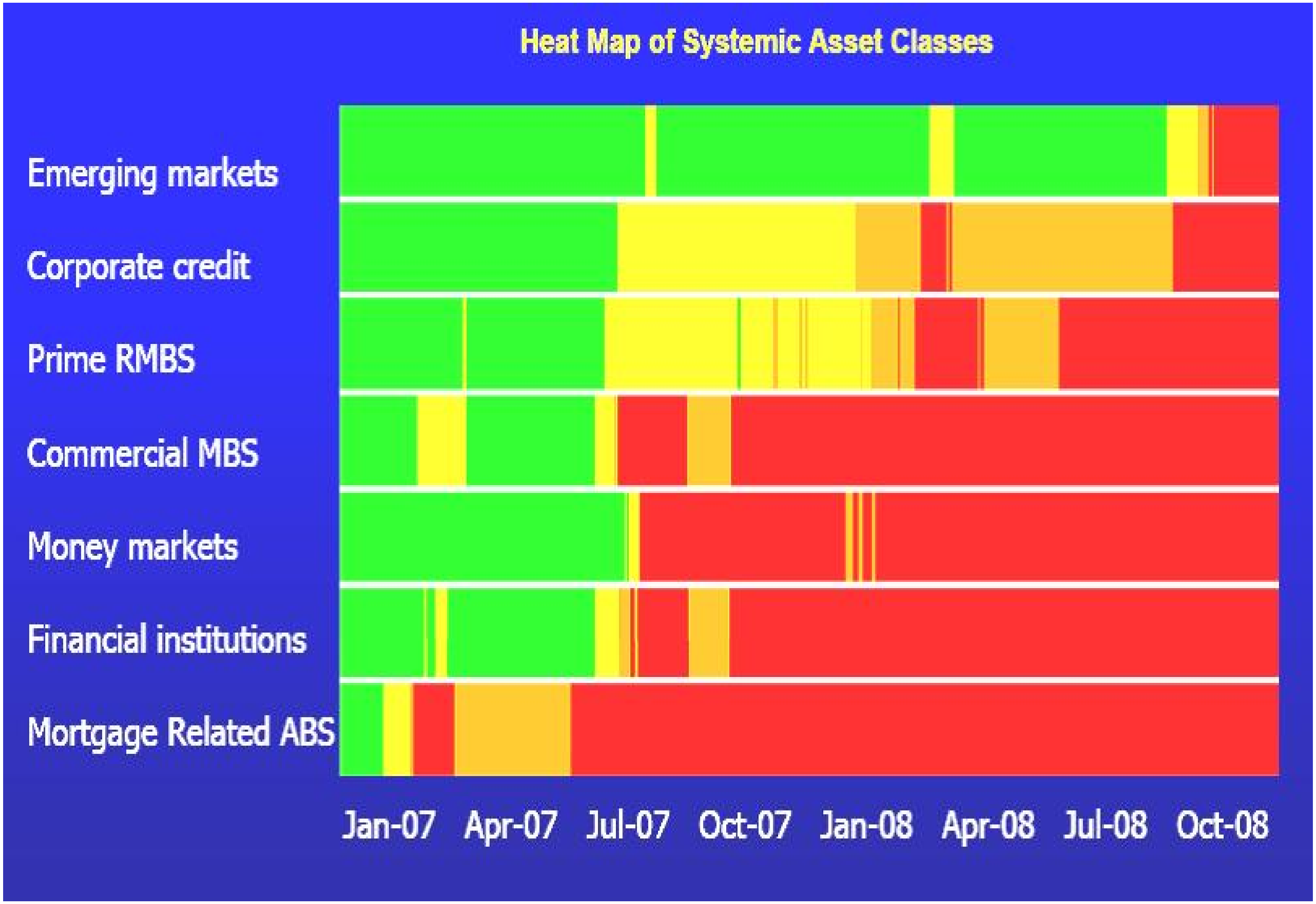
MENA Vulnerability through Real Sector channel

In addition to oil prices, the following real sector economic transactions may increase MENA vulnerability to the crisis:

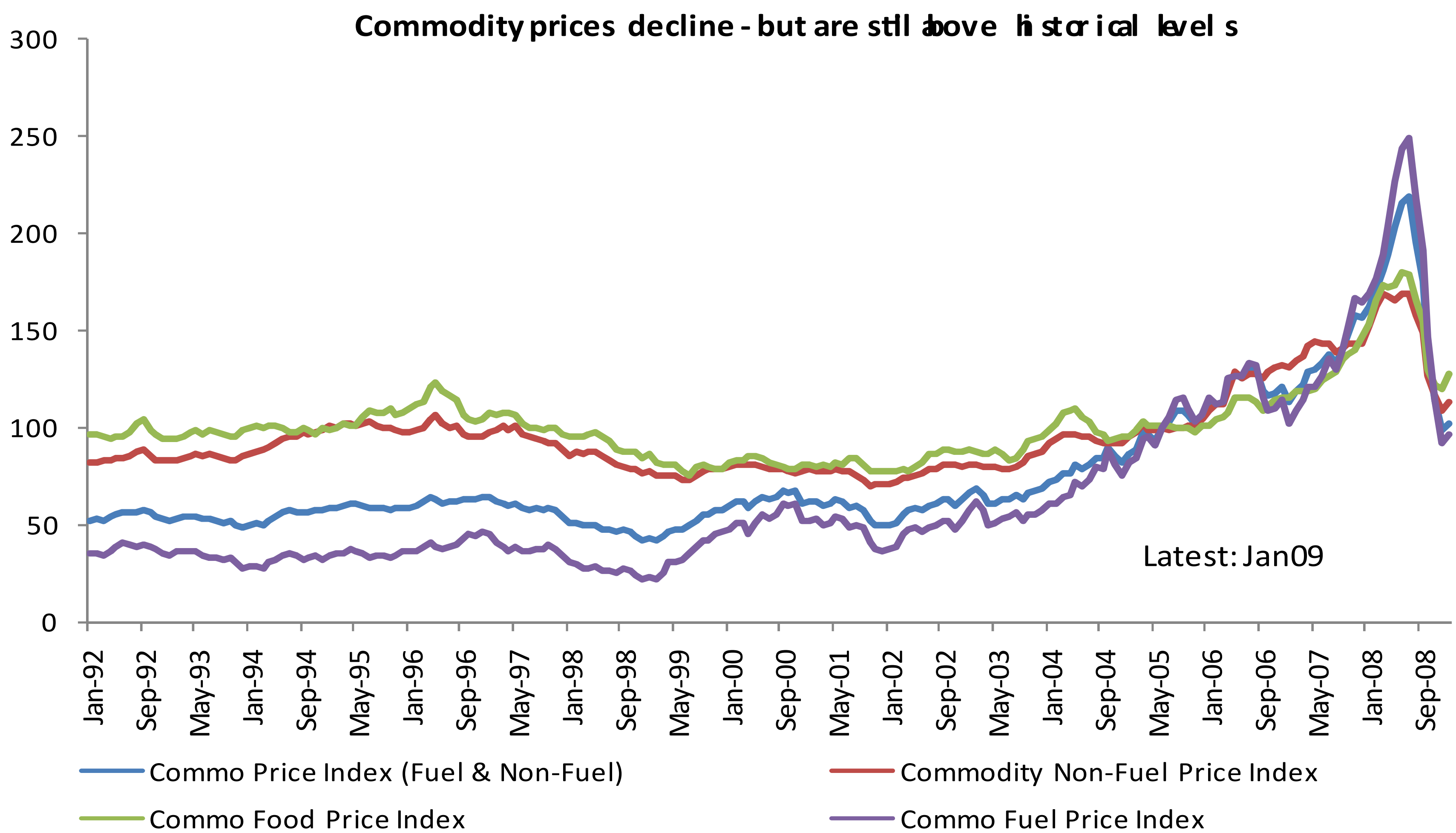
- Decline in International Trade
- Decline in Tourism
- Decline in Foreign Direct Investment
  - Countries with ties to Europe are most vulnerable including Tunisia, Morocco and Egypt
- Decline in Remittances affecting labour exporting countries

But spread of the crisis to emerging markets will continue

(IMF, WEO 2009)

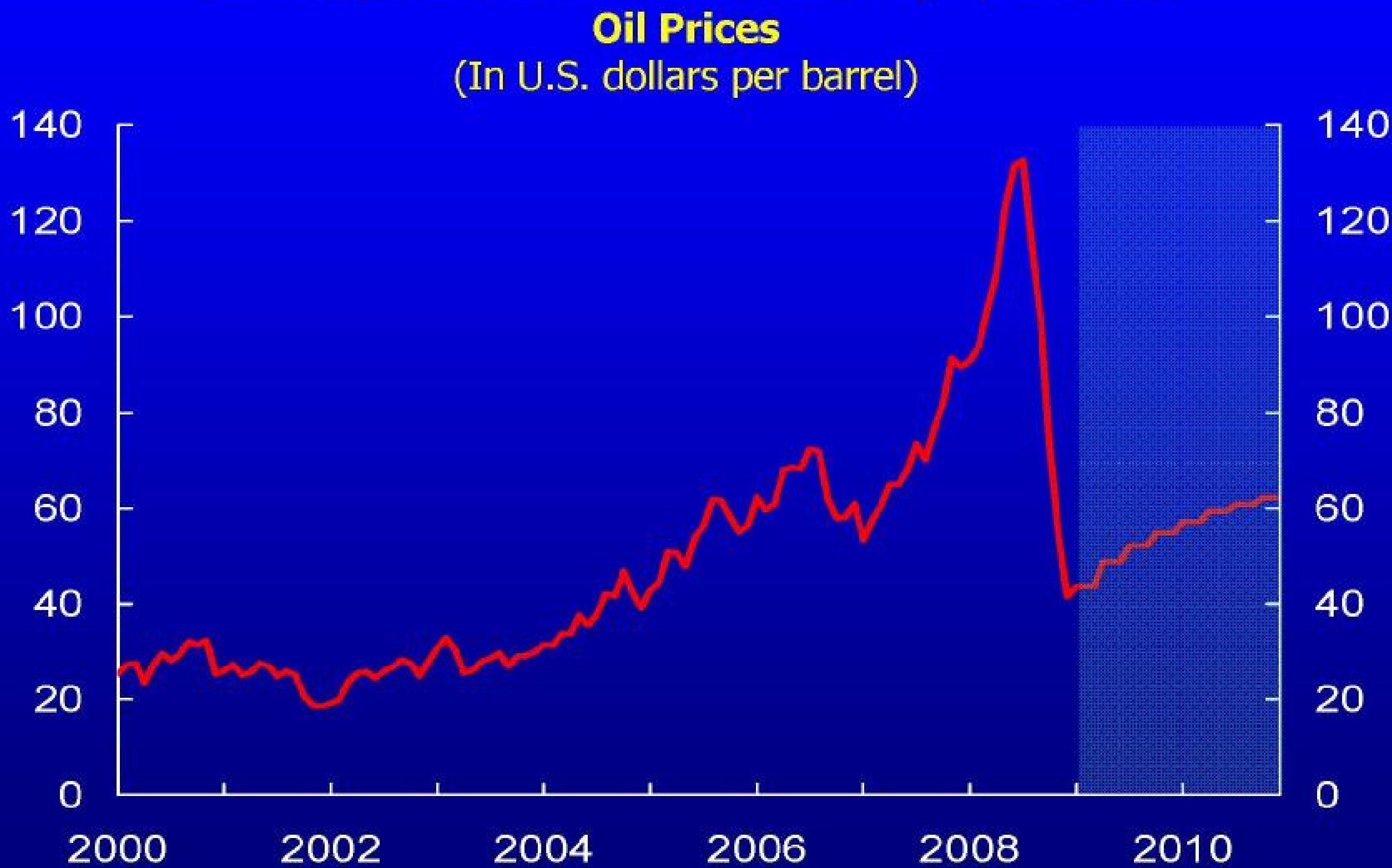


Commodity prices fall= Commodity Exporters hurt

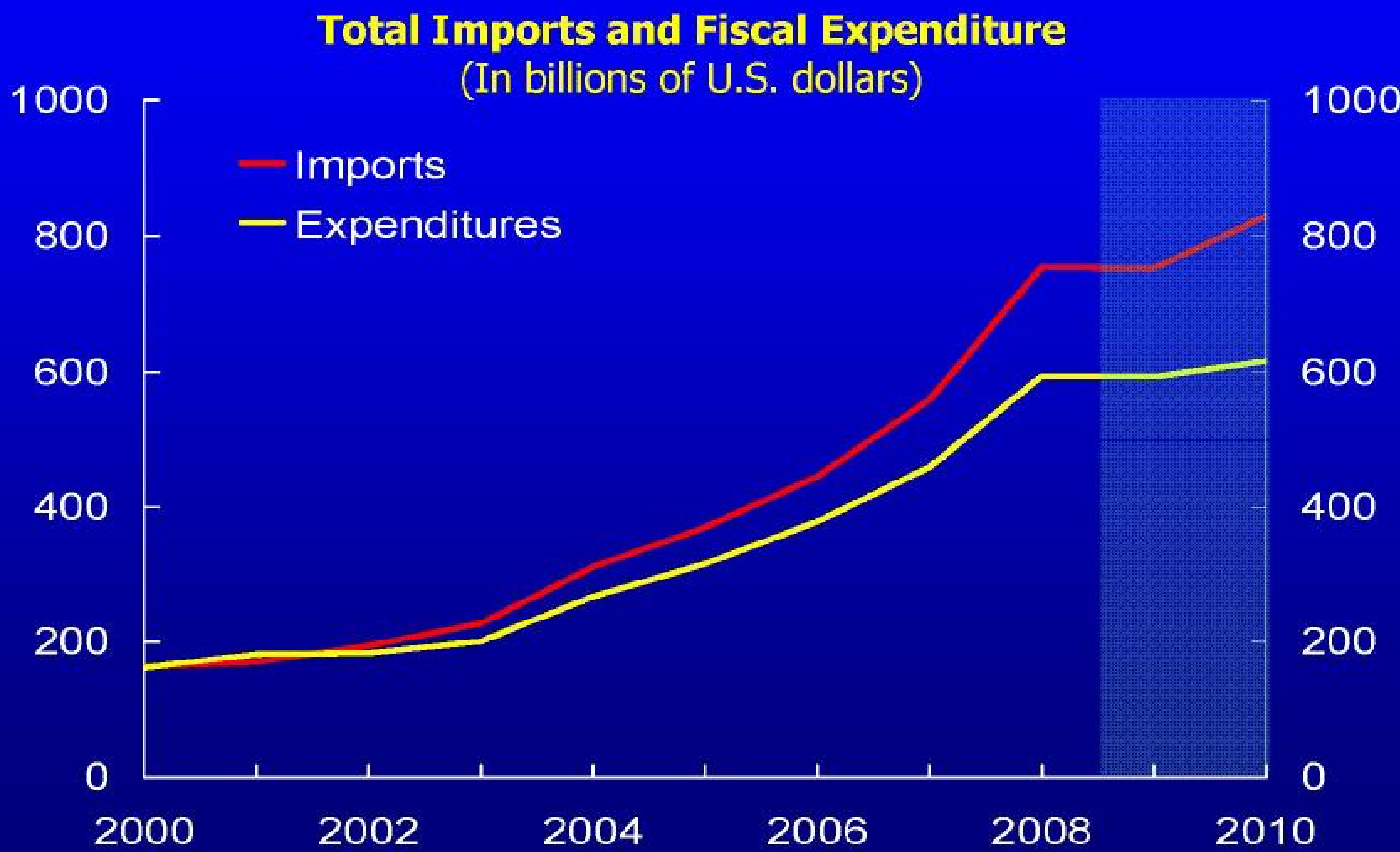


Source: IMF, DIFC Economics.

The slump in global demand has led to a collapse in commodity prices



But governments likely to maintain spending



Policy measures in the GCC

- Bahrain cut the repo rate by 25bp and the overnight rate by 50bp
- Kuwait cut the repo rate by 100bp and the discount rate by 125bp. A series of other measures included 1bn USD investment by KIA in local stock market, liquidity injections, increase in the loan/deposit ratio, extensive deposits guarantee.
- Qatar has instructed QIA to buy 10-20% of local banks' capital
- KSA reduced its repo rate by 50bp (but left unchanged the reverse repo rate), and set up a 36bn USD liquidity facility (only 2-3 bn have been used) and reduced reserve requirements from 13% to 10%.
- UAE guaranteed all deposits (including interbank) and set up a 50bn AED emergency liquidity facility (little used so far), while the government deposited 70bn AED in local banks. The repo rate was reduced to 1.0% effective 19 January 2009
- All governments are maintaining infrastructure and investment spending and are likely to run modest deficits of 2%-3% of GDP

Banking sector in GCC

- GCC Banks remain well capitalized and profitable, with NPL below 5% of the total. Vulnerability will emerge as growth rates decline.
- Liquidity problems were caused mostly by an outflow of speculative capital betting on a currency revaluation and by the seizure of international money markets
- While cost of wholesale funding has increased, the region has no shortage of capital and its creditworthiness is solid
- However, IIF estimates that international banks have provided between 20% and 50% of project financing with the highest share in the UAE. In June 2008 foreign liabilities of the UAE stood at USD 88 from 23 billion at end 2005.

MENA/GCC POLICY REFORM MEASURES

MENA/GCC Structural Reform & Policy Issues

1. Real Estate & the Housing Market: develop long-term housing finance
2. Financing Growth: deposit & credit guarantee
3. Building Capital Markets: bond market, money market, alternative investment markets
4. Public Debt & Finances: build capacity for fiscal sustainability

Corporate governance and the financial crisis

"Underlying much of the credit crunch has been a fundamental failure in corporate governance. While the financial institutions involved may have been in compliance with local requirements and codes, they have ignored the key point – Good corporate governance is about boards directing and controlling the organisations so they operate in their shareholders interests….The use of overtly complex financial products, which thwarted effective supervisory control, and the unethical advancement, at the point of sale, of loans to people with little realistic hope of repaying them shows a lack of basic corporate governance."

Association of Chartered Certified accountants "Climbing out of the Credit Crunch", September 2008

Failure of financial regulatory systems

"The directors of Northern Rock were the principal authors of the difficulties that the company has faced since August 2007. The directors pursued a reckless business model which was excessively reliant on wholesale funding. The Financial Services Authority systematically failed in its regulatory duty to ensure that Northern Rock would not pose a systemic risk"

House of Commons Treasury Committee, (January 2008) "The Run on the Rock"

CG & Policy issues to be addressed

- Board Composition and Competence
- Risk Management process and governance
- Executive Compensation & Incentive structures
- Accounting and Disclosure issues
- Role, Regulation & Oversight of credit rating agencies
- Corporate Governance in the banking and financial sector
- Scope of the regulatory frontier
- Role of central banks as lenders/rescuers of last resort and the nature of collateral
- The Basel II framework & Liquidity Risk Management
- Macro-Prudential risk management

Corporate Governance in the aftermath of crises

- CG Policy has lagged: development and refinement of Corporate Governance standards has followed the occurrence of Corporate Governance failures
- Beware the political backlash…
- Corporate Governance deficiencies facilitated or did not prevent practices that resulted in poor performance
- GCC are not immune to risks and crisis has impacted the markets of the region: stock market value losses, credit cost increased, liquidity tightening, reduced lending, international investors offloading GCC & MENA positions due to financial crisis
- Pressing CG issues: related party ownership, related party lending, stock market regulation, disclosure & transparency, accounting standards

Hawkamah-IFC CG Survey 2007-08

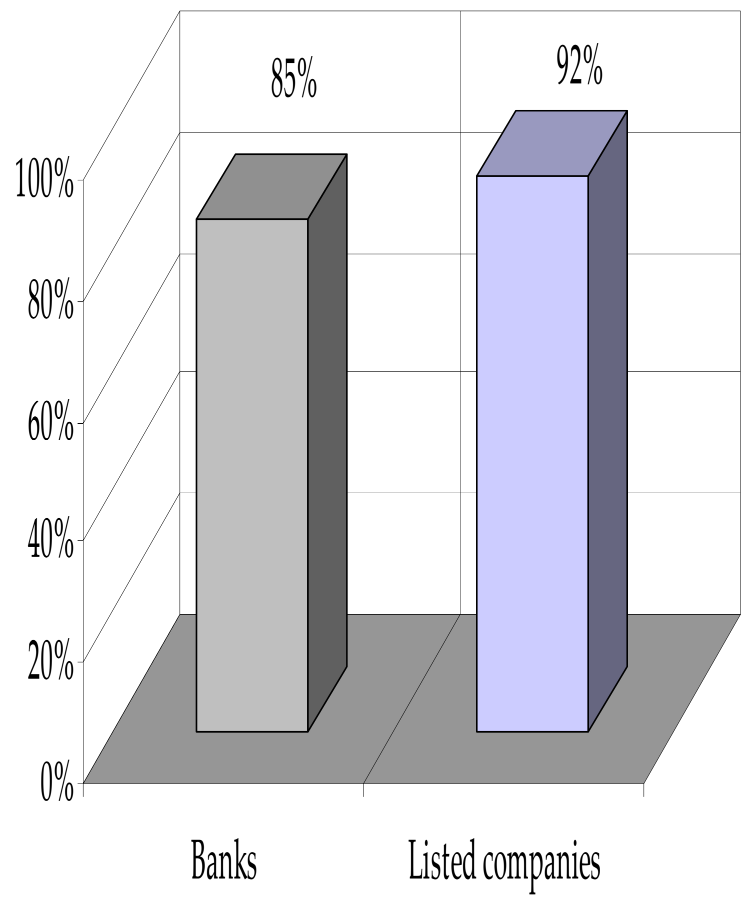
http://www.hawkamah.org/publications/IFC/

- 42.3% of companies that still combine the function of chairman and CEO should separate these roles to comply with best practice.
- Only 25% of banks and listed firms provide information on their dividend policies online, and just 12% have online information on key executives remuneration.
- Most respondents view disclosure from a compliance point of view, rather than see it as an effective tool for managing stakeholder relations and adding value to their business.
- Only 50% of listed family-owned enterprises (FOEs) had adopted a family constitution, while only 25% had family councils in place. Three-quarters of FOEs said their boards are composed of a majority of family members.

Hawkamah-IFC MENA CG Survey: Key Findings

- **Internal Audit is well-established in the Region**
- **Risk Mgt and Internal Control functions need improvement**
  - **Less than half have a risk mgt function (43%), likewise less than half have internal control function (47%)**
- **Most have external auditor, but rotation remains an issue**
  - **Only about one-third have rotation policy (32%)**

Do you have an Internal Audit Function?



Hawkamah-IFC MENA CG Survey: Transparency

Transparency & Disclosure

- Most provide financial statements, but could improve non-financial disclosure.
  - Minority include Management Discussion (28%)

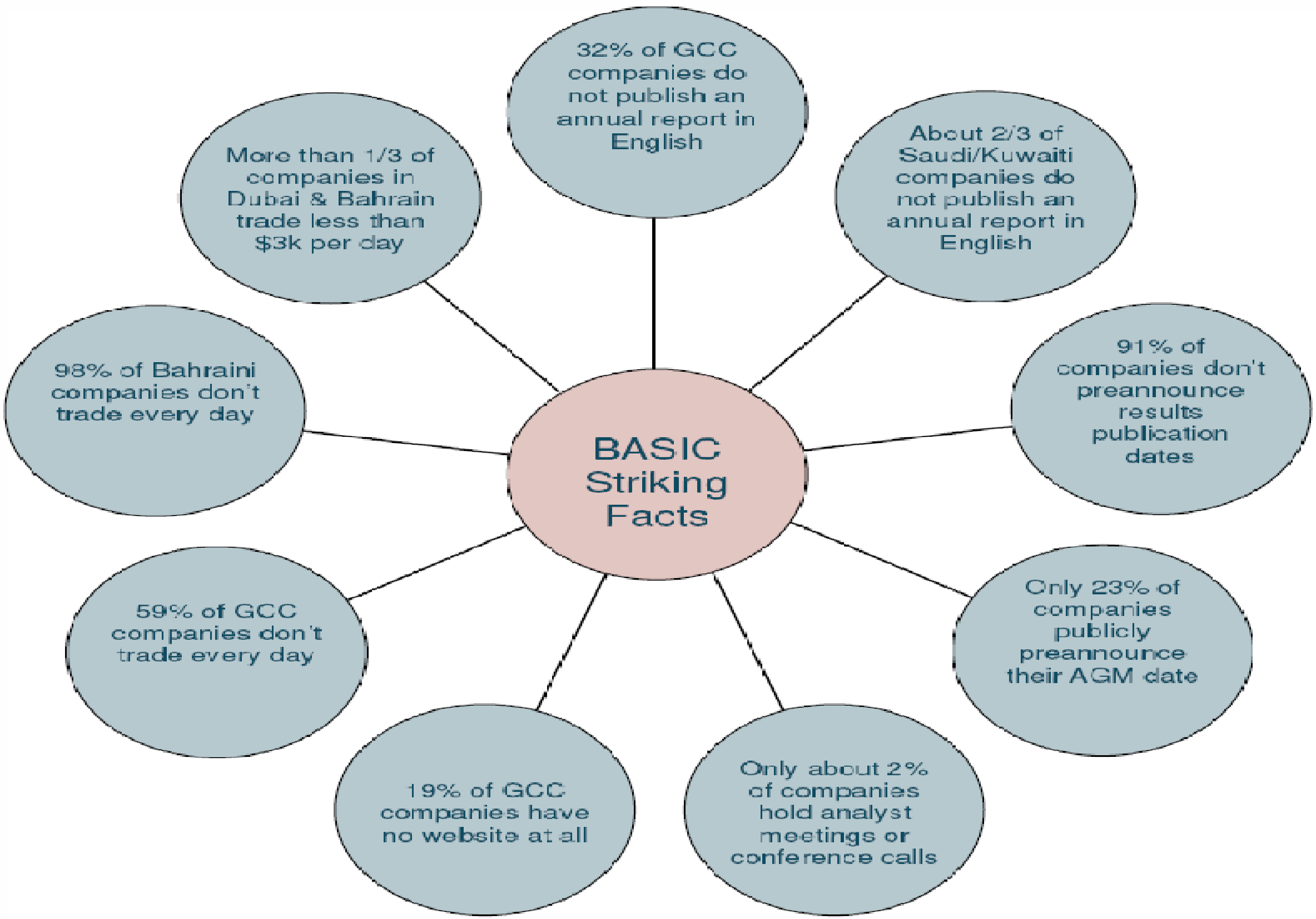
Shareholder Rights

- General Assemblies are well-attended (75%); Directors are elected by shareholders in most organizations (81%).
- Conflict of interest & related party transaction policies are common (~75%); but perception is that not always put into practice.
  - Significant percentage believe directors fail to avoid conflict of interest (55%) or use insider information (67%)

Hawkamah-IFC Survey: Information contained in Annual Reports

	% of respondents
Report of the chairman	85
Financial statements	82
Market share, sales and marketing	77
Ownership structure and dividend policy	72
Future plans of the company	64
Dividend history	54
Remuneration	44
Biographical details of the board	41
Beneficial owners	36
Management discussion/analysis	30
Corporate governance policies	28
Environment, social and economic sustainability	27
Share options policy	13

Hawkamah-TNI Survey, August 2008



Source: TNI Investment Research

MENA/GCC Reform Measures

1.IMPROVE statistical capacity and public dissemination of data & information

2.ESTABLISH company registrars and companies houses, centralised credit reporting

3. FOCUS on the development of local financial market as an imperative

4. EXTEND the regulatory & supervisory powers of central banks; Strengthen banking & capital regulators: independence and capacity building.

5. ADOPT and IMPLEMENT existing guidelines on good practices as promoted by the Bank for International Settlements and IOSCO for the governance and accountability of regulators.

6. MODERNIZE effective creditor rights and insolvency systems and the development of strong rescue and restructuring frameworks for the region.

7. REFORM risk management frameworks.

8. ADDRESS the role and form of regulation of credit rating agencies and improve ratings agencies incentives by increasing the transparency of their modeling practices and holding their managements accountable for negligent ratings errors;

9.LINK executive remuneration and incentive structures to long-term performance and risk profile of firms.

10.Introduce mandatory CG Codes, Guidelines and Laws and enforce them; strengthen corporate governance practices, in particular by increasing board competence and responsibility; implement risk management principles.

11.Strengthen Transparency & Disclosure for listed companies.

12. Consider suspending “mark to market” or “fair value accounting” until markets become functional

Some concluding remarks

- Emerging Markets lessons: develop local financial markets & focus on banking sector soundness
- Corporate Governance failures & mal-governance facilitated or did not prevent practices that resulted in poor performance leading to banking & financial crises
- Political backlash will lead to new Regulatory framework and Corporate Governance reforms
- CG reform should be an economic policy imperative to address pressing CG issues in MENA/GCC: related party ownership, related party lending, stock market regulation, disclosure & transparency, accounting standards
- New Economic Geography is emerging:
  - GCC countries growing economic & financial integration can be main driver of MENA monetary and financial policy reforms;
  - Gulf Monetary Union and Gulf Common Currency leading to a new global currency and contributor to new international financial architecture

Thank you