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Financial markets in GCC countries: recent crises and structural weaknesses

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Executive summary

Gulf Co-operation Council (GCC) countries' financial sectors are solid, but not very sophisticated: business is mostly financed through bank lending rather than bonds or stock issues, and banks continue to rely on state support and, in many cases, are directly state owned.

Credit markets have suffered from the post-2008 international crisis, but have made a fairly quick recovery on the back of increased state spending. GCC countries have witnessed some innovation in bond markets after 2009, but otherwise remain conservative.

Financial markets do not play the integrating and innovating role that they should:

- While banks exerted some pressures for improved corporate governance on their creditors after the crisis, these have subsided with renewed credit expansion in 2011.
- Restrictive lending practices contribute to high entry barriers in the private sector and small entrepreneurs have a hard time getting loans.
- Stock markets have lost their lustre as investment channels for GCC countries' citizens after two waves of crashes since 2006, contributing to a disconnect between GCC citizens and the local private sector.

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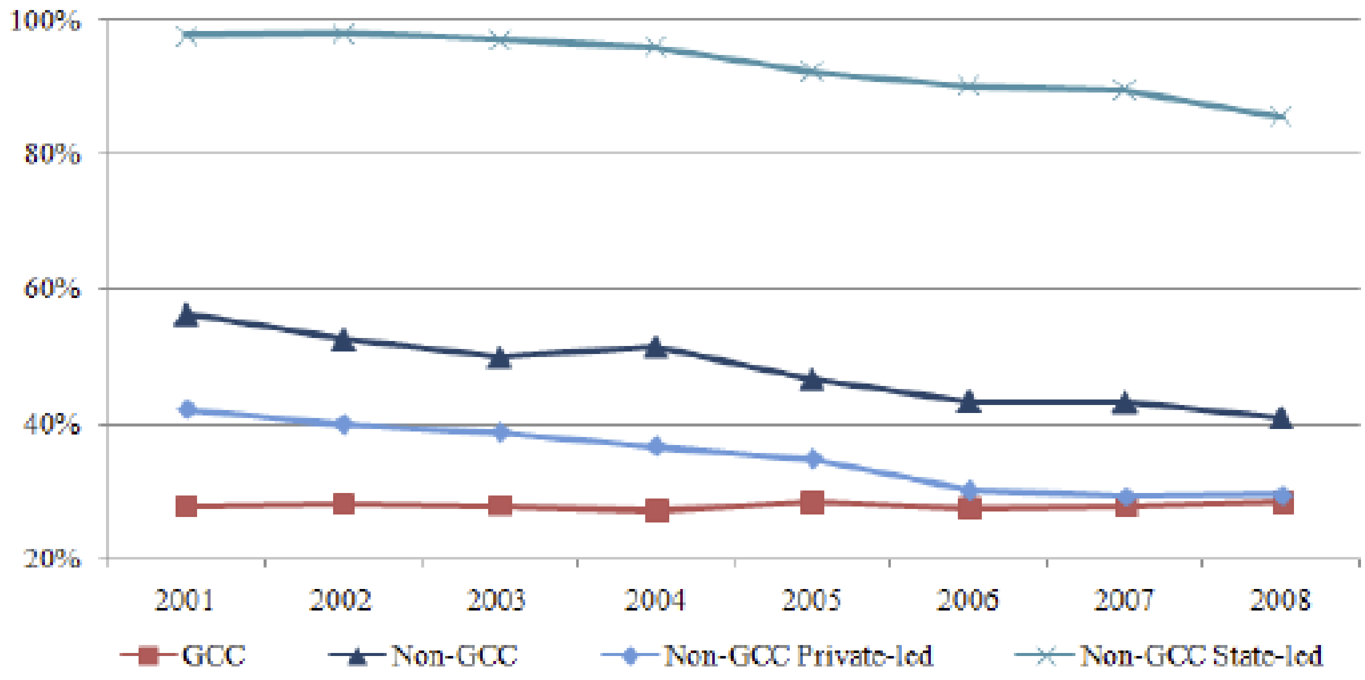
Structure and developmental role of GCC financial service sectors

Financial sectors in Gulf Co-operation Council (GCC) members remain bank dominated. As stock markets and markets for corporate debt (both corporate and Islamic "*sukuk*" bonds) remain relatively underdeveloped, most companies, including very large ones, are financed through retained profits or conventional bank loans.

GCC banks

GCC banks in turn are often part state owned, reflecting the abiding large role of GCC governments in local economic development. While the role of banks with majority state ownership has been trending downwards in the rest of the Middle East and North Africa (MENA) region – albeit starting from higher levels – state banks continue to hold a stable 30% of total assets in GCC countries (see Figure 1).

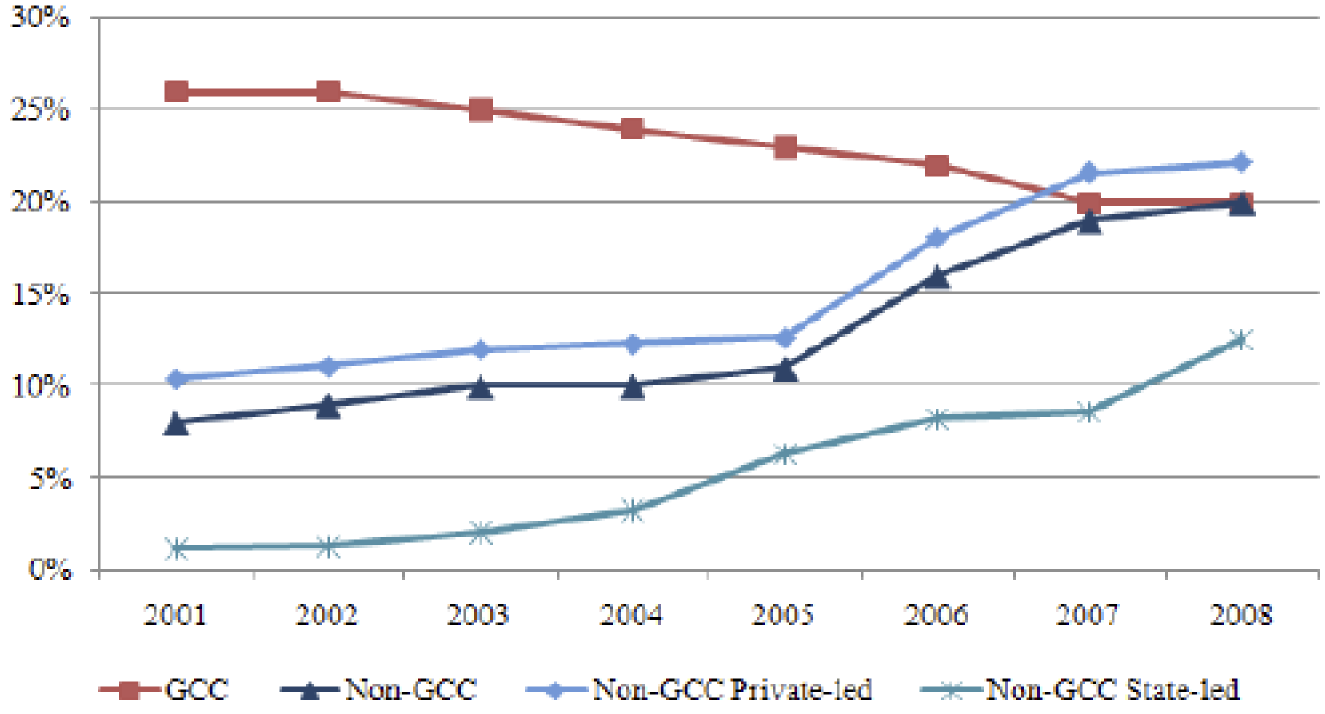
Figure 1: Share of state banks in total assets in MENA, 2001-2008



Source: Subika Farazi, Erik Feyen & Roberto Rocha, "Bank ownership and performance in the Middle East and North Africa region", World Bank Policy Research Working Paper no. 5620, Washington, DC, World Bank, April 2011, p 31

Most non-governmental shares in local banks are held by a limited number of large local merchant families. Foreign ownership is relatively limited, and different from the non-GCC MENA region, the share of majority foreign-owned banks in total assets has been trending downwards over the last decade (see Figure 2).

Figure 2: Share of foreign banks in total assets in MENA, 2001-2008



Source: Farazi, Feyen & Rocha, “Bank ownership and performance in the Middle East and North Africa region”, 2011, p 32

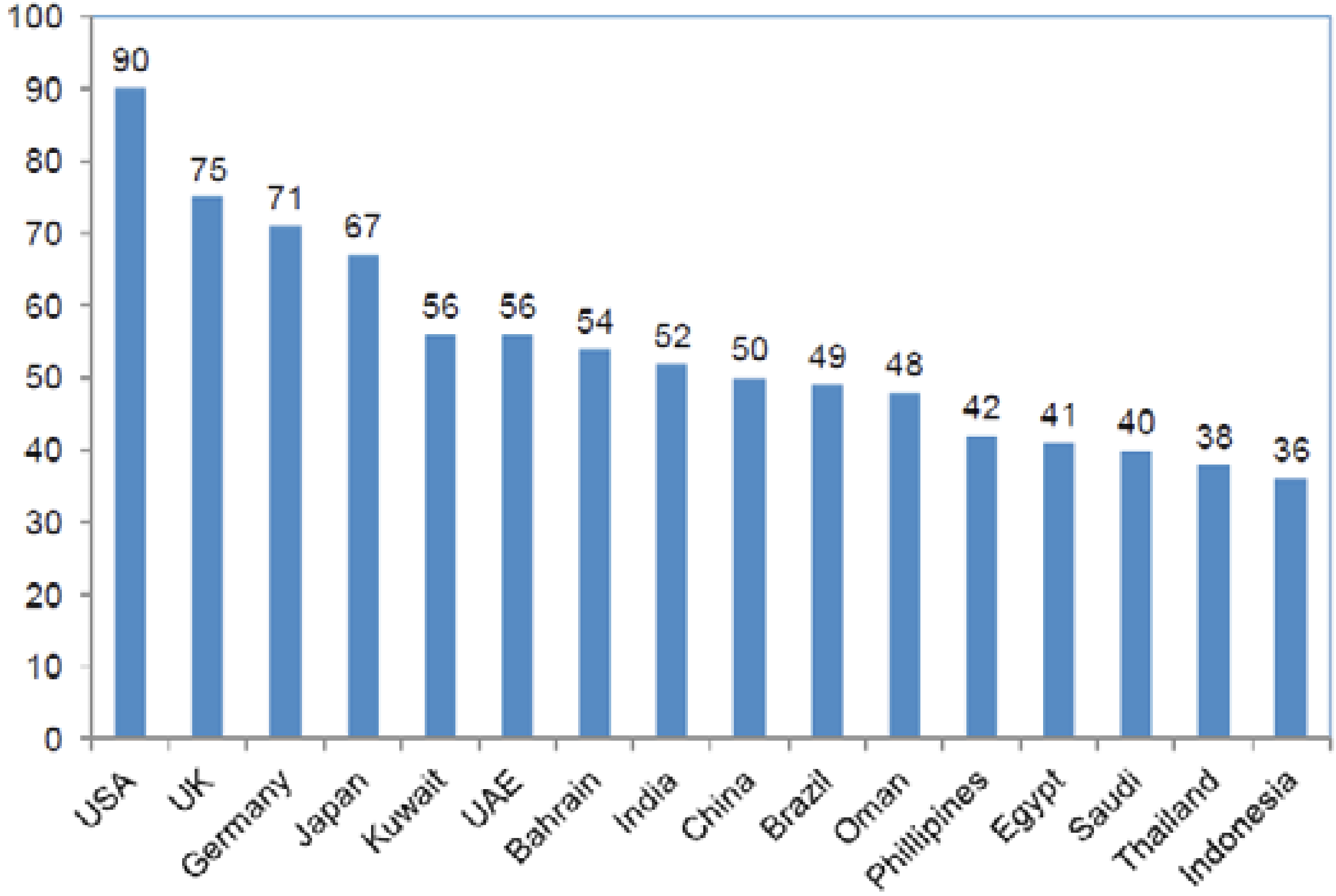
In other words, during the oil boom decade of the 2000s the state retained an important position in local banking and the sector has to some extent become *less* internationalised, contrary to trends in poorer MENA countries that have been subject to liberalisation and globalisation trends.

Stock markets

The role of stock markets in GCC countries' economic development is relatively limited. Total capitalisation reached almost $800 billion in early 2012, corresponding to almost 60% of the region's nominal gross domestic product of $1.4 billion in 2011. While this is not unduly low by international standards (some developed economies like Germany have even lower rates), much of the wealth on the stock market is represented by either partially state-owned companies or companies whose shares are held by a limited number of large investors who often do not trade them actively. State entities control about 30% of the shares on GCC stock markets and the “free float” of actively traded shares is only about half or less of the total (Figure 3).

Trading on GCC countries' stock markets is thin and often speculation based. Few institutional investors such as pension funds are active; there are hence few shareholders with good technical investment knowledge and interest in improving the corporate governance of local companies. None of the GCC stock markets has yet been upgraded to “emerging market” status by international market index providers like MSCI, which contributes to the muted interest of professional international investors in GCC equities.

Figure 3: Equity markets' free float for selected countries (% of total shares)



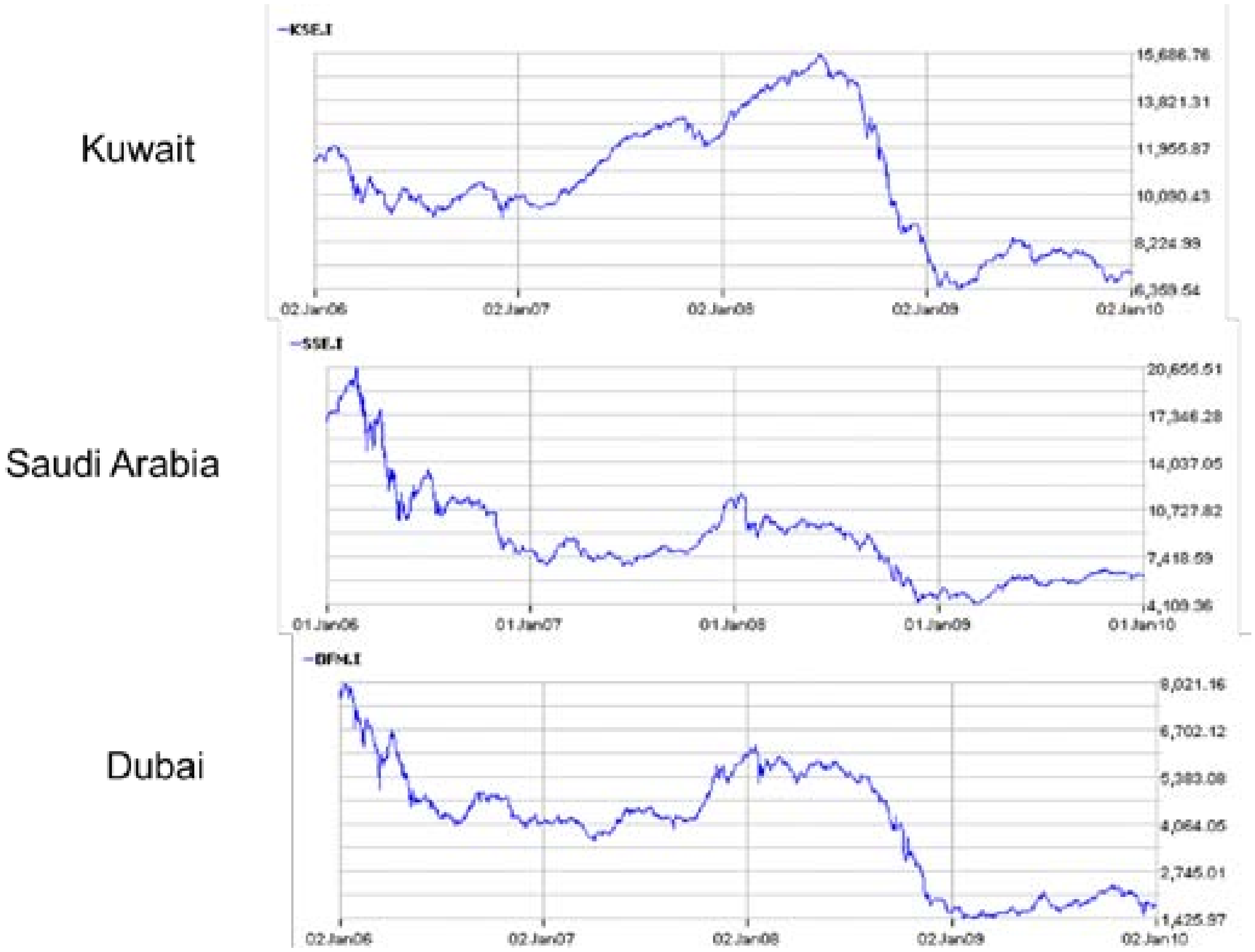
Source: Tahsin Saadi Sedik & Oral H. Williams, "Global and regional spillovers to GCC equity markets", IMF Working Paper no. WP/11/138, Washington, DC, IMF, June 2011, p 20

Most large private sector groups in GCC countries remain family controlled and are not listed on local stock markets; this is one of the reasons why the oil-induced growth spurt in 2010 and 2011 has not been reflected in stock market valuations.

GCC countries' stock markets have gone through two substantial crises: the first occurred in 2006, when a speculative bubble that had built up in the first half of the 2000s burst and valuations declined in Saudi Arabia[1] and Dubai in particular (by 65% and 50%, respectively, from the previous peaks; see Figure 4). The second crisis occurred in the wake of the 2008 international financial crisis, which hit all of the local stock markets and led to valuations that in many cases were a third or less of what they had been in the mid-2000s. Stock prices have stagnated since then.

[1] While the focus of this paper is supposed to be on the five smaller GCC countries, I have also included Saudi Arabia in the discussion, as it is in many ways the bellwether of GCC economic development.

Figure 4: Stock market valuations in Kuwait, Saudi Arabia and Dubai, 2006-2010



Source: HSBC

The 2006 stock market crisis in particular generated huge losses for hundreds of thousands of unsophisticated local retail investors who had been drawn into the stock market frenzy of the first half of the decade. There was a popular backlash against large investors who had been "gaming the market". Although stock market regulation and policing of insider trading in particular have somewhat improved over the last five years, stock markets have yet to recover their previous popularity as investment vehicles for GCC nationals.

Bond markets

Bond markets have historically been even more underdeveloped in GCC countries than stock markets. The share of private sector companies issuing bonds remains limited, but GCC governments and state-owned enterprises have increasingly taken to financing large projects through conventional bonds or Islamic "*sukuk*" bonds.

According to Bloomberg, GCC *sukuk* offerings totalled $17.4 billion in the first half of 2012, twice as much as the $8.7 billion for non-Islamic bonds. This is more than twice what was issued in 2011, indicating a substantive deepening of the market for debt instruments – although few of these are held by retail investors.

The impact of the international financial crisis since 2008

The post-2008 international financial crisis initially seemed to bypass GCC countries, but then triggered several parallel crises in 2009. The more visible, but structurally less important one was Dubai's sovereign debt crisis, which started with the debt default of state-owned Dubai World in November 2009. The Dubai crisis was a result of highly leveraged local and international investments by mostly state-owned companies and had limited spillover effects in the other GCC countries.

The international financial crisis, however, had parallel effects on private investors in other GCC countries, as it caused:

- losses for private GCC investors with overseas assets, some of whom were heavily leveraged;
- a freeze in international funding for GCC banks (which impacted the United Arab Emirates – UAE – in particular); and
- a freeze in international project finance.

These processes triggered solvency crises in numerous large and mid-sized local investment firms in Kuwait and Bahrain, and solvency and liquidity crises for several large family business groups, including the Saad Group and the Al-Gosaibi family in Saudi Arabia, Al-Khorafi in Kuwait, and the Abdullah brothers in Dubai. In several cases, the crisis led to the discovery of large-scale malfeasance and fraud, and a collapse of trust in local banking markets, which to a significant extent had operated on the basis of personal networks.

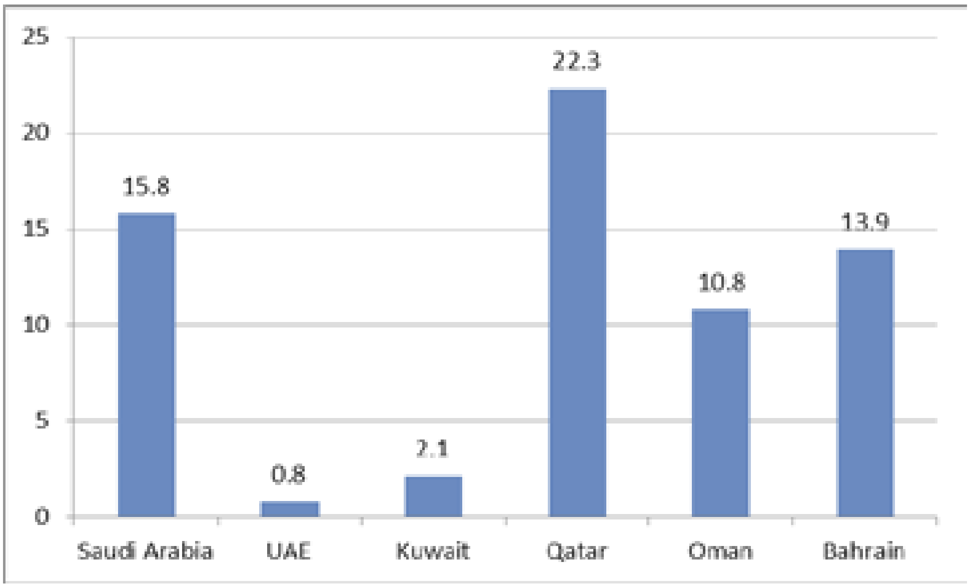
A strong decline in local real estate values in GCC countries was both a result of the international crisis and a contributing factor of the local financial crisis, as many business families and investment firms were heavily invested in speculative real estate projects. A temporary freeze of bank credit markets from late 2009 onwards affected even healthy businesses, stunting private sector growth. As a result, practically all large-scale investment projects since 2010 have been state initiated, as cash-rich governments have strongly increased their capital expenditure as a counter-cyclical measure.

Current status and outlook

Although stock markets remain in the doldrums, other financial sectors in GCC countries have recovered from the post-2008 crisis. The Arab Spring has had a negligible effect on the sector – with the important exception of Bahrain, whose reputation as a regional financial hub has probably been irreparably damaged by the local political unrest since early 2011, which has led to the exit of several important financial institutions. In some cases, notably Dubai, GCC countries have acted as a safe haven for Arab investors from unstable countries.

The year-on-year growth of total revenues for GCC banks reached 10% in 2011, while loan-to-deposit ratios and non-performing loans (which had shot up to 15% of the total in the case of Dubai) have continued to decline, indicating a more solid financial basis for local banks. Figure 5 shows that all countries saw at least some growth in the provision of loans to the private sector in 2011.

Figure 5: Growth in loans to the private sector in 2011 (%)



Source: Boston Consulting Group

Much of this expansion, however, remains state driven and reflects loans to finance private contractors who work on government projects. It is revealing that loan growth has stagnated in the two countries where state spending remains frozen, i.e. the UAE and Kuwait. The two growth leaders, Qatar and Saudi Arabia, are also the two countries with the largest increases in infrastructure spending.

Bank lending generally remains risk averse, short term and focused on larger companies. While there is much talk about supporting small and medium-sized enterprises (SMEs), banks have shown little action in this regard: there is relatively less SME lending than in the rest of MENA, although banks in the rest of the region themselves lend less to SMEs than is typical for emerging markets.

For at least another five years none of this is a major concern, because governments (with the partial exceptions of Bahrain and Oman) have enough overseas resources to drive economic growth through their own spending. In the long run, however, the limited developmental role of the financial sector in GCC countries is a serious challenge to sustainable and private sector-driven diversification.

Specific development challenges and opportunities

Perhaps the most striking positive development in the wake of the Eurozone crisis has been the emergence of a *stronger local bond market* to finance large-scale development projects. This has been indirectly triggered by the collapse of European project finance, which previously accounted for the majority of large syndicated loans in GCC countries. While most projects remain state sponsored, the local *sukuk* market increases the region's resilience to international crises and provides new opportunities for local investors.

Increasing the *provision of SME loans and venture capital* will remain more difficult: for most GCC banks it is too easy to make money with government projects and loans to big local families. Independent entrepreneurship is hardly supported and financial markets do not play their designated role of widely and efficiently allocating risk and capital. It is likely that here too the state will have to intervene to incentivise broader-based lending to smaller ventures.

Stock markets are likely to continue their gradual improvement in supervision and the *implementation of corporate governance codes*. International institutional investors are likely to slowly enter GCC markets and add further pressure towards improved governance, but the process will remain haphazard. There is limited scope for any GCC country to become more than a regional financial hub: the global ambitions of both Qatar and Dubai have been scaled back significantly in recent years.

The large family business failures of recent years have also caused banks to increase *pressure for better accounting, business planning, and the separation of management and ownership in non-listed family companies*. These pressures have receded since 2011, however, as government spending sprees have injected much liquidity into both the banking sector and the private sector at large. Whether there will be a meaningful evolution towards professional family business management remains to be seen.

The political role of GCC financial markets

Until the stock market crashes of 2006, GCC governments had pursued a deliberate policy of creating a local brand of "popular capitalism", notably through under-pricing initial public offerings of state-owned companies and assuring a wide distribution of their shares through subscription rules that favoured small retail investors. This policy could in principle have led to a stronger integration of GCC countries' citizens into the private economy, from which they are otherwise largely excluded, because the majority of national employees hold jobs in the public sector (and the private sector pays no taxes from which citizens could indirectly benefit).

Due to the various post-2006 crashes, the popular capitalism idea has arguably backfired, alienating local investors from stock markets and creating a polarisation between small-time stockholders and well-connected "big fish" who manipulate local markets. For the time being, stock markets are just another sector in which the interests of large businesses and GCC countries' citizens appear to be at odds.