# Local Currency Debt Markets in the Middle East

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# Agenda

Progress in the ME/GCC debt markets

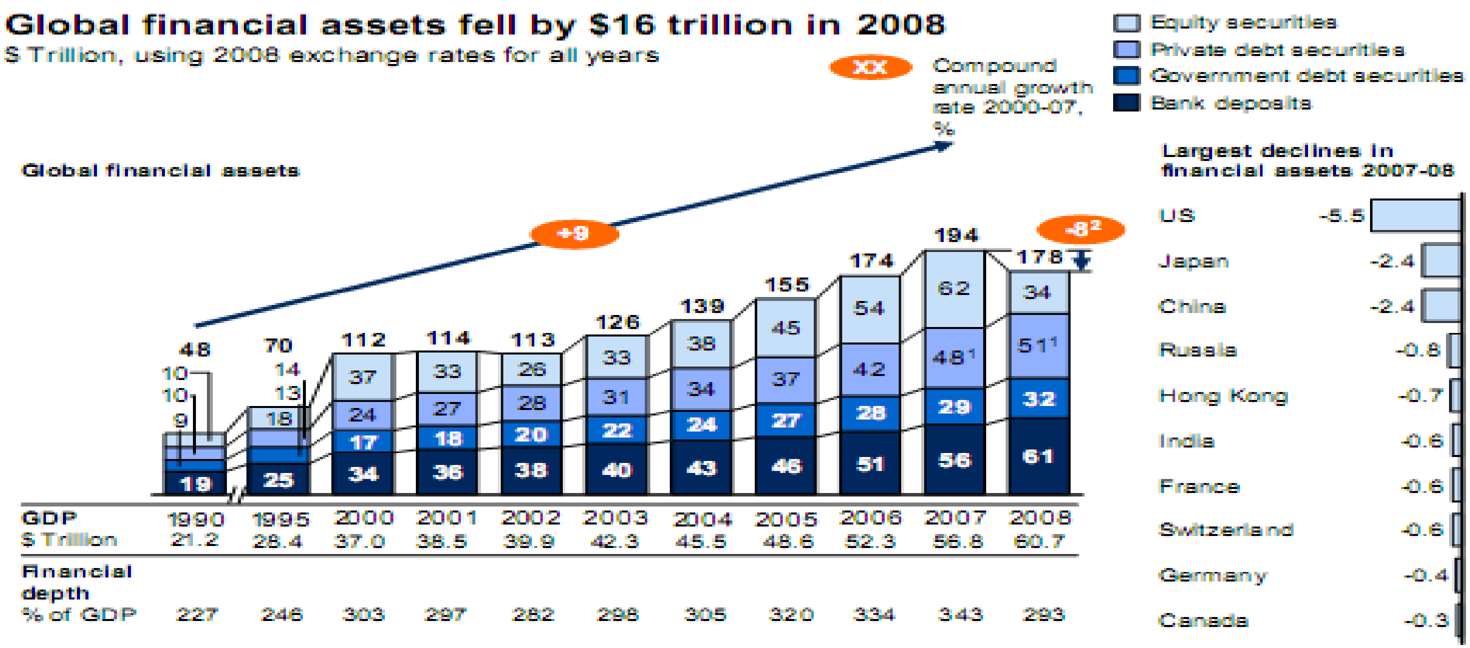
Markets dislocation and new financial market architecture

Role of DIFC

Recommendations and items for Action Plan

# The Repercussions of the Crisis

**By end 2007, after almost 3 decades of buoyant growth the total value of global financial assets reached a peak of $194 tn, corresponding to 343 % of GDP, but by the end of 2008 this figure had fallen to $178 tn.**



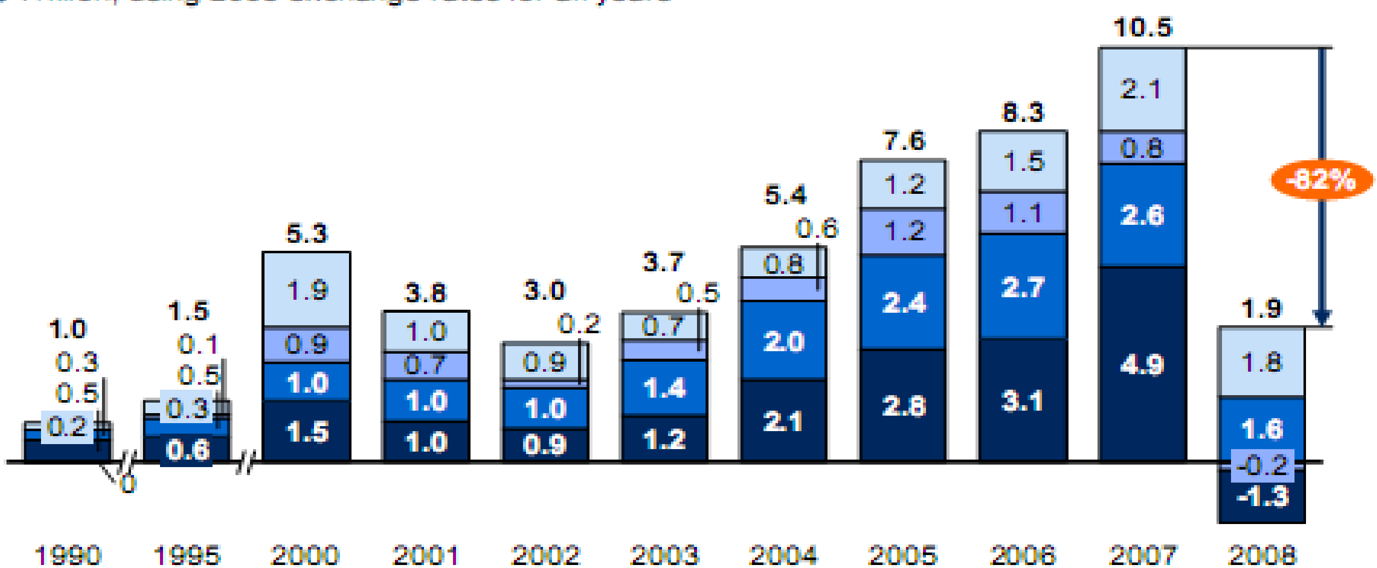

[1] Excludes debt write-downs of $0.28 trillion in 2007 and $0.98 trillion in 2008.
[2] In current exchange rate terms the drop in global financial assets would have been $22 trillion in 2008, or 11 percent of global financial assets.
Note: Figures may not sum due to rounding.
SOURCE: McKinsey Global Institute Global Financial Assets database; Bloomberg

# The Lehman Shock

## The fall in global capital flows in 2008 was driven by a decrease in bank lending

FDI
Equity securities
Debt securities
Lending and deposits

**Total cross-border capital inflows**[1]
$ Trillion, using 2008 exchange rates for all years




| % of global GDP | 4.7 | 5.4 | 13.5 | 9.4 | 7.8 | 9.9 | 13.3 | 15.9 | 17.3 | 20.7 | 3.1 |
|---|---|---|---|---|---|---|---|---|---|---|---|

[1] Capital inflows represent net purchases by foreigners of FDI, equity, and debt securities, as well as deposits and loans to local banks.

Note: Figures may not sum due to rounding.
SOURCE: McKinsey Global Institute Cross-Border Capital Flows database

# Debt Securities Fared Better

- **The total face value of all private debt—including corporate bonds, financial institution bonds, and asset-backed securities—rose to $51 tn by end of 2008.**

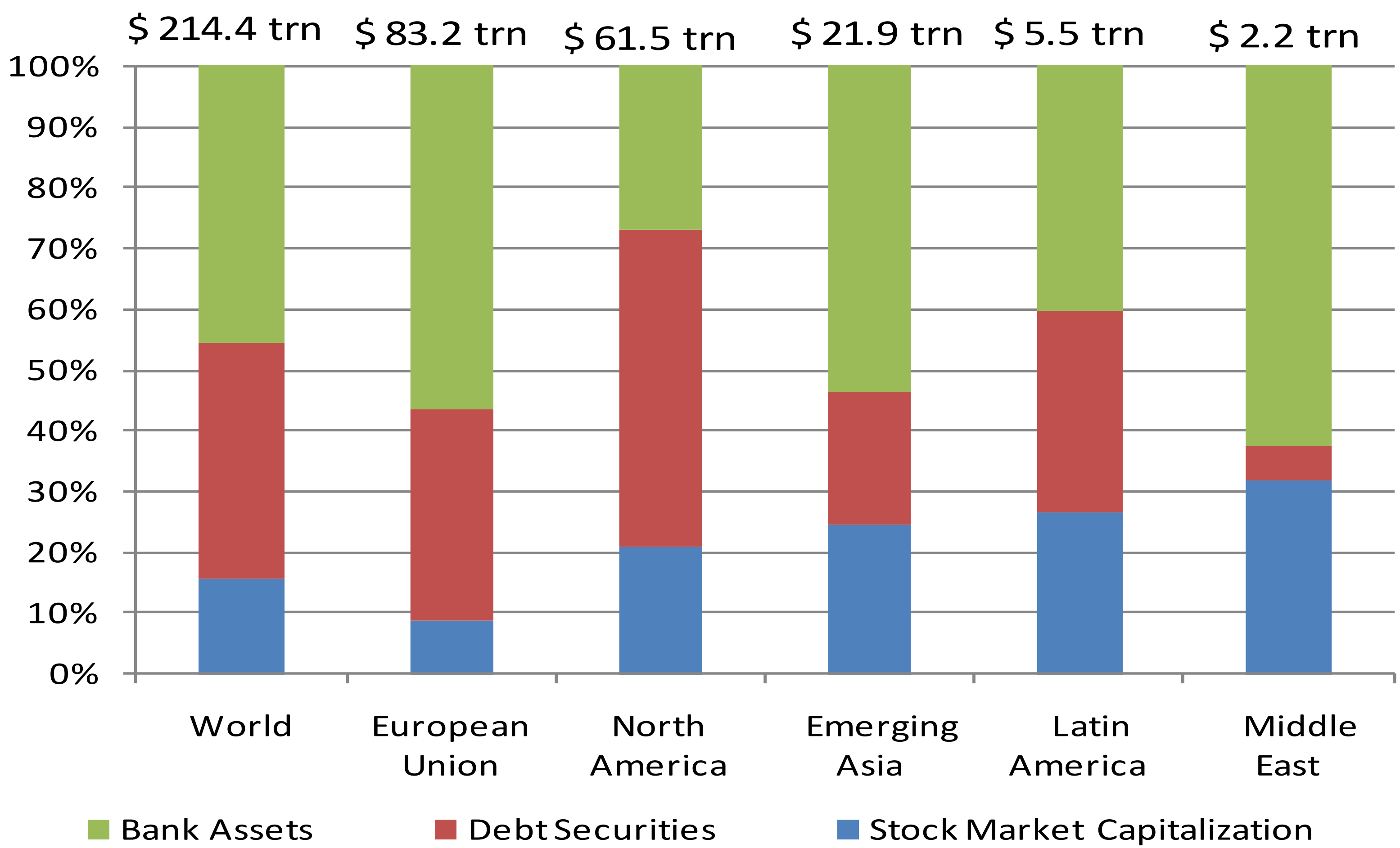
- **However if instead of face value one considers the market value the figure would be trimmed by an estimated range of $2.4 to $3.2 tn, leaving its value roughly the same as end 2007.**

- **Incidentally, Government debt also grew in 2008, rising 9% to $31.7 tn substantially faster than its previous trend, with an acceleration in 2009 and 2010 as a result of the various stimulus programs.**

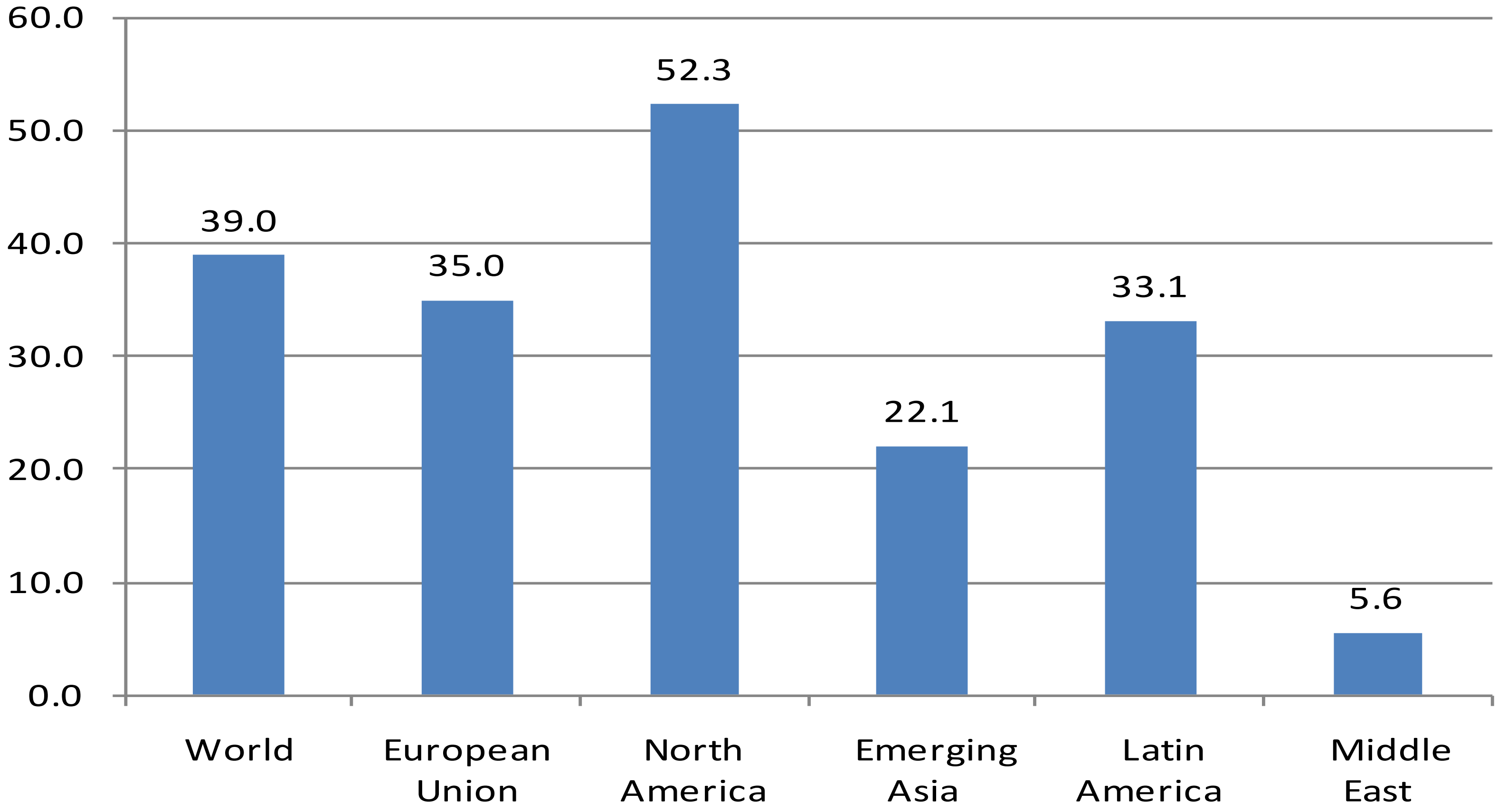
# MENA Debt Markets are still in infancy

- Financial depth across the region shows the relatively low dependence of the Middle East on debt securities as of the end of 2008.
- According to end-2008 data from the International Monetary Fund, the world capital markets consist of an average 38.9% bond instruments, 15.6% equities and 45.4% bank assets
- In the Middle East region, the capital market is dominated by equities and bank assets, which together make up 94.4% of finance. Debt securities make up just 5.6% of the Middle Eastern capital markets.
- The bond market in the MENA region remains the weakest among the world's regions in terms of financial intermediation. Bond financing is tilted towards sovereign issuers, as opposed to a relatively more balanced distribution in other regions

# Financial Structure Across Regions, 2008



# Total Debt Securities, 2008 (as % of GDP)






Source: IMF Global Financial Stability Report, Oct09

# The Importance of Debt 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.

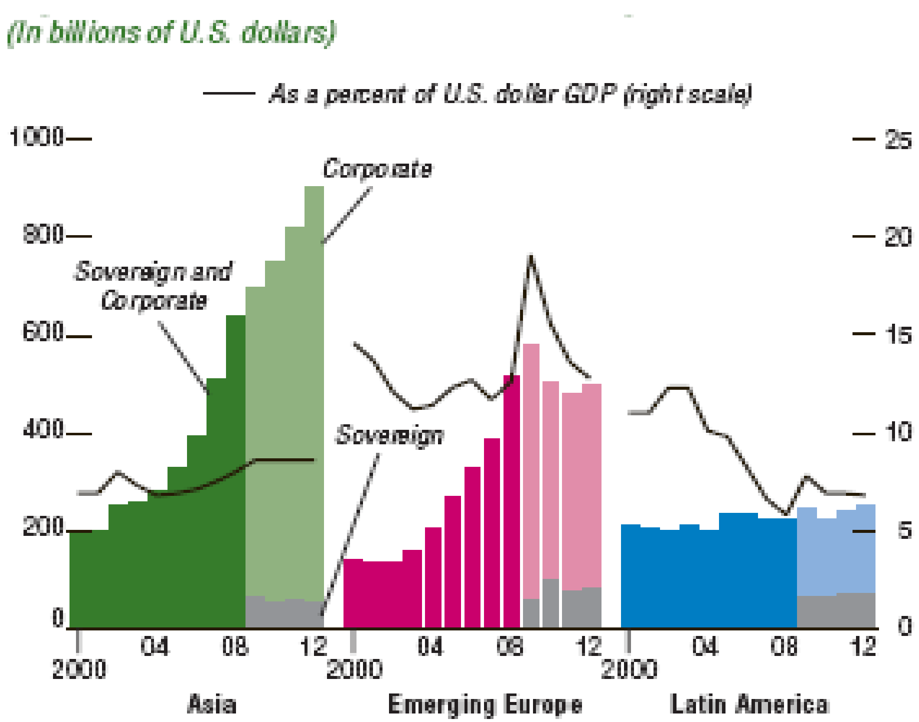
- Market depth and liquidity reduce transaction costs, provide an efficient channel to allocate resources to productive uses and improve risk allocation by all financial intermediaries. A debt market also provides the central bank with tools to effectively conduct its policy by injecting or reducing liquidity.

- 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.

# The Leverage Threat

- Given the decline in asset values and growth in debt, leverage in the global economy has risen during the financial crisis rather than declined.
- In other words the extraordinary level of leverage in financial institutions and households that had been built over the last decade has been shifted substantially to the public sector, but despite this massive intervention many households, banks, and some segments of the corporate sector continue to be highly leveraged.
- In aggregate, the global debt-to-equity ratio nearly doubled, jumping from 124% in 2007 to 244% by the end of 2008 according to McKinsey Institute.
- The global economy hence is extremely exposed to further shocks. “The process of deleveraging in the private sector has at best only just begun, and in the public sector has yet to begin.”

# External Debt Refinancing Needs in Emerging Markets

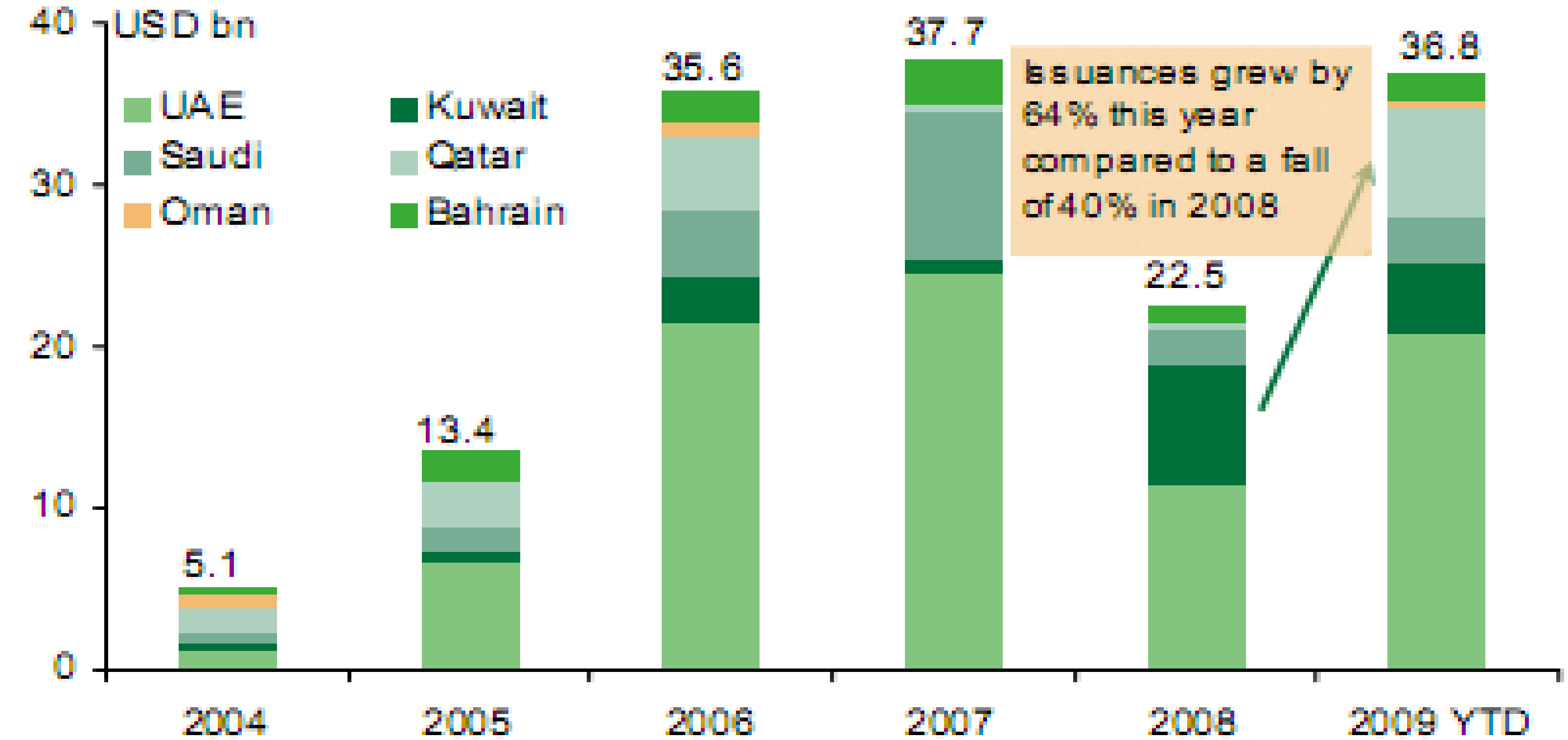



Sources: Bloomberg L.P.; IMF, International Financial Statistics and World Economic Outlook databases; and IMF staff estimates.
Note: Amortization of medium- and long-term debt on the year and short-term debt outstanding at the end of previous year. Corporate debt includes financials.

The leverage threat is an element of fragility likely to hit emerging markets because their refinancing needs will compete with the huge increase in public debt of developed countries.

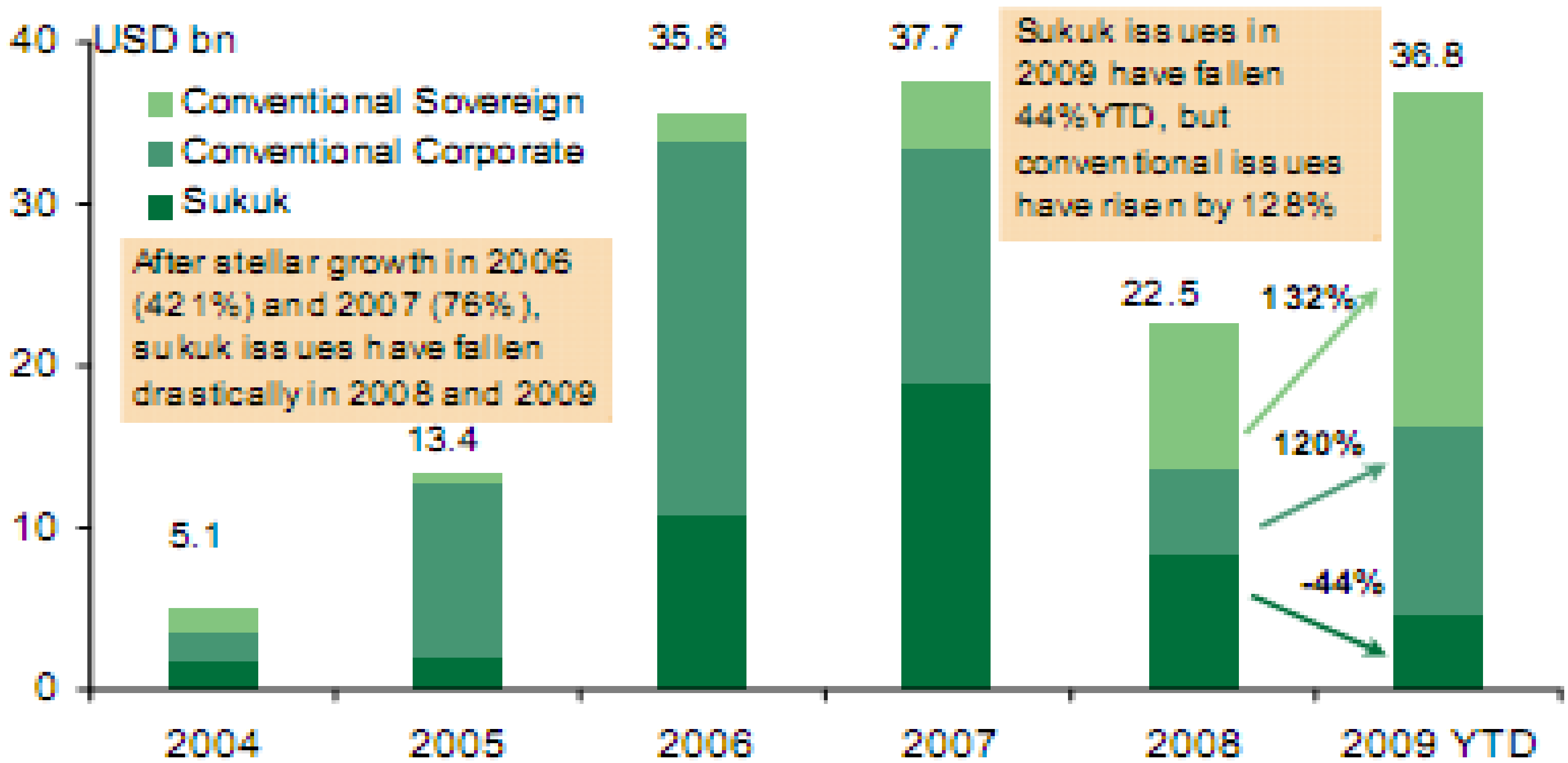
Countries that do not have solid domestic debt markets risk to be impaired and prone to confidence crisis.

# GCC Debt Market by Country



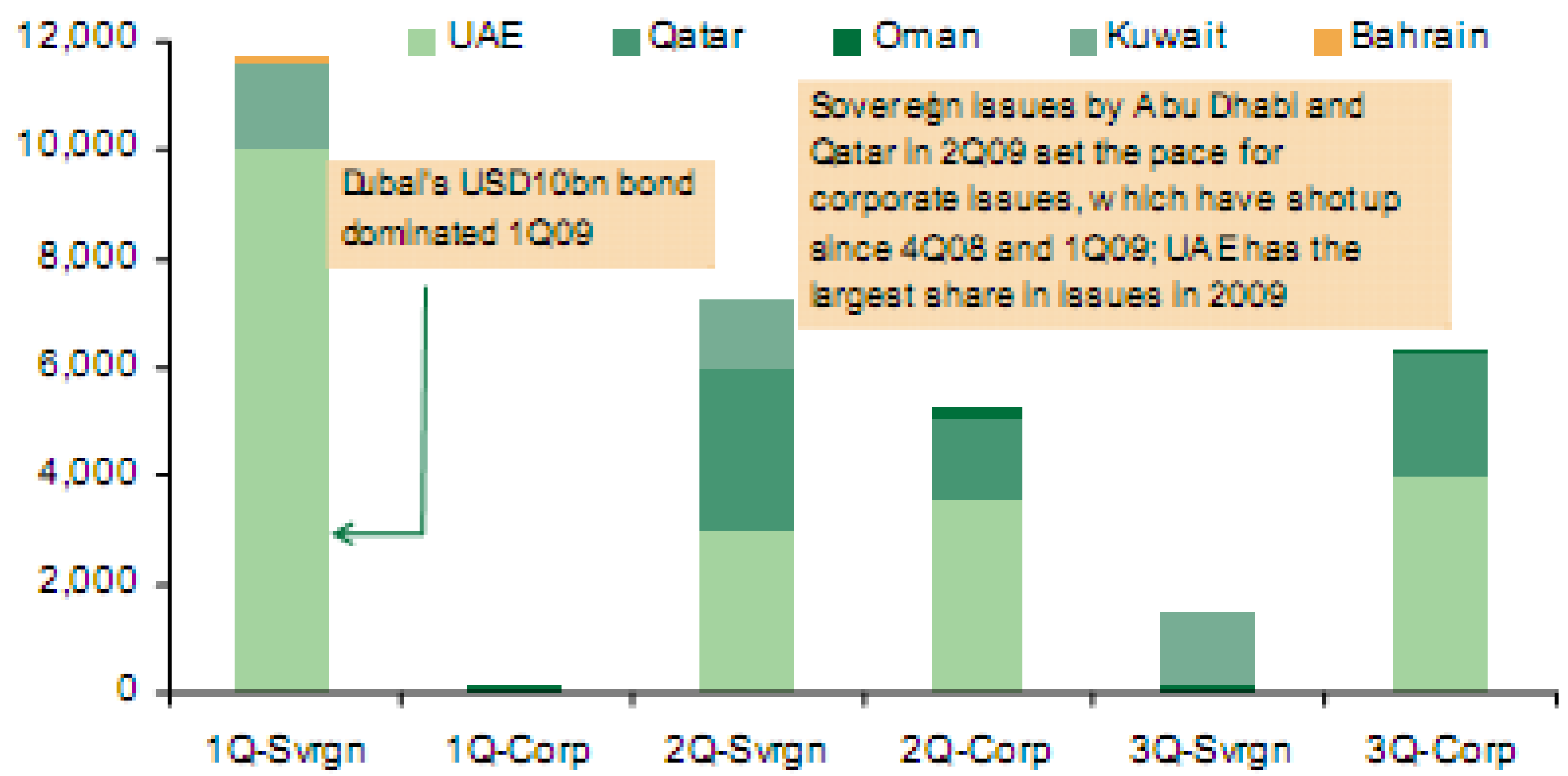

Source: Bloomberg, Zawya, NCBC Research; YTD indicates till 3Q09

# GCC Issuances by Type



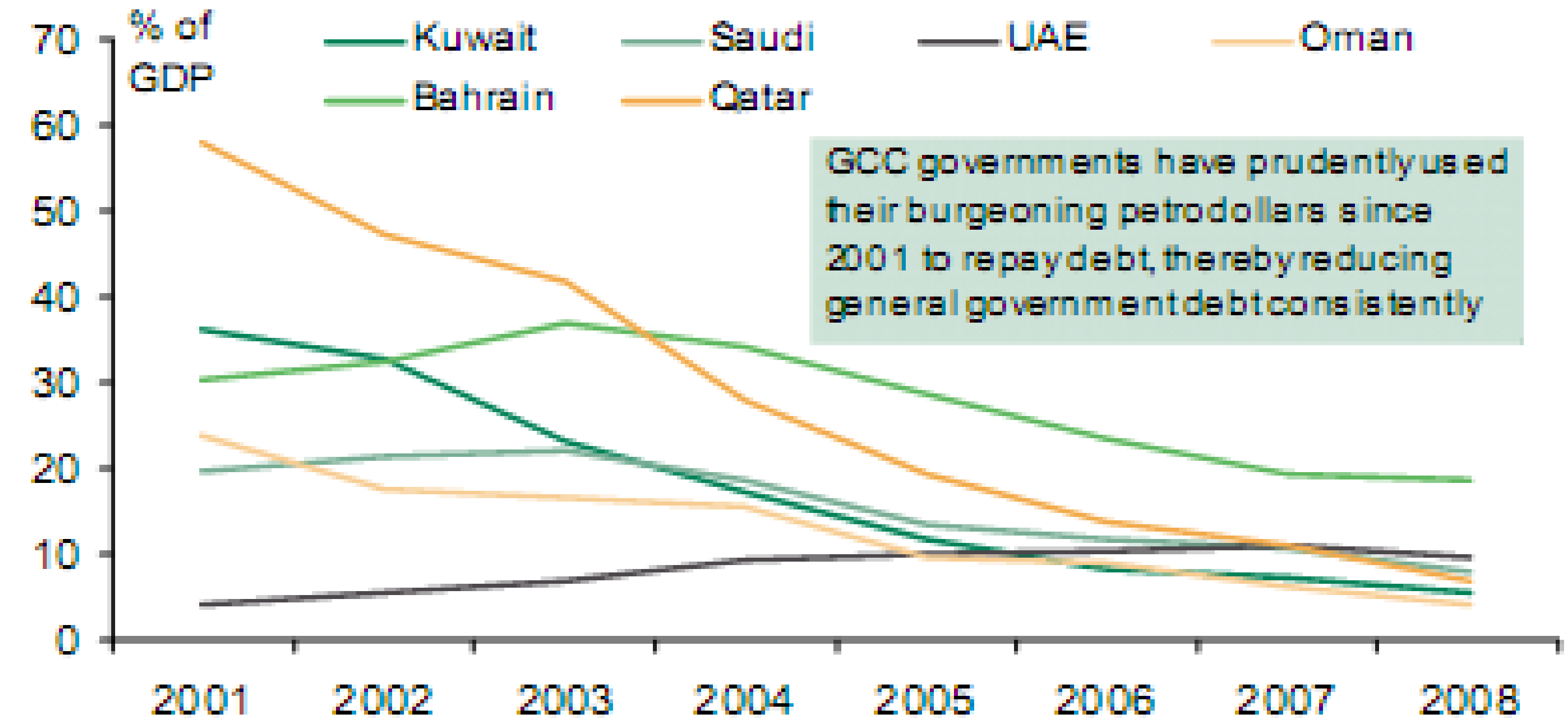

Source: Bloomberg, Zawya, NCBC Research; YTD indicates till 3Q09

# GCC Conventional Debt Market




Source: Bloomberg, NCBC Research

# GCC Government Debt




Source: Moody's Investors Service, NCBC Research

# Conventional Bond Market Issuances in the GCC

**CDS spreads** for GCC sovereigns **peak** in Feb

With **USD80bn** of outstanding debt and falling asset prices, **Dubai** looked most vulnerable

**Concerns rise** regarding rising **debt burden** of GCC sovereigns and businesses

**Protracted negotiations** take away some of the sheen of the new debt raised by Dubai

**Dubai** sells USD10bn of bonds to the UAE Central Bank at 4%-fixed on 22 February

**Qatar** follows with **USD3bn**. Its **USD2bn** 5-yr issue is the largest to be placed in GCC

**Abu Dhabi** raises **USD3bn** (5-yr and 10-yr split equally)

**CDS spreads** ease as GCC economies revive on the back of rising energy prices

**Aldar** sells **USD1.25bn** 5-yr bonds

In Qatar, **Qtel's** USD1.5bn debut bonds are 8.6x oversubscribed

**Mubadala** raises **USD1.75 bn**, the first conventional corporate issue since July-08

**Corporate issuances rise**

**Dolphin Energy** raises **USD1.25 bn** in 10-yr bonds in UAE

**Ras Laffan** raises a total of **USD2.23bn** in Qatar

Issues by **energy companies** dominate **July**

**ADCB** looks set to sell **USD1bn** worth of bonds

Abu Dhabi's **TAQA** raises **USD1.5bn**

**NBAD's USD850 mn** 5-yr bonds was the 1st USD sale by a GCC bank since 2007

**Banks and utilities** come back to tap debt markets in **September**

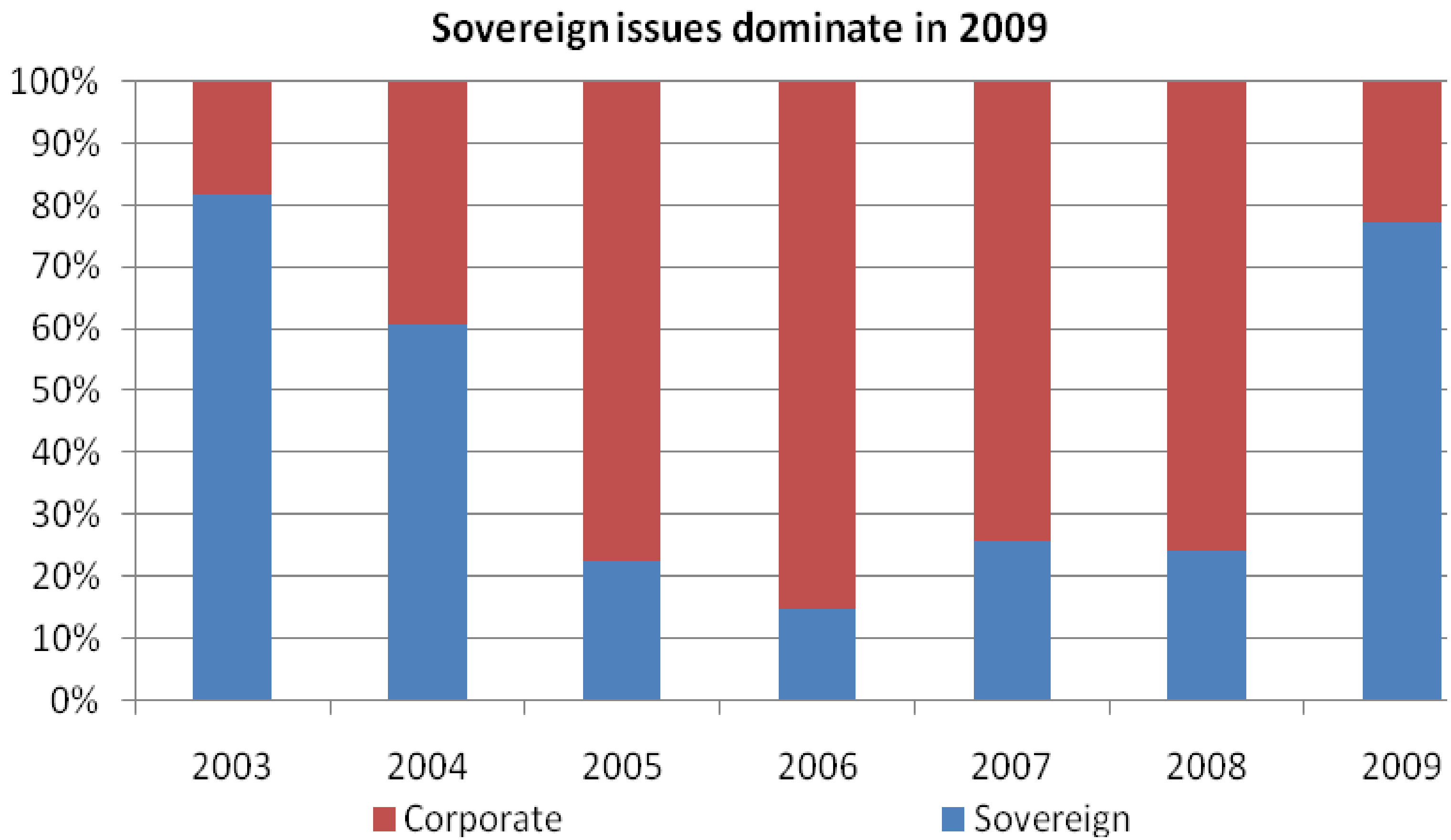
**1Q09 (USD11.7bn: sovereign, USD0.1bn: corporate issues)**

**2Q09 (USD7.3bn: sovereign, USD5.2bn: corporate issues)**

**3Q09 (USD1.4bn: sovereign, USD6.3bn: corporate issues)**

Source: Bloomberg, Zawya, NCBC Research

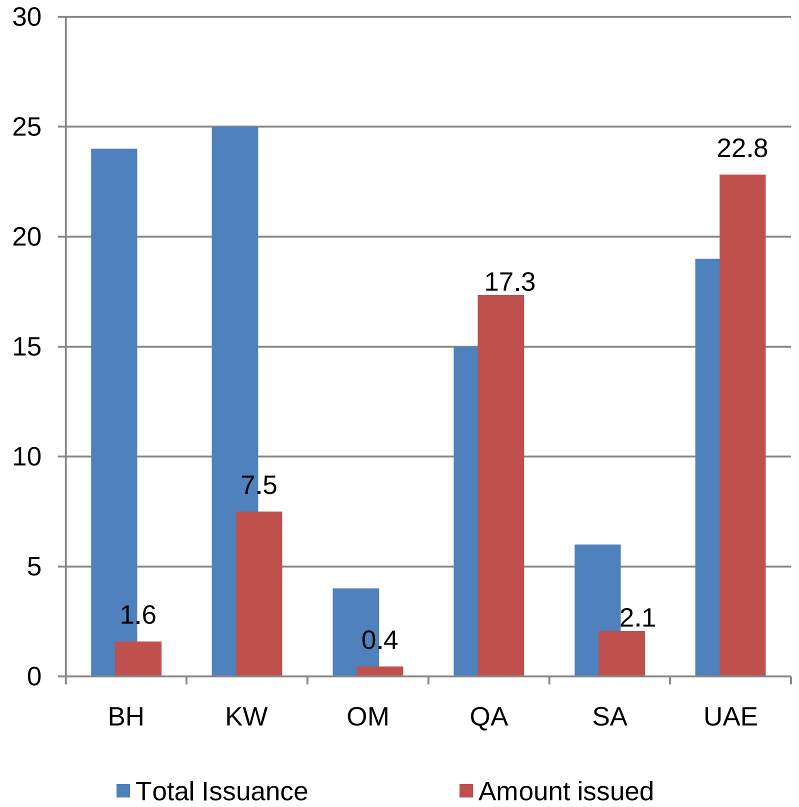
# GCC Bonds Issuance by Type



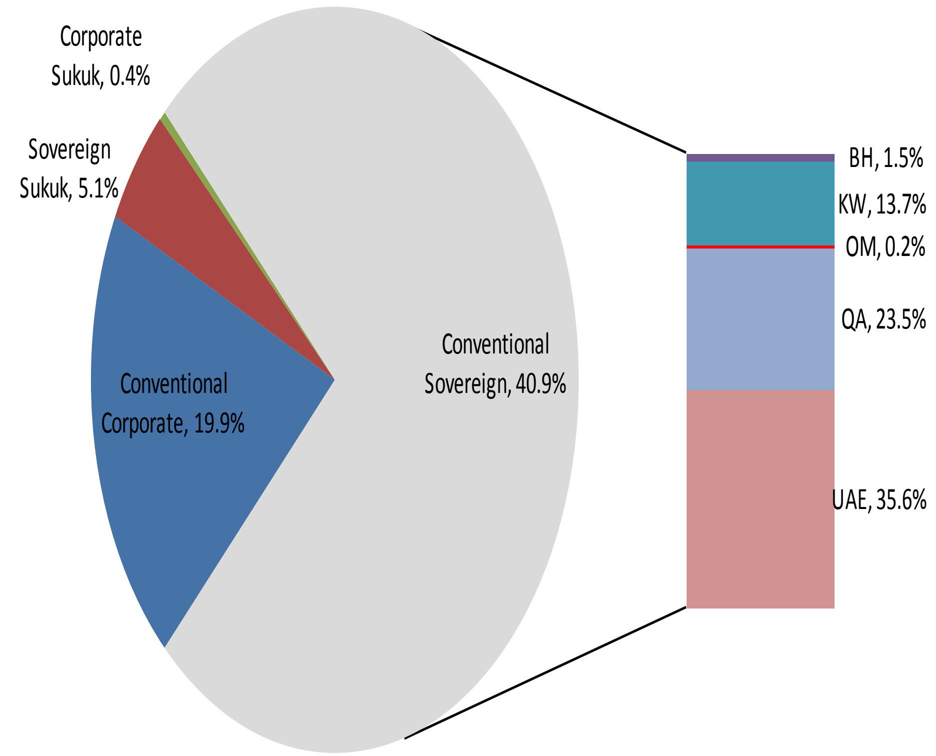

***Source: Bloomberg***

# GCC New Issuances in 2009 and Breakdown by Type

**Issuances in 2009: By number and amount of issuance**




**Conventional Sovereign Issues formed 40.9% of debt issuance till end-Aug09**






***Source: Bloomberg***

# Shift in Economic Geography

• A solid recovery is underway in Emerging Markets: a decoupling from developed countries is a distinct possibility. For investors and financial intermediaries alike, Emerging Markets could become more important as their share of global capital markets continues to expand.

• Debt markets should be a key element in this shift of economic barycenter to achieve a more balanced underpinning of financial sector.

• The challenge is to create an investor friendly environment with regulation and governance trusted by the public.

# Debt Market has Emerged as an Attractive Alternative

- Bonds have been used rarely, in large part because until very recently they were deemed unnecessary in a region flush with capital and hydrocarbon wealth. Financing of large projects was available through banks and government coffers.

- The reversal in hot money flow, the losses in the region's equity markets post-Lehman, and the prohibitive cost of long-term borrowing has been a powerful reminder over the vulnerability of relying on external finance. With precarious sources of external finance GCC countries are tapping the pool of wealth in the region and foreign capital is looking for relatively safe investment.

- Activity in the debt market has substantially increased post-crisis to match the governments' commitment in infrastructure projects and as part of counter-cyclical fiscal policy.

# Compelling Reasons for MENA Debt Markets

- **The development of the local debt markets can be viewed as an investment in the economy, similarly to any other public investment (e.g. in infrastructure, health, education, etc…).**
- **Even in the absence of a pressing need to borrow by the government, the creation of a debt market is a key milestone on the road to develop an advanced economy.**
- **A mature and liquid debt market can improve resource allocation by channeling national and regional savings into domestic investments and can diversify the choices available to both retail and institutional investors.**
- **Relying exclusively on commercial bank channels heighten the vulnerability due to the mismatch of short term liabilities (i.e. deposits) and long term risky assets (i.e. loans and mortgages).**

# Infrastructure and Housing Finance

- **In the MENA Region, and in particular in the GCC, the growing propensity and need to invest both in private and public projects make an even more compelling case for developing a sophisticated fixed income market.**

- **Project Financing is particularly well suited for Islamic Finance structures (Sukuk) due to their emphasis on asset based financing**

- **Housing Finance could also benefit from deepening of markets and the creation of mortgage backed securities markets**

# Example: Government of Dubai – Inaugural Sukuk

## Transaction summary

- In October 2009, DIB (DIB Capital) acted as Arranger for the establishment of a US$2.5 billion Sukuk Programme ("Programme") for the Government of Dubai ("GoD") which came to the market through Department of Finance
- This Programme is GoD's inaugural Sukuk Programme
- DIB (DIB Capital) also acted as joint lead manager and bookrunner for GoD's inaugural dual tranche Sukuk issuance under the Programme with an aggregate issuance amount of US$1.93 billion equivalent
  - US$1,250 million, 5-year, fixed rate Sukuk
  - AED 2,500 million, 5- year, floating rate Sukuk
- The landmark Sukuk offering is the:
  - ***Largest sovereign Sukuk issued till date; and***
  - ***Largest Sukuk issued in 2009***
- The dual tranche Sukuk marked GoD's successful return (after April 2008) to the international capital markets amid concerns and speculation over Dubai's indebtedness
- The transaction was launched following successful investor meetings in Hong Kong, Singapore, Dubai and London
- Initial price guidance was released at EIBOR / MS + 375 bps however due to the strong interest from investors (over US$6.3 billion equivalent orders across both tranches) , the Sukuk issues were priced 5 bps inside the guidance at 370 bps over EIBOR / MS
- The order book ,at close, included over 300 accounts in total
  - The US$ Sukuk was 4x oversubscribed with orders of US$4.9 billion
  - The AED Sukuk was 2x oversubscribed with orders of AED 5.2 billion

## Financing overview

| | | |
|---|---|---|
| Issuer: | Dubai DOF Sukuk Limited | |
| Obligor: | Government of Dubai | |
| Programme Size: | US$2,500,000,000 | |
| Structure: | Sukuk Al Ijara | |
| Issue rating: | Not Rated | |
| Format: | Reg S | |
| Issue Size: | US$1,250,000,000 | AED 2,500,000,000 |
| Maturity: | November 2014 | November 2014 |
| Issue Price: | 100% | 100% |
| Reoffer Spread: | MS + 370 bps | 3M EIBOR + 370 bps |
| Profit Rate: | 6.396% p.a. | 1st payment 5.655% p.a. |
| Frequency of Periodic Distribution: | Semi – annual | Quarterly |
| Listing: | Dubai Financial Market and London Stock Exchange | |
| DIB / DIBC's role: | Arranger for the Programme and Joint Lead Manager & Bookrunner for the inaugural Sukuk under the Programme | |

# The Emergence of Sukuk

- **A striking element was the fast growth of Sukuk, (although dampened in 2008 and 2009) which are expected to exceed US$200bn by 2010.**

- **Global issuance has historically been primarily in US dollars and concentrated in parts of Asia and GCC. About half of the issues in value terms originate in Asia (Malaysia and Brunei) and the other half in the GCC and Pakistan.**

- **There has been a significant change in currency of choice for the Sukuk market - the share of US dollar-denominated Sukuk dropped from 85% in 2002 to 10% of issuance in 2008;**

- **Sukuk data for the year shows a turnaround with USD denominated Sukuk rising to 20% of total issues, indicating the return of the greenback as one of the main currencies.**

# Role of DIFC Role: Market Infrastructure

- DIFC has a sophisticated framework of laws, regulations and controls to support bond and Sukuk issuance
- DFSA is a world class independent risk based regulator
- DIFC offers a domicile for the registration of collective investment schemes, reflecting an increasing investor preference for conventional & Shari'a-compliant investment products originating and managed in the region.
- The DIFC, through the Nasdaq Dubai offers an electronic platform for the primary listing, secondary trading and custody of bonds and Sukuk, ETFs and derivatives.
- NASDAQ Dubai currently largest global exchange in terms of value of listed Sukuk, with 21 Sukuk, valued at $16.7 bn. (as of 8th Nov09)
- Setting up RAPID: an RTGS which will clear and settle $ and Euro in Dubai time zone

# DIFC White Paper: Holistic Approach

- **DIFC staff has prepared a White Paper with a plan for the development of a debt market in the UAE detailing the steps for the UAE Federal Authorities**

- **The White Paper has been submitted to the major banks operating in the DIFC and in the UAE, the members of the GSBA, the Dubai Financial Services Authority, Nasdaq Dubai**

- **The version incorporating all comments and the outcome of the discussion among stakeholders has been circulated to the IMF to benefit from its experience.**

# DIFC White Paper: Main Planks I

- *Systematic program of issuances along the maturity spectrum aiming to create a yield curve and benchmarks, stating in advance the terms & conditions and the amount*
- *Homogeneous characteristics (coupons, legal obligations, transaction costs and custody fees)*
- *The fiscal authorities will also have to consider how important infrastructure projects will be funded, even if they are not typically the subject of direct government funding*
- *Standardization of Islamic securities*
- *A debt management office that defines the long term program and carries out the role of front, middle and back office*
- *Simplification of listing procedures on Nasdaq Dubai for public debt securities*

# DIFC White Paper: Main Planks II

- ***A Primary Dealer system to ensure participation in auctions***
- ***A regulatory environment which suitably promotes a meaningful disclosure of terms, conditions and risks without a heavy regulatory environment for Banks, Insurances, Brokers, Primary Dealers, Pension Funds, Asset Managers.***
- ***An efficient market infrastructure easily accessible by residents and non- resident investors, with a key role in ensuring the success of the issuance assigned to reputable primary dealers.***
- ***Central Bank, designated as fiscal agent of the government, should accept government securities as collateral for repos***
- ***Banks should hold a minimum percentage of their statutory/liquid reserves in government paper***
- ***From government securities to corporate bonds, to MBS, to securitized paper, to derivatives and hedging instruments***

# The IFC Sukuk listing

On 4th Nov, 2009 the International Finance Corporation, an affiliate of the World Bank listed a Sukuk on the DIFC's international exchange, Nasdaq-Dubai & Bahrain Exchange.

- The IFC Hilal Sukuk is a dollar-denominated $100 million issue, Aaa rated, with a five-year maturity.
- It is the **first time that a non-Islamic financial institution issues a Sharia compliant security** for term funding.
- It is also the first time that a sizeable Sukuk will be **listed exclusively in the Gulf,** i.e. on Nasdaq Dubai and the Bahrain Stock Exchange - an acknowledgment of the progress made by the emerging financial sector in the region, in terms of liquidity, trading, clearing & settlement, and the legal and regulatory environment.
- The Hilal Sukuk will **raise funds for IFC infrastructure and health projects** in Yemen and Egypt, stressing the ideal suitability of Islamic finance for the financing of tangible, real assets. Given the infrastructure projects in the pipeline, this issue underscores the opportunity in project/infrastructure financing.
- So far a **liquid Sukuk secondary market in the region** has struggled to emerge in part due to a shortage of high quality securities compared to the demand by a host of Islamic institutions (which typically buy and hold most of the supply). The IFC issue might help turn the tide!

# Concluding Remarks

- The development of a capital market is a multi-faceted undertaking. Above all, a sound macroeconomic framework and policies are an essential pre-requisite. When a government commits to the development of a bond market it acts as catalyst, issuer, and regulator

- Embryonic markets need to be created through a carefully structured plan and continuously nurtured in order to achieve critical mass and sustainable growth.

- The successful launch of a bond market for long-term instruments requires a holistic approach in enacting complementary policies such as an enabling legal environment, good corporate governance principles, risk management and treasury management systems. Efficiency of bond markets would depend on standards of accounting, auditing and disclosures, institutional infrastructure, and prevalence of an environment for enforcement of contracts.

# Action points & recommendations

- **Developing MENA/GCC debt markets is a policy priority & should be viewed as part of structural solutions to resolving current and future global imbalances.**
- **Existing market infrastructure can support modern debt markets**
- **EMEs/MENA/GCC: Infrastructure, public works, development & housing investments can be major drivers of debt markets**
- **International Financial Institutions (IMF, WB/IFC, BIS) along with regional development banks (EIB, ADB, AfDB, IDB, IADB) should use IS as part of their funding strategy for (a) own Treasury operations and (b) country and regional development finance.**

## The Way Forward: Technical Assistance

- **Technical Assistance by IFIs and central banks**
- **Launch of a "Giovannini" Group to produce a report detailing a Reform Agenda aimed at bridging the gap with best practices**
- **Permanent Working Group on Debt Markets in the MENA region hosted by the DIFC Authority**
- **Commitment on a programme of Bond issuance by Multilateral Institutions (conventional and Islamic)**

# Thank you!