Institutional and Regulatory Challenges for the GCC in the Face of the Global Crisis

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Dr. Nasser Saidi

Chief Economist DIFCA

DIFC Dubai International Financial Centre

Institutional and Regulatory Challenges for the GCC in the Face of the Global Crisis

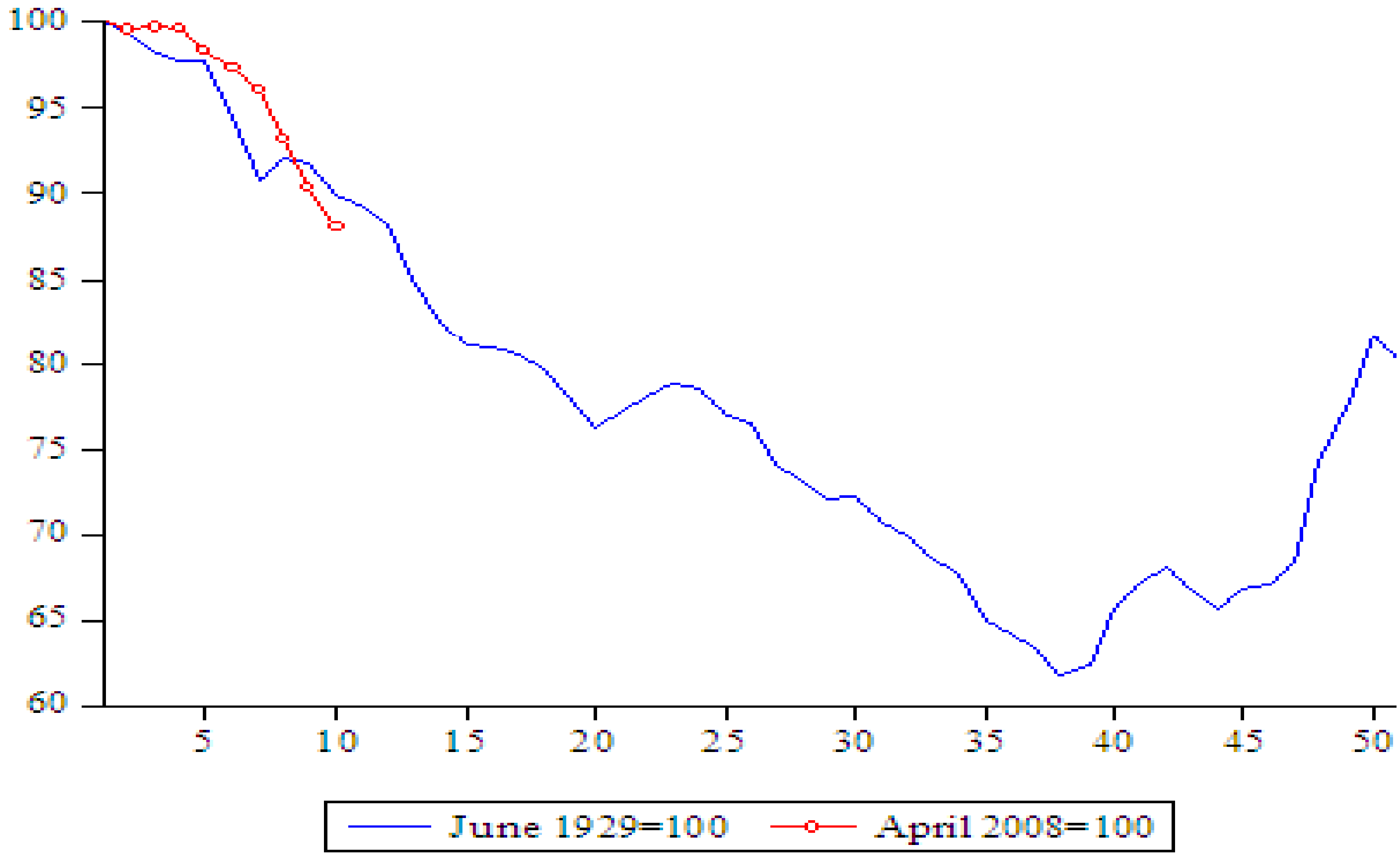
- **Contagion effects & consequences from the 'New Great Depression'**
- **GCC Policy Responses**
- **Institutional & Policy Lessons from the Crisis**

Channels of Contagion to MENA/GCC Economies

- **Financial:**
  - International Credit freeze
  - Equity Market meltdown

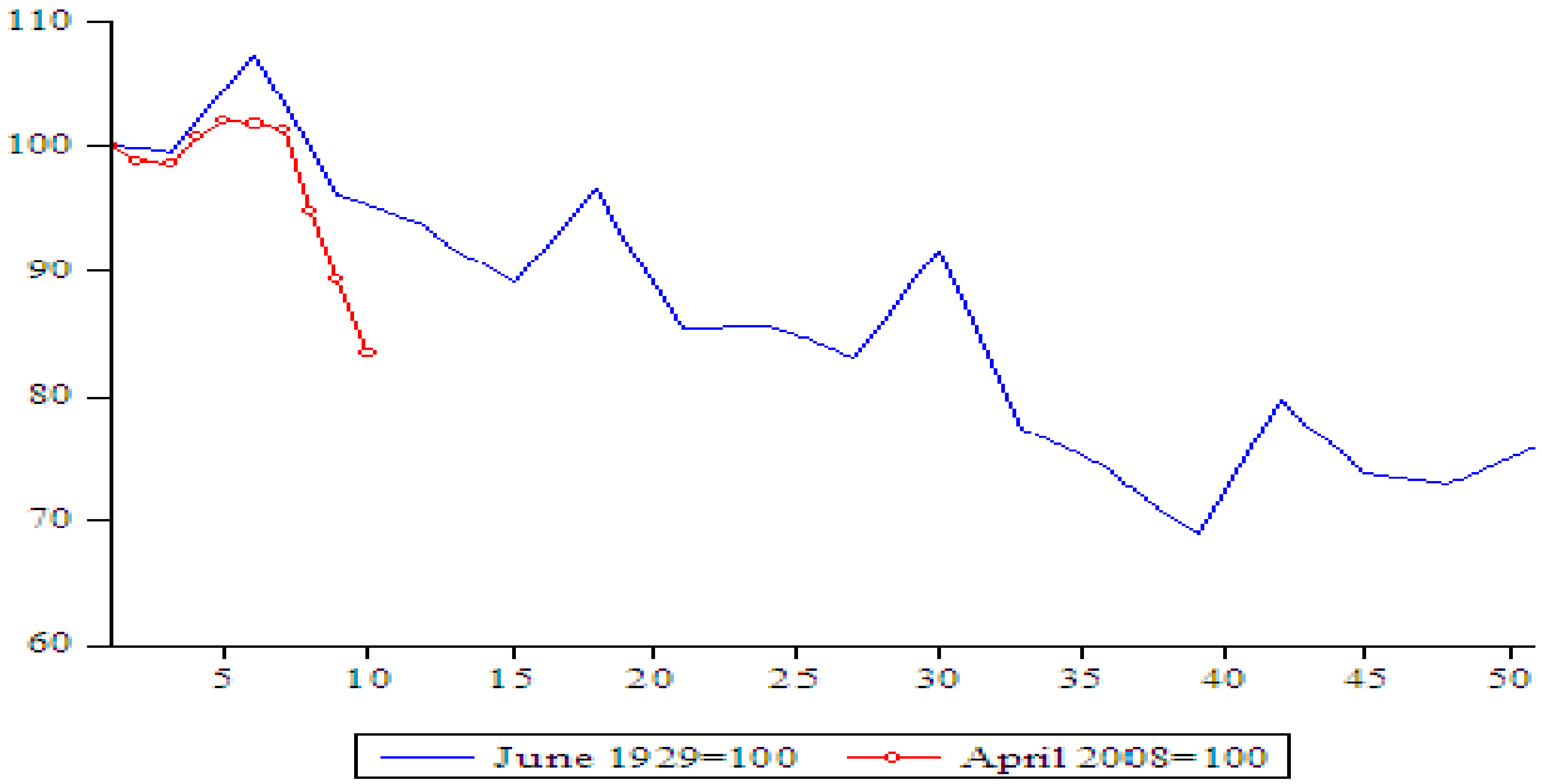
- **Real:**
  - Energy Commodity Prices
  - Plunging Trade Flows
  - Declining Tourism

World Industrial Output: Great Depression and Now



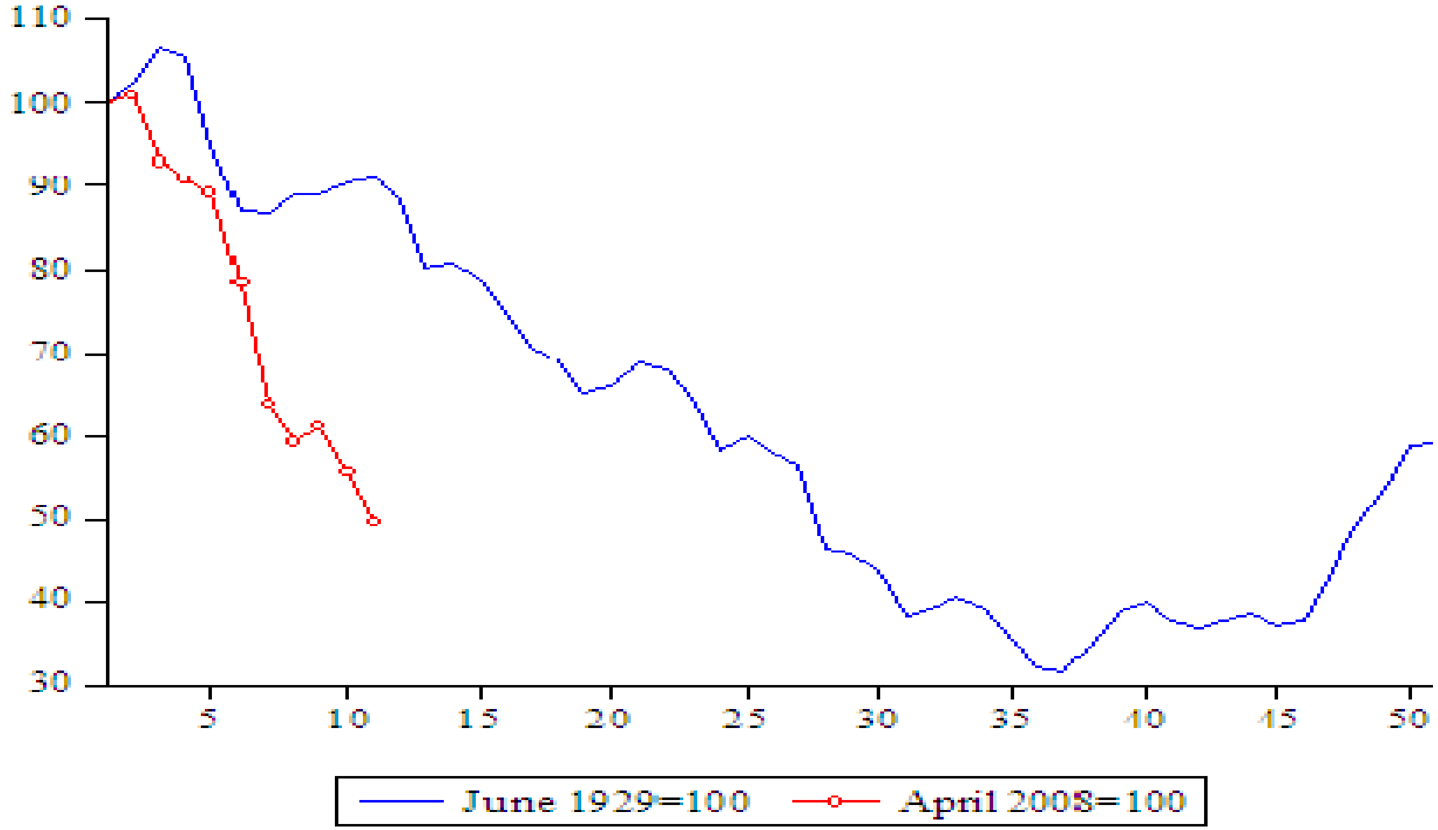
Source: Eichengreen and O'Rourke (2009) and IMF.

Plunging World Trade flows



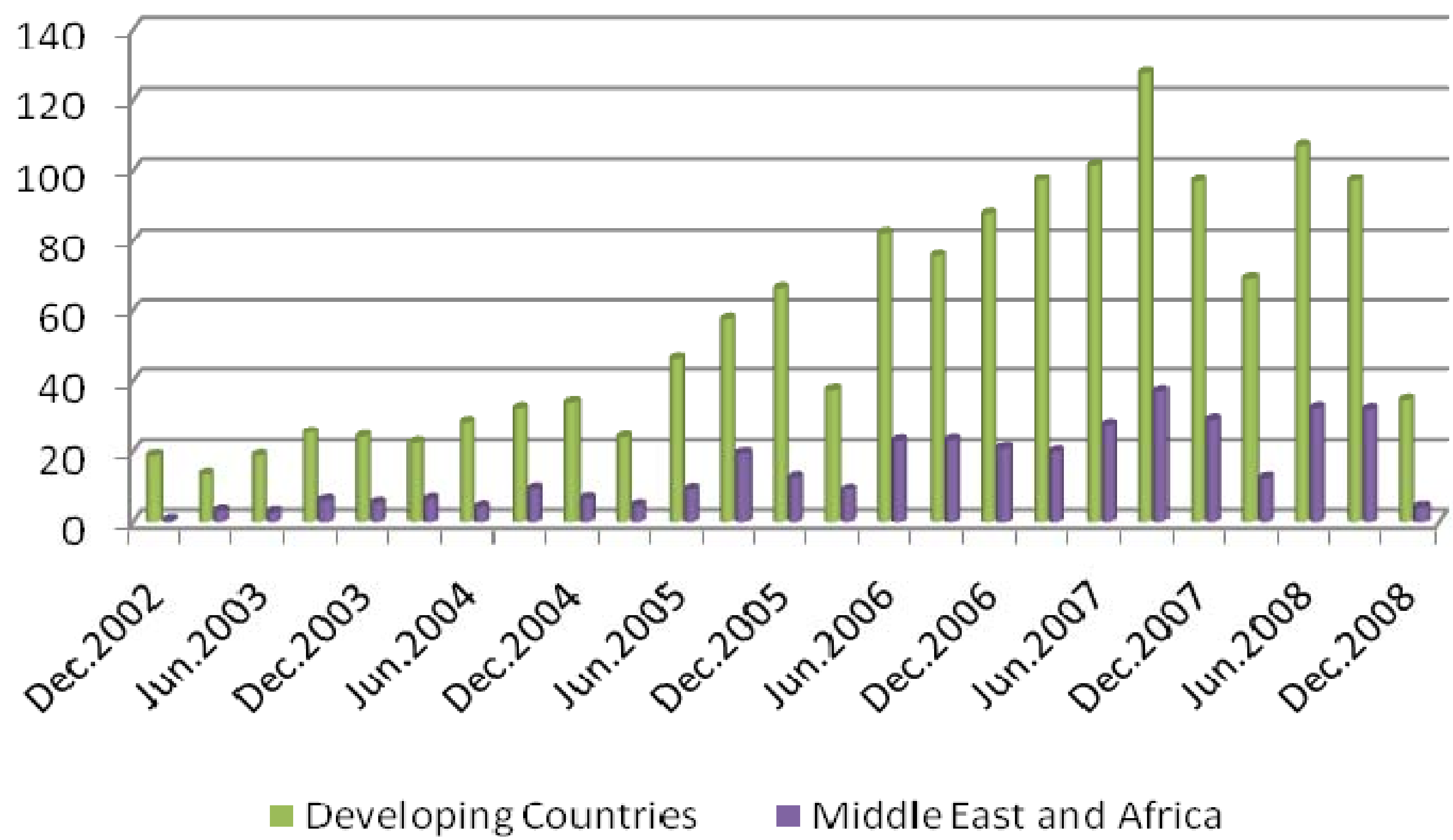
Source: League of Nations Monthly Statistical Bulletin and Trade Monitor by Netherlands Bureau for Economic Policy Analysis

Meltdown in World Equity Markets



Source: Global Finance Database

Drop in International Syndicated Loans



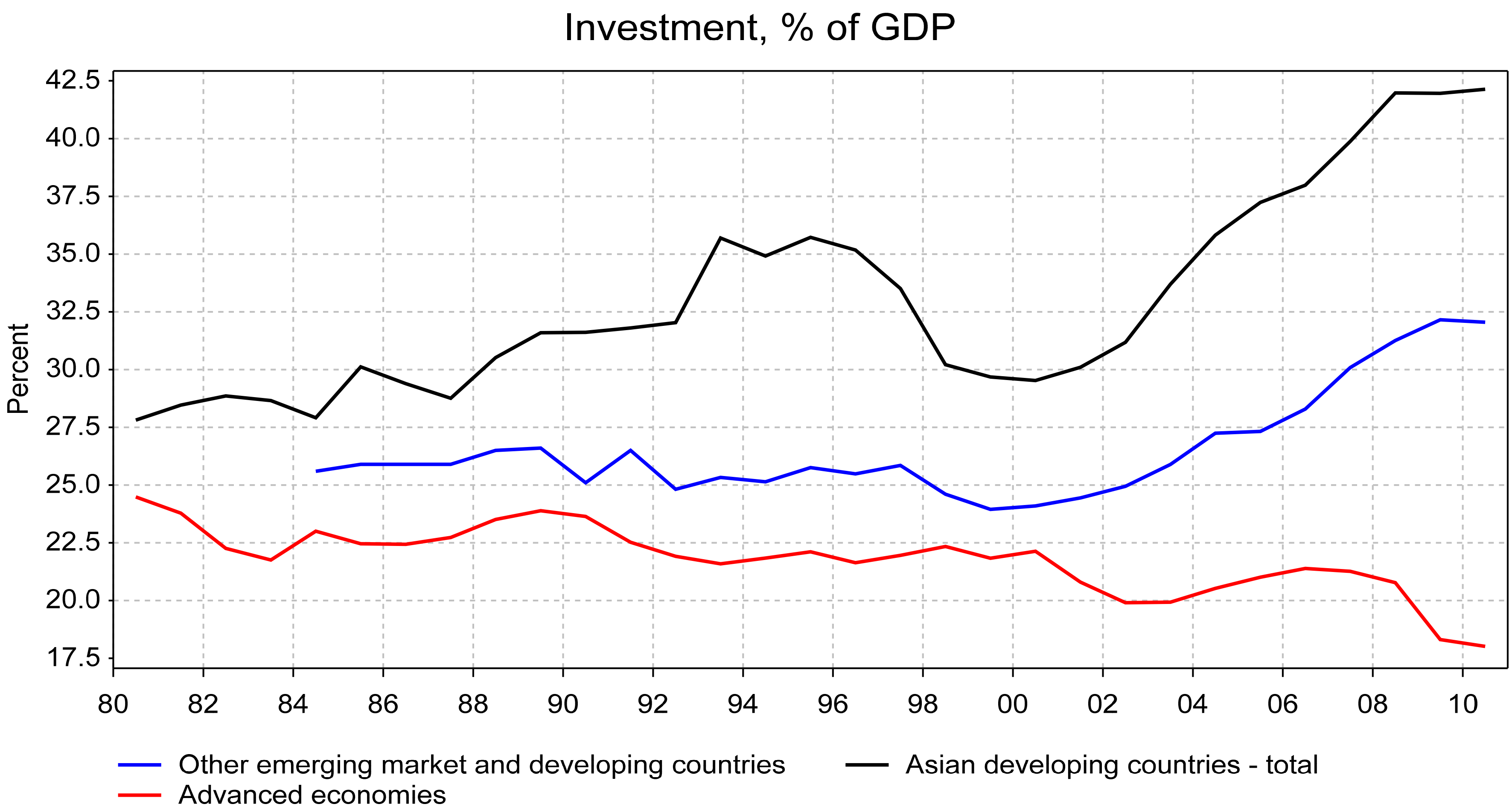
Source: BIS

Financial Crisis Repercussions on MENA

- **MENA, especially the Gulf region, comparatively less severely hit by the financial turmoil and toxic assets thanks to**
  - Strong macroeconomic fundamentals
  - Fiscal discipline and sizeable stock of foreign assets
  - 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 and compliance with Shari'a
  - Structural change resulting from policy & infrastructure spending

Infrastructure investment

✓ Investment in infrastructure is sustaining EME growth. Investment as share of GDP has grown at a faster pace in the emerging economies and infrastructure investment especially has led to structural change in the EMEs.



Source: Reuters EcoWin

GCC Policy Measures I

- GCC countries reacted to the sudden freeze of credit markets last September with a host of measures directed at addressing liquidity problems and strengthening valuations of domestic equity markets.
- Policy measures included:
  - Monetary policy easing within the confines of the US$ peg
  - Initiation of a counter-cyclical Fiscal policy response
  - Banking & Financial policies aimed at strengthening the soundness and capitalisation of banks and financial institutions

GCC Policy Measures II

- Measures have been largely successful in preventing an escalation of the financial crisis and preventing a spread of contagion to domestic financial institutions: effective as a precautionary intervention and emergency response.
- However, need to:
  - Institutionalize and frame a more coherent set of policies directed at creating a financial market in the GCC on par with the most advanced ones.
  - Participate in the process that has been initiated by the G20 Meeting in April 2009

Policy Measures by GCC Countries

SAUDI ARABIA

- Jan. 19 - SAMA cut its benchmark repurchase rate by 50bp to 2% and its reverse repurchase rate by 75bp to 0.75%. It said the cuts aimed to ensure credit was available to meet corporate demand.
- Dec. 16 - SAMA lowered its repo rate by 50bp to 2.5% and its reverse repo by 50bp to 1.5%, ahead of a U.S. Federal Reserve policy decision.
- Nov. 23 - SAMA slashed its repo rate by 100bp to 3% on and also lowered bank reserve requirements to 7% from 10%.
- Oct - SAMA reduced the repo by 150bp to 4% in two moves, and cut reserve requirements from 13%.
- Oct. 26 - The kingdom extended $2.67 billion in credit to low-income citizens having difficulty getting access to loans.
- Oct. 21 - SAMA poured $3 billion in long-term bank deposits, its first direct injection of U.S. dollars in a decade.
- Oct. 17 – The top economic body, the Supreme Economic Council, promised to guarantee bank deposits.

Policy Measures by GCC Countries

QATAR

- March 24 – CB says it has not cut interest rates since the autumn because liquidity is fine and policy is directed at tackling inflation.
- March 20 - Qatar said it bought $1.79 billion worth of listed banks' investment portfolios
- March 9 – The government said it would begin buying listed shares within banks' investment portfolios before the end of the month.
- Jan. 19 - The government ordered two domestic real estate companies to merge as consolidation rises to face global turmoil
- Oct. 13 - The Qatar Investment Authority, said it would buy 10 percent to 20 percent of listed banks' capital to boost confidence.
- Oct. 9 - Qatar central bank said it stood ready to act if needed. However, it opted not to match U.S. Federal Reserve interest rate cuts since October.

Policy Measures by GCC Countries

UNITED ARAB EMIRATES

- Feb. 25 - Dubai said it is working on a stimulus package to support small- and medium-sized companies.
- Feb. 25 - Dubai's real estate regulator said developers can access up to $2.2 billion from escrow accounts to cover construction commitments.
- Feb. 22 - Dubai launched a $20 billion bond program and sold the first $10 billion tranche to the UAE central bank, easing worries state-linked companies could default on debts.
- Feb. 19 - The CB said it is working with the finance ministry to cut rates on corporate deposits.
- Feb. 4 - Abu Dhabi government said it plans to inject $4.4 billion to recapitalize five of its banks.
- Jan. 19 - UAE lowered overnight repurchase rate by 50bp to 1%. The CB had refrained from cutting the benchmark after the U.S. slashed rates in December and November.
- Nov - The government set up a committee to come up with policy responses to the crisis, including the economy minister, central bank governor and minister of state for finance.
- Oct. 21 - The finance ministry poured $6.8 billion into bank deposits, the first tranche of a $19.1 billion rescue facility. It has since deposited another $6.8 billion into banks.
- Oct. 13 - The UAE vowed to guarantee bank deposits and protect lenders from credit risk. The finance minister said on Dec. 16 the state would enact legislation to that effect soon.
- Oct. 8 - Central Bank cut repo by 50bp to 1.5%. It also lowers the borrowing rate on its $13.6 billion facility announced in September.
- Sep. 25 - The central bank set up a $13.6 billion emergency bank lending facility.

Policy Measures by GCC Countries

KUWAIT

- April 12 – CB decided to cut its benchmark discount rate by 25 basis points to 3.5 percent from April 13.
- April 2 - Cabinet approved a law to implement a $5.11 billion economic support package, including a guarantee of 50 percent of new loans extended to local firms.
- Dec. 17 - The CB cut its discount rate by 50bp to 3.75%. It also reduced its one-month repurchase rate to 2.5% from 3%.
- Dec. 4 - Kuwait's sovereign wealth fund said it would invest 1.5 billion dinars into Kuwaiti equities, saying later in the month the funds aimed to stabilize the bourse and would invest for the long term.
- Nov. 19 - The central bank introduced new short-term repurchase agreements to give banks more access to funding.
- Oct. 29 - All bank deposits were guaranteed after the central bank was forced to save Gulf Bank, which suffered steep derivatives trading losses.
- Oct. 26 - A task force headed by the CB Governor was set up to deal with the financial crisis.
- Oct. 9 - The Kuwait Investment Authority pumped cash into the bourse to help stabilize markets.

Policy Measures by GCC Countries

BAHRAIN

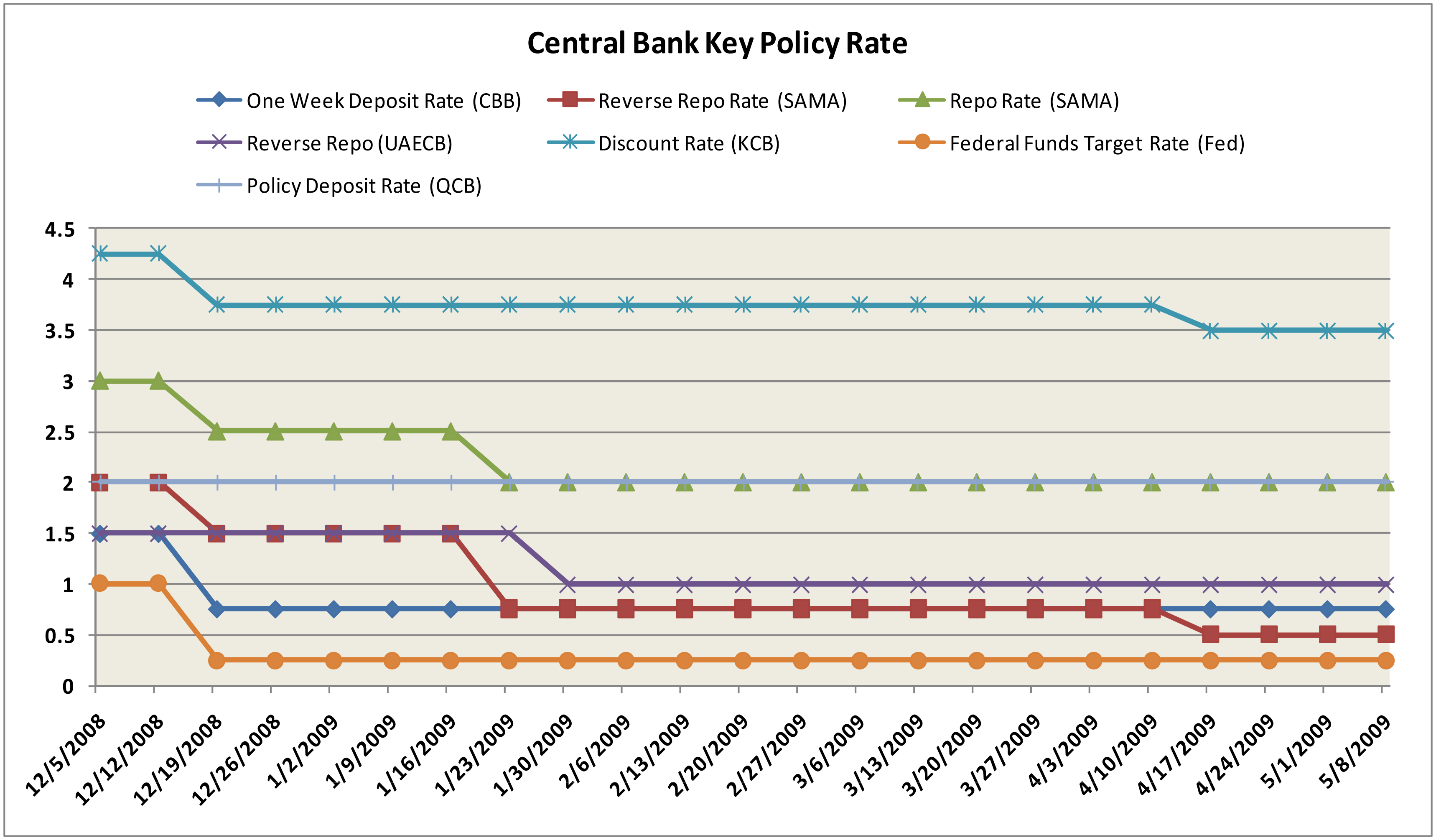
- Mar. 3 – CB cuts bank reserve requirements to 5%from 7%, citing easing inflation
- Feb. 26 - Bahrain plans to issue almost $800 million in bonds to finance housing projects, CNBC Arabiya reported, citing the minister of housing.
- Dec. 18 - The central bank slashed all key interest rates by 75bp in response to a Federal Reserve cut, taking its lending rates to 2.75%, its one-week deposit rate to 0.75% and its over-night deposit rate to 0.25%.
- Nov. 19 - The CB governor said the kingdom could raise its bank deposit guarantee to a maximum of 20,000 dinars ($53,060) from 15,000 dinars.
- Oct. 30 - Central Bank slashed overnight secured rate and repurchase rate by 125 basis points to 3.5 percent. It cut its one week deposit rate to 1.5 percent from 1.75 percent and its overnight deposit rate to 1% from 1.25%.
- Oct. 30 - Central bank expanded acceptable collateral for overnight funds to include ijara sukuk, a type of Islamic bond.
- Oct. 9 - Bahrain lowered its one-week deposit rate by 25bp to 1.75%and overnight deposit rate to 1.25%. Its overnight repurchase and secured rates were lowered by 50 basis points to 4.75%

Policy Measures by GCC Countries

OMAN

- Jan. 27 - Oman said it would start a $389.7 million market-maker fund on Feb. 1. The fund was announced late last year.
- Dec. 21 - The CB said it planned to reduce bank reserve requirements to 5% from 8% and raise the lending ratio from Jan. 1.
- Dec. 4 – The CB said it amended bank reserve requirement rules to release 270 million rials ($701.3 million) into the banking system.
- Dec. 31 – The CB raised its repurchase rate by 47bp to 2%, having slashed it by 89bp on Dec. 15 to 1.53%. It lowered the rate by more than 200bp from November to mid-December.
- Nov. 3 – The CB allocated about $2 billion to local banks at LIBOR plus 150bp to provide dollar liquidity to banks.

Selected Central Banks Rates in the GCC



Source Bloomberg & National Central Banks

Some Major Lessons from the Crisis

Crisis highlighted weaknesses in our financial systems that require a comprehensive and coordinated approach especially among the GCC which share a common market and will share a common currency

- **International accounting standards** should become the norm for all financial institutions. So far only the DIFC has adopted the new IASB rules.
- **Strengthening Corporate Governance** is imperative, with specific emphasis on board of directors' independence and oversight, shareholders rights, transparency & disclosure. Executive compensation must avoid creating incentives for risk taking.
- **Financial Sector Regulation** needs to be strengthened & extended to cover all financial institutions including insurance and fund industries.
- **Financial Safety Net**: Deposit insurance scheme need to be in place to complement the lender of last resort function of the central banks. In view of the launch of the single currency, it makes sense to adopt a common framework to prevent national disparities and ensure a level playing field.

Lessons for Financial Structure, Policy & Regulation I

- **Financial markets in the developed world and in EME will undergo profound reforms & likely to lead to more effective regulation and sounder financial architecture.**
- **GCC governments need to ensure that their financial systems do not lag behind and actually take this chance to leap forward:**
  1. **Banking Supervision: Experience from US, EU shows weakness of fragmented national supervisors ⇒ desirable to have a single supervisory authority for the Gulf Monetary Union**
  2. **Strengthen market resilience:**
     i. **Set-up mortgage guarantee corporations to mitigate risks**
     ii. **Set up legal & regulatory basis for securitized debt and project financing**
  3. **Develop local currency money and debt markets**

Lessons for Financial Structure, Policy & Regulation II

4. **Institutionalise and Build Policy Capacity:**
   - **Statistical data collection and dissemination**
   - **Professional Policy Units in key Ministries**
   - **Updated Budget Execution and Monitoring**
   - **Communication of public policies**
5. **Strategy for GMU and GCC Common Currency needs to include:**
   - **Monetary policy tools,**
   - **Money market operations**
   - **Harmonization of rules and procedures for interbank loans and other bank operations**
   - **Payment and settlement system**
6. **Engage in design of future Financial Structure, Policy & Regulation**

Institutional & Regulatory Challenges

- Financial crisis has underlined both in US and EU that fragmented national supervisors are critically impaired in performing their duties when financial institutions can operate in various jurisdictions and countries. It would be desirable to institute a single supervisory authority for the Gulf Monetary Union. Meanwhile, cross-border licensing and supervision of banks should be more pervasive and rigorous.
- Time is ripe to set up institutions that could strengthen markets' resilience. Given large investments in the real estate sector and infrastructure across the GCC:
  - Setting up mortgage guarantee corporations can mitigate risks.
  - Set up legal & regulatory basis for securitized debt and project financing without the excesses witnessed in the build up and spread of toxic assets

Debt and Fixed Income Markets

- Drawing from the general lessons for EME, it is imperative to build in the GCC resilient and sound local capital and bond markets. Well-functioning and liquid fixed income security markets contribute greatly to the efficiency and stability of financial intermediation and to economic growth in general.
- In the MENA Region, and in particular in the GCC, the growing propensity to invest both in private and public infrastructure and long gestation projects make a compelling case for developing a sophisticated fixed income market and reduce dependence on commercial bank financing, which leads to maturity mismatching. Especially in the financing of infrastructure it would be desirable to raise funds through securities issuance, possibly backed by the future cash flows, as typical of project financing.
- Deeper bond markets in local currencies allow small open economies better to absorb volatile capital flows, provide institutional investors with instruments that satisfy their demand for safe and stable long term yields, reduce financial instability associated with asset price bubbles, and grant a stable source of capital to fund public and private ventures under the constant scrutiny of markets.

Institutionalizing and Building Policy Capacity

The upgrade of financial regulations and in general the improvement in macroeconomic policy calls also for a set of basic elements to be in place

•Statistical data collection and dissemination
•Professional Policy Units in key Ministries
•Updated Budget Execution and Monitoring
•Communication of public policies

In preparation for the single currency it is critical to address 4 key areas in addition to banking supervision:

•Monetary policy tools,
•Money market operations
•Harmonization of rules and procedures for interbank loans and other bank operations
•Payment and settlement system

Engaging in the Design of the New Architecture

- Changes in international legal, supervisory and regulatory reforms (new Basel III) will occupy the international economic diplomacy for the next months or years. The main areas under scrutiny encompass corporate governance resulting from G20 decisions, macro-prudential management, liquidity risk management, systemic risk framework, an early warning system and in general the structure of the international financial architecture
- Explicitly or implicitly the core issue -- which has arisen with heightened frequency and that has always been eschewed since the demise of Barings -- will be the ever-increasing complexity of large and complex financial institutions which has emasculated the role of governance from existing shareholders and non-executive board members.
- The traditional board model (suitable for other industries)—characterized by infrequent meetings and rather stable external conditions—is obviously inadequate and dangerously misplaced. The bottom line is that board members are out of touch with the swiftness and strategies by which the risk profiles of these institutions can be altered by sophisticated (or reckless) traders and securities desks.

Final Remarks

These exceptional times call for resolve to take an active role in world affairs because from this crisis will emerge a new financial order with global consequences

- For the EME the crisis means a further boost of their economic weight and therefore a call for assuming wider responsibilities.
- The outlook for GCC is for a speedier recovery (along with Asian and LA EMEs) than in advanced countries
- The GGC economies in particular have larger room to adopt counter-cyclical policies, thanks to past fiscal prudence, to mitigate the effects of the external shock. Specifically, investment in infrastructure and human capital should constitute the cornerstone of these programs.
- It is also essential to establish early warning systems to detect strains in financial conditions and the build up of systemic risks.
- It is imperative to invest in good corporate governance frameworks and compliance to address issues of transparency, disclosure, risk management and sound executive incentive structures.
- The GCC states should not miss the occasion to upgrade their institutional set up and participate in the design of a new global financial order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