

# Impact of the Global Financial Crisis on the Gulf Cooperation Council Countries and Challenges Ahead



Prepared by a team led by May Khamis and Abdelhak Senhadji and comprising Maher Hasan, Francis Kumah, Ananthakrishnan Prasad, and Gabriel Sensenbrenner

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## Acronyms

ABC	Arab Banking Corporation
CAR	Capital adequacy ratio
CBK	Central Bank of Kuwait
CDS	Credit default swaps
DIFC	Dubai International Financial Center
DSM	Doha Securities Market
DW	Dubai World
FDI	Foreign direct investment
FSI	Financial soundness indicator
GCC	Gulf Cooperation Council
GD	Government of Dubai
GIB	Global Investment Bank
GREs	Government-related entities
ICs	Investment companies
IPO	Initial public offering
MENA	Middle East and North Africa
MENAP	Middle East, North Africa, Afghanistan, and Pakistan
MOCI	Ministry of Commerce and Industry
MoUs	Memoranda of Understanding
NPLs	Nonperforming loans
OFCs	Offshore financial centers
PCA	Prompt corrective action
QCB	Qatar Central Bank
QFC	Qatar Financial Center
REER	Real effective exchange rate
SWFs	Sovereign wealth funds
UNCTAD	United Nations Conference on Trade and Development





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## Executive Summary

*The countries of the Gulf Cooperation Council (GCC) have not been left unscathed by the global financial crisis. But countercyclical policies and financial sector support measures made possible by reserves accumulated during the 2003–08 oil price boom have helped contain its impact. Nevertheless, while the medium-term outlook remains broadly positive, the crisis has revealed some vulnerabilities in the region’s financial markets that need to be addressed to limit future disruptions.*

The oil price boom led to large fiscal and external balance surpluses in the GCC countries. But it also generated domestic imbalances that began to unravel with the onset of the global credit squeeze. Buoyant economic activity, rising consumer and investor confidence, and abundant liquidity fueled credit growth, inflation, and asset price increases. In some countries, banks’ growing dependence on foreign financing and exposure to real estate, construction lending and—to a lesser extent—the equity market, contributed to balance sheet vulnerabilities. In the corporate sector, the boom was associated with higher leverage, which increased vulnerabilities to a reduction in the availability, and higher costs, of financing.

As the global deleveraging process took hold, and oil prices and production fell, the GCC’s external and fiscal surpluses declined markedly, stock and real estate markets plunged, credit default swap (CDS) spreads on sovereign debt widened, and external funding for the financial and corporate sectors tightened. As a result, of an estimated \$2.5 trillion in projects at different stages of planning and implementation at end-2008, around \$575 billion had been placed on hold by end-2009. Banks, however, remained profitable despite adverse conditions, and generally showed adequate capacity to absorb potential losses as capital adequacy ratios in most countries were already high going into the crisis.

To offset the shocks brought on by the crisis, governments—buttressed by strong international reserve positions—maintained high levels of spending and introduced exceptional financial measures, including capital and liquidity injections. As part of a five-year \$400 billion investment plan, Saudi Arabia passed a stimulus package that is the highest (as a share of GDP) among the G-20. These measures helped sustain growth in the GCC, had positive spillovers for neighboring countries, and contributed to global demand during the global economic downturn.

Looking ahead, while the GCC’s short-term economic outlook may be clouded by recent developments concerning Dubai World, the medium-term outlook for the region remains broadly positive. External funding for nonbanks has generally shown positive signs since early 2009. Non-oil GDP growth is estimated at just below 2.8 percent in 2009, and the rebound in

growth in 2010 is expected to be stronger than in advanced economies. Headline inflation is estimated to have fallen from double-digit levels in 2008 to less than 3 percent in 2009. The external and fiscal surpluses have weakened in 2009, but are expected to recover partially in 2010 in line with the expected increase in oil prices. However, developments in Dubai have temporarily disrupted the recovery in regional equity markets and the decline in CDS spreads experienced since early 2009.

### Policy Challenges

*The immediate priority is to complete the cleanup of bank balance sheets and the restructuring of the nonbanking sector in some countries. Clear communication by the authorities would help implementation, ease investor uncertainty, and reduce speculation and market volatility.*

**The banking sector.** GCC countries should conduct periodic reviews of banks' asset quality, in addition to stress testing, to determine whether the level of capital support is sufficient. Where possible, recapitalization should be based on private sector capital injections to minimize moral hazard, and the authorities should reverse public sector injections as soon as market conditions allow it. Specifying rules for bank interventions triggered by objective criteria through a prompt corrective action framework will help ensure that banks address emerging problems quickly.

**The nonbank financial sector.** The authorities should facilitate the restructuring of nonbank institutions—particularly in Kuwait and the U.A.E.—including by supporting viable entities while ensuring a smooth exit of nonviable institutions. Regulatory and supervisory weaknesses should also be addressed.

*Over the medium-term, these measures should be accompanied by improved disclosure; an expanded set of macroprudential tools to support monetary and fiscal policies; and regulatory and supervisory frameworks that focus on ensuring the stability of the financial system as a whole.*

**Corporate governance and transparency.** Improving corporate governance and transparency is a priority, since lenders' risk aversion has put pressure on GCC conglomerates to enhance disclosure. Encouraging family businesses to go public could help, and there is a need for better corporate governance and transparency in state-owned/affiliated enterprises. GCC countries should also make their banking sectors' financial soundness indicators available on a timely basis, as delays increase speculation and complicate the market's ability to conduct a timely analysis.

***Excess liquidity and asset price bubbles.*** To tackle any resumption of speculative inflows, overheating pressures, and asset price inflation, reserve requirements should be used actively and prudential limits on banks strictly enforced. A capital gains tax on property and equity transactions could be considered.

***Macroprudential regulation and supervision.*** A macroprudential approach that focuses on the stability of the financial system as a whole, as well as its links to the macroeconomy, is warranted. Policies should aim to insulate the GCC countries' financial system as much as possible from the oil cycle. Regulations should promote prudent provisioning—similar to case of Saudi Arabia, which has already been implementing countercyclical provisioning policies—and capital buffers over the business cycle. Excessive corporate sector leverage should be avoided, and spillover risks from offshore financial centers monitored and addressed. Cross-border cooperation should be enhanced and the timeliness and coverage of financial and macroeconomic data improved to enable the authorities to conduct effective surveillance.

***Diversification.*** Ongoing initiatives to diversify financing channels away from banks should be pursued. The development of bond markets will require the governments' commitment to issue their own securities in a full range of maturities and in a fairly systematic way. Structural reforms aimed at diversifying real sector economic activity should focus on facilitating private sector activity, including by further streamlining business registration procedures and reducing administrative barriers to investment.



## The Run-up to the Crisis: The Boom Years

*The 2003–08 oil price boom strengthened GCC countries' fiscal and external balances and placed them in a relatively strong position to confront the global crisis. However, the boom resulted in rapid credit growth, a rise in inflation and asset prices, and a buildup of financial sector vulnerabilities, in a context of limited countervailing policy tools in view of the peg to the U.S. dollar.*

### Buoyant Economic Activity, Diversification, and Stronger Fiscal and External Balances

The 2003–08 oil price boom spurred economic activity in the region and strengthened balance sheets in all sectors. Overall growth averaged 6.6 percent a year, three percentage points above the pre-oil price boom period (1997–2002). Non-oil growth—the appropriate measure of job-creating economic activity in oil-exporting countries—averaged 7.3 percent a year during the same period, compared to 4.8 percent during 1997–2002 (Table 1). Table 2 provides a set of key economic indicators across the region as of end-2008.

Fiscal and external positions improved markedly (Figure 1), providing the fiscal space necessary to address the overarching policy challenges of diversifying the economy and reducing unemployment, while preserving oil wealth for future generations. The region-wide budget contribution to aggregate demand—measured as the non-oil primary deficit—jumped by 10 percentage points from its average in the pre-boom years, to 51 percent of non-oil GDP at end-2008. The value of GCC investment projects (planned and under implementation) increased from \$300 billion at end-2004 to \$2½ trillion at end-2008—representing a more than seven-fold increase in fixed investment spending (Figure 2).<sup>1</sup> Investments were broad-based in all countries—except the U.A.E., where they were more concentrated in construction—and thereby contributed to economic diversification,<sup>2</sup> with the ratio of real non-oil GDP to overall real GDP increasing by 3 percentage points during 2003–08, to 64 percent (Figure 3).

---

<sup>1</sup>Source: MEED (a Middle East Business Intelligence group). The U.A.E. and Saudi Arabia dominate project activity.

<sup>2</sup>Investments spanned the hydrocarbon sector and related infrastructure development, construction, the industrial sector, water and waste, and power.

**Table 1. GCC: Average Annual Real GDP Growth, 1991–2008**  
(Percent change)

	Oil Real GDP			Non-oil Real GDP			Overall Real GDP		
	1991– 2002	1997– 2002	2003– 08	1991– 2002	1997– 2002	2003– 08	1991– 2002	1997– 2002	2003– 08
Bahrain	5.7	6.7	-3.1	4.5	4.0	9.3	4.8	4.7	6.9
Kuwait	12.3	9.1	7.3	7.5	6.8	9.8	8.1	7.2	8.7
Oman	9.7	15.0	1.0	6.3	6.5	9.2	7.3	9.3	5.8
Qatar	9.8	16.1	10.8	4.1	5.5	15.6	6.8	10.6	13.0
Saudi Arabia	1.2	-1.7	5.8	3.0	3.5	4.6	2.4	1.7	4.9
U.A.E.	-1.6	-0.1	3.9	8.6	7.3	9.9	4.1	4.7	8.3
<b>GCC</b>	<b>5.1</b>	<b>1.7</b>	<b>5.6</b>	<b>4.7</b>	<b>4.8</b>	<b>7.3</b>	<b>4.0</b>	<b>3.7</b>	<b>6.6</b>

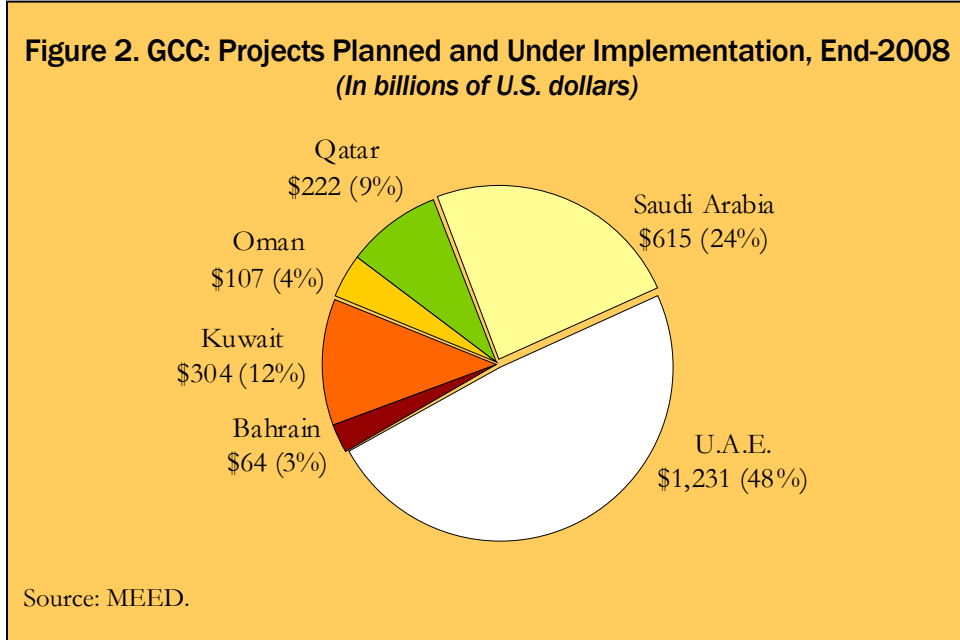
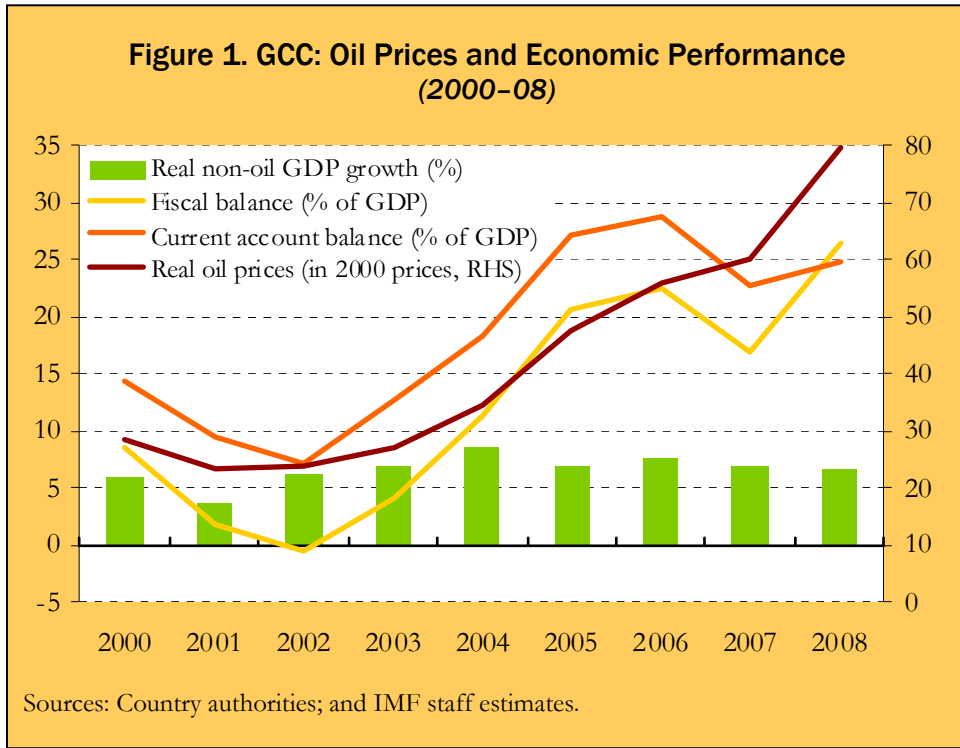
Source: Country authorities.

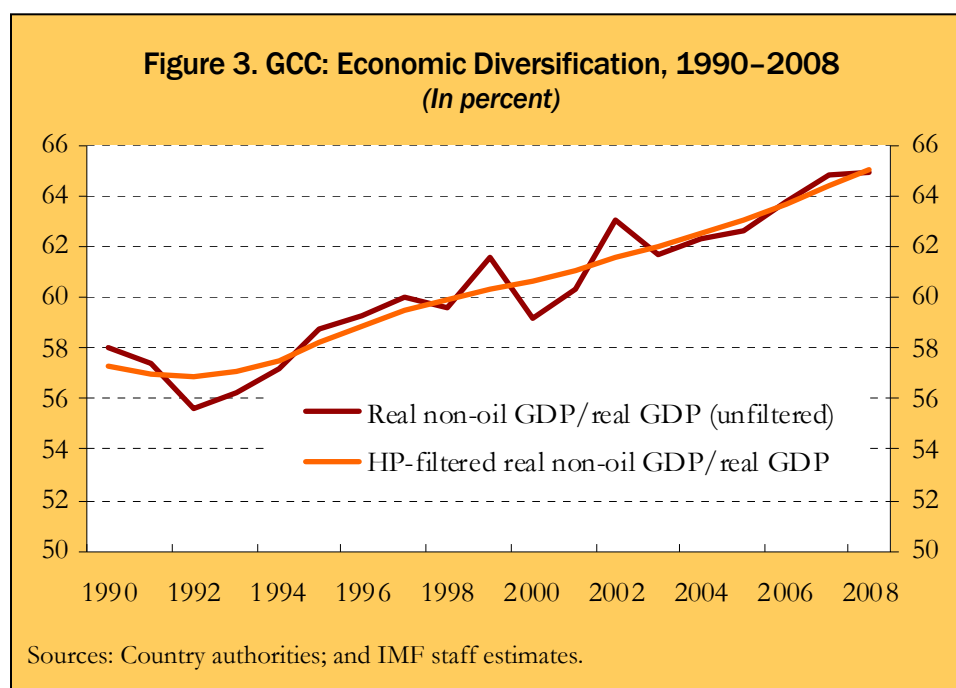
**Table 2. GCC: Selected Economic Indicators for 2008**

	Bahrain	Kuwait	Oman	Qatar	Saudi Arabia	U.A.E.	GCC Total
Population (in millions)	0.8	3.4	2.8	1.1	24.9	4.8	37.8
Nominal GDP (in billions of U.S. dollars)	21.2	148.2	59.9	100.4	469.4	261.4	1,060.6
GDP per capita (in thousands of U.S. dollars)	27.2	43.0	21.6	91.5	18.9	54.8	28.4
PPP GDP per capita (in thousands of U.S. dollars)	34.7	39.9	24.7	86.0	23.8	38.9	35.9
Oil reserves (in % of global reserves)	0.0	8.7	0.4	2.2	21.0	7.8	40.1
Gas reserves (in % of global reserves)	0.1	2.0	1.3	33.5	10.0	8.5	55.3
Spare capacity (in % of OPEC capacity)	0.0	8.0	0.3	1.7	56.5	7.6	74.1
Growth past 5 years (average, 2004–08)	6.9	5.1	6.9	14.3	4.3	7.6	6.0
Fiscal balance (in % of GDP)	8.0	34.0	13.9	11.5	33.0	20.5	26.5
Current account balance (in % of GDP)	10.6	43.7	9.1	33.0	28.6	8.5	24.7
Oil revenue (in % of total revenue)	85.3	76.8	87.4	56.8	89.3	80.4	82.1
Oil exports (in % of total exports)	79.6	95.0	76.0	91.4	89.6	42.8	78.1
Inflation (year average)	3.5	10.6	12.6	15.0	9.9	11.5	10.7
Share of GCC Nominal GDP (in %)	2.0	14.0	5.7	9.5	44.3	24.6	100.0

Sources: Country authorities; and IMF staff estimates.







The large increase in oil revenue and prudent fiscal management resulted in fiscal surpluses averaging 26 percent of GDP by 2008, compared with minimal surpluses, or even deficits, in the pre-boom years. Part of these surpluses was used to retire domestic and external debt, resulting in a decline in total government debt from 66 percent of GDP in 2002 to 12 percent by end-2008 (Table 3).<sup>3</sup> Despite significant increases in import demand, the GCC's external current account surplus more than doubled to \$262 billion (24 percent of 2008 GDP), from 7 percent in 2002. The buildup of international reserves also reached record levels. Gross official reserves increased tenfold during 2003–08, to \$515 billion, over a year of prospective imports (Figure 4).<sup>4</sup> Sovereign wealth funds (SWFs) also accumulated significant wealth during this period, with market estimates of their assets ranging from \$600 billion to \$1 trillion at end-2008.

### Credit and Asset Price Boom

Most GCC countries, in particular Qatar and the U.A.E., experienced significant increases in banking system credit to the private sector during 2003–08 (Figures 5 and 6). Real average credit growth was close to 23 percent a year during 2003–08, which led to increasing bank leverage and almost doubling the ratio of private sector credit to non-oil GDP to

<sup>3</sup>The reduction in government debt was most significant in Qatar and Saudi Arabia.

<sup>4</sup>The buildup of gross official reserves by Saudi Arabia dominated the total increase; assets of SWFs for countries that have them (Kuwait, Oman, Qatar, and the U.A.E.) are not included in gross official reserves.

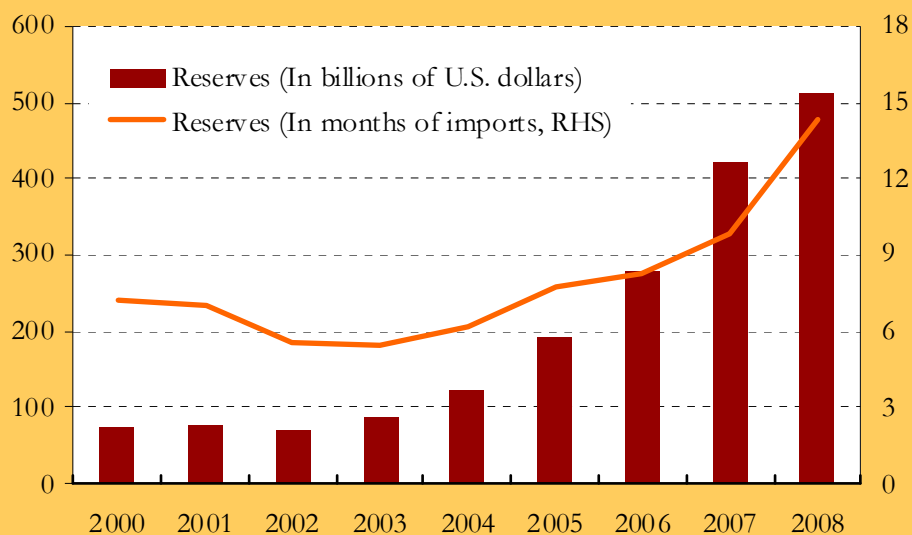
**Table 3. Government Debt, Official Reserves, and External Current Account Balances**  
(In percent of GDP, unless otherwise indicated)

	Government Debt		Gross official Reserves <sup>1</sup>		Current Account Balances	
	2002	2008	2002	2008	2002	2008
Bahrain	32.1	15.2	1.4	3.8	-0.7	10.6
Kuwait	29.9	5.3	8.4	16.7	11.2	40.8
Oman	18.1	5.0	3.2	11.4	6.8	9.1
Qatar	47.9	15.4	1.5	9.8	21.9	33.0
Saudi Arabia	96.9	13.5	42.0	441.9	6.3	28.6
U.A.E.	5.2	15.1	15.3	30.9	4.9	8.5
<b>GCC</b>	<b>65.8</b>	<b>12.4</b>	<b>71.9</b>	<b>514.6</b>	<b>7.3</b>	<b>24.4</b>

Source: Country authorities.

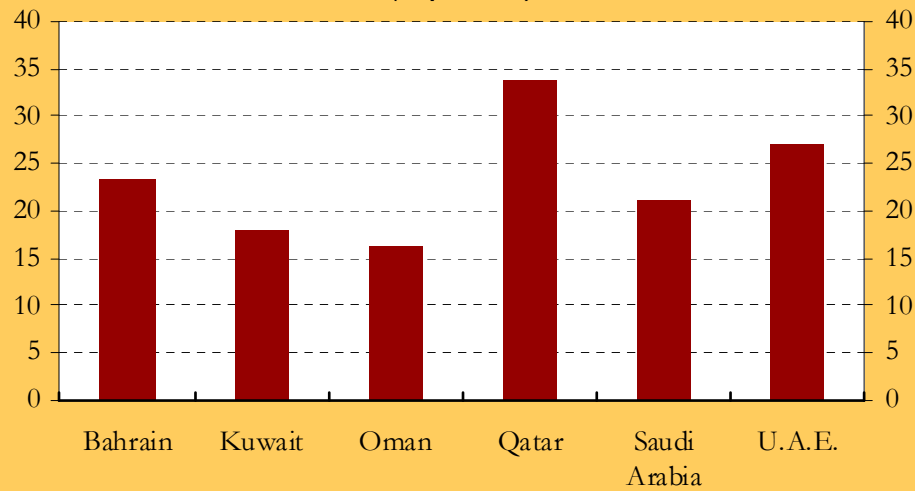
<sup>1</sup>In billions of U.S. dollars. Gross official reserves for Bahrain, Kuwait, Oman, Qatar, and the U.A.E. do not include assets held by their sovereign wealth funds.

**Figure 4. GCC: Gross Official Reserves, 2000–08**



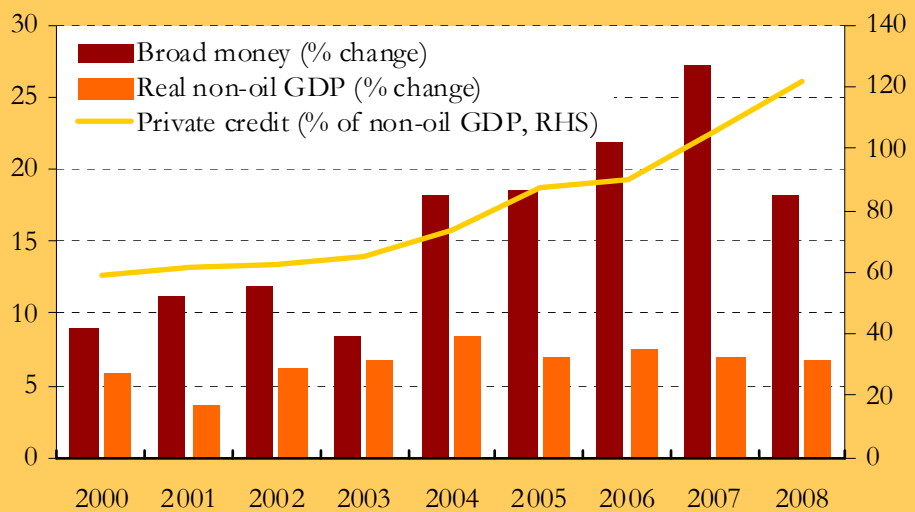
Source: Country authorities.

**Figure 5. GCC: Average Annual Real Growth in Credit to the Private Sector, 2003–08**  
(In percent)



Source: Country authorities.

**Figure 6. GCC: Economic Activity, Money, and Credit, 2000–08**



Source: Country authorities.

122 percent by end-2008.<sup>5</sup> The cumulative deviation from trend credit/non-oil GDP during 2005–08, a simple measure of excess credit, was significant in all countries (except Kuwait and Oman), ranging between 35 percent of the 2008 non-oil GDP in Bahrain and 70 percent in the U.A.E. (Figure 7). Broad money growth averaged 19 percent a year, compared with a pre-boom average of 10 percent. This, together with low interest rates and buoyant economic activity, supported higher demand for real estate and equities, pushing prices up across the region. In some countries, notably the U.A.E., speculative investments contributed to marked increases in real estate prices. Following the stock market decline in 2006, GCC markets posted 22–60 percent gains in 2007, before declining by 29–73 percent in 2008 with the intensification of the global crisis.

### **Inflationary Pressures and the Peg to the U.S. Dollar**

Average GCC headline inflation rose steadily from 1.7 percent in 2004 to 10.7 percent in 2008, fueled by the strong increase in domestic demand and housing shortages, nominal U.S. dollar depreciation, and rising international commodity prices (Figure 8). As the economic cycles in the GCC and the United States diverged significantly in 2007 and the first half of 2008, policy action was limited by the peg to the U.S. dollar. Inflationary pressures, combined with appreciations of the equilibrium real effective exchange rates (REER) given large terms of trade gains (Figure 9),<sup>6</sup> triggered speculative capital inflows into the region, further exacerbating these pressures. As a result, in May 2007, Kuwait abandoned the dollar peg and returned to a peg of a basket of currencies.

### **A Buildup of Vulnerabilities**

In some GCC countries, credit growth went largely into construction and real estate lending, fuelling a real estate boom (Figure 10), and some countries experienced an increase in lending for the purchase of securities.<sup>7</sup> While most of this growth was financed by domestic deposits, banks' foreign liabilities also increased (Figure 11).

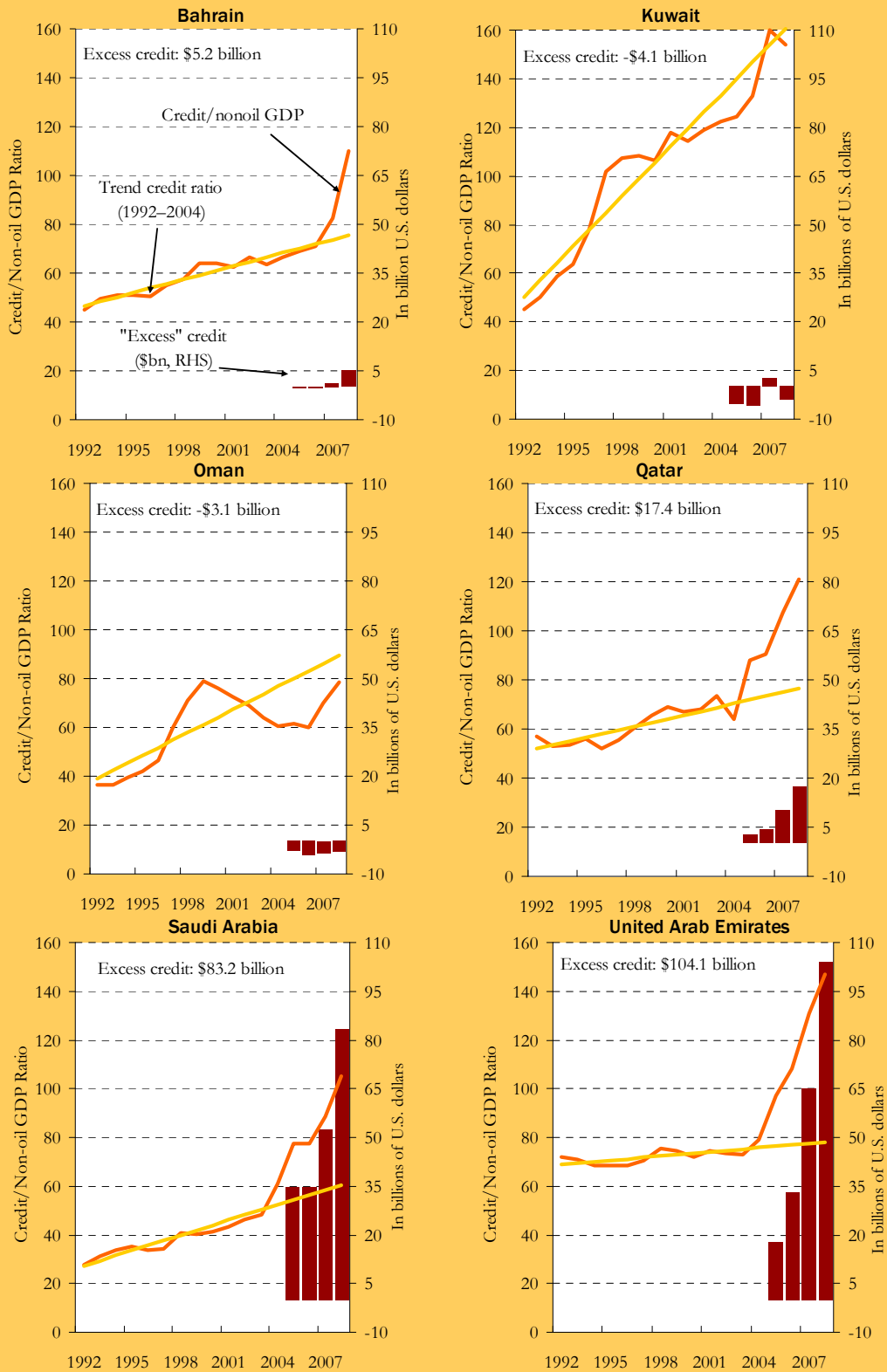
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<sup>5</sup>Non-oil GDP is the more relevant metric to measure credit expansion because the hydrocarbon sector has required little domestic financing in recent years of high oil prices.

<sup>6</sup>The impact of rising inflation on the REER of GCC currencies during this period was largely offset by the depreciation of the nominal effective exchange rate of the U.S. dollar, which resulted in a depreciation of the GCC currencies against their trading partners' currencies, mainly in Asia.

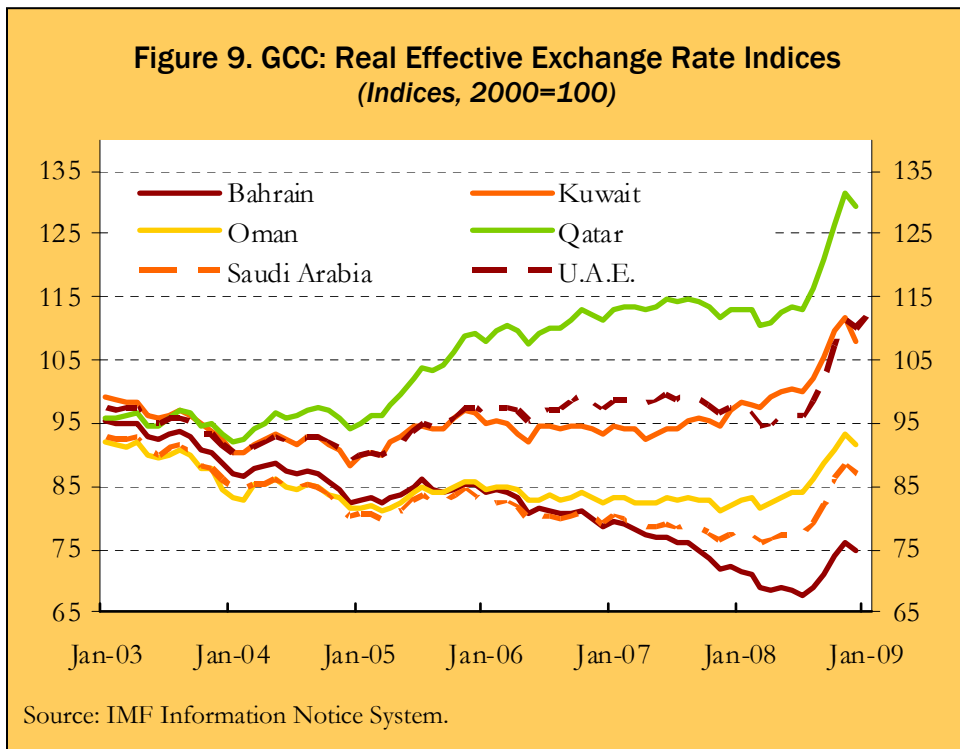
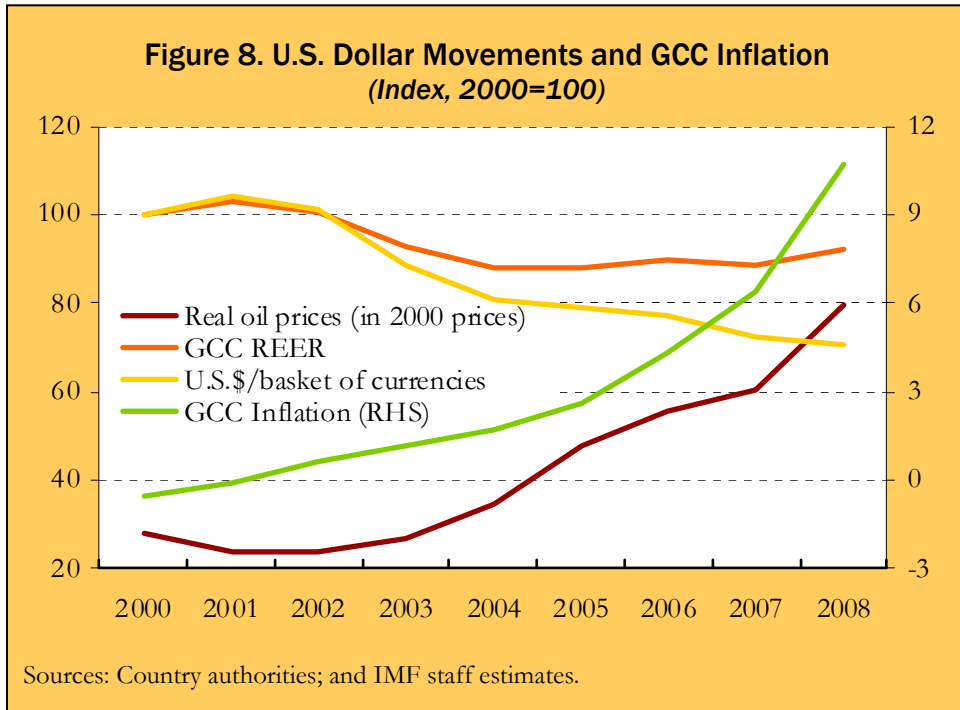
<sup>7</sup>For example, Kuwait bank loans for security purchases amounted to close to 12 percent of the banks' total loan portfolio in 2008. While other GCC central banks do not report bank lending for equity purchases separately, personal loans in other GCC countries might have been used for this objective. (See Mansur and Delgado, 2008, *Stock Market Developments in the Countries of the Gulf Cooperation Council*.)

Figure 7. GCC: Trends in Private Sector Credit, 1992–2008

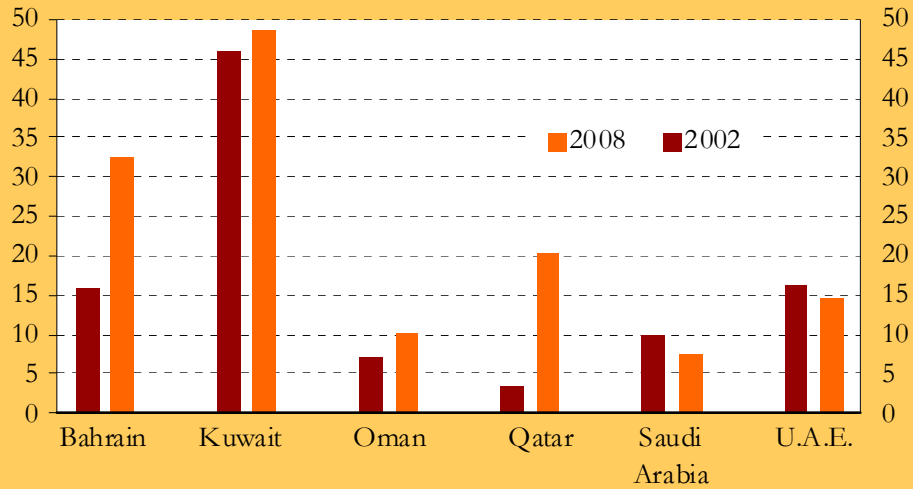


Sources: Country authorities; and IMF staff estimates.

Note: Excess credit indicates the cumulative deviation from trend credit/non-oil GDP for each GCC country during 2005–08.

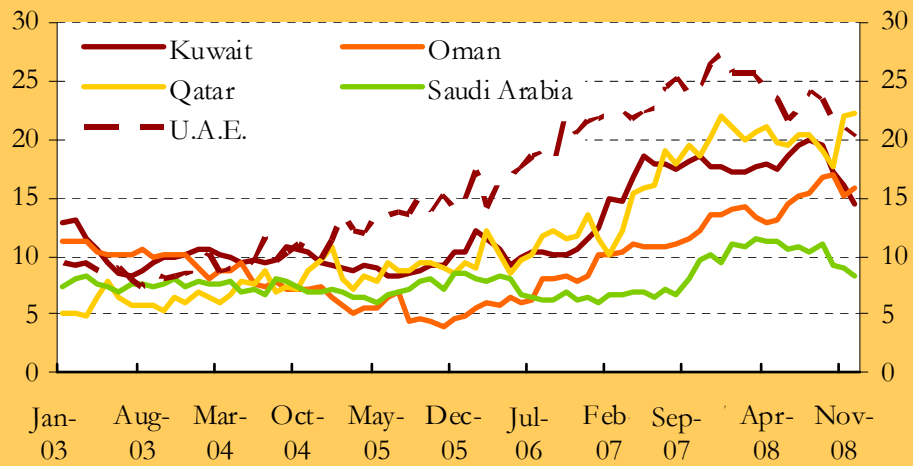


**Figure 10. GCC: Share of Credit to Real Estate and Construction Sectors, 2002 and 2008**  
(In percent)



Source: Country authorities.

**Figure 11. GCC: Foreign Liabilities to Total Liabilities, 2003-08**  
(In percent)

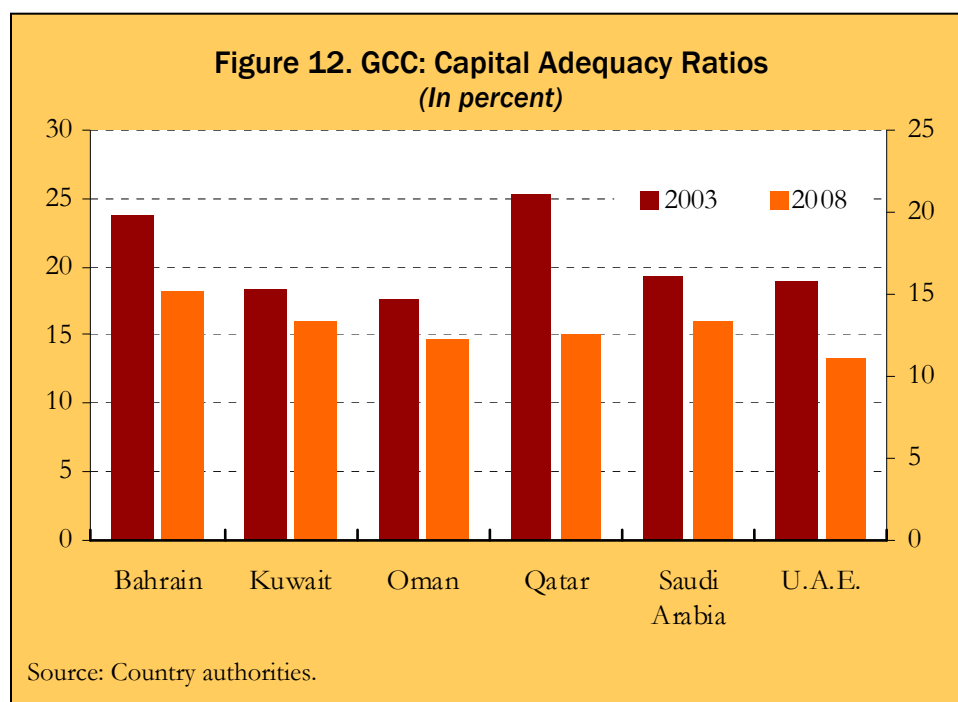


Sources: Country authorities; and IMF staff estimates.

Note: Bahrain is excluded from the chart as the relicensing of some wholesale banks into retail banks in early 2007 complicates the analysis of the ratio of foreign liabilities to total liabilities.

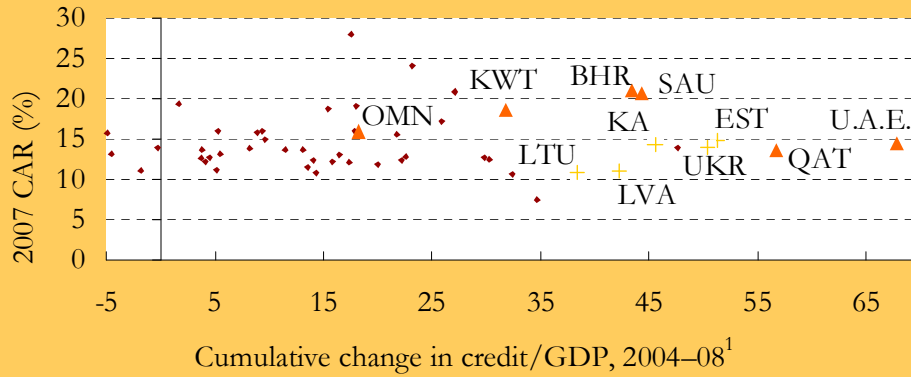


Some of this increase was related to banks' issuance of foreign medium-term notes to address asset-liability maturity mismatches. However, in 2007–08, banks also used short-term speculative foreign deposits to finance their lending, exacerbating maturity mismatches and creating a refinancing risk on their balance sheets. Additionally, higher bank leverage, combined with the more rigorous capital standards of Basel II, resulted in a decline in the CARs of GCC banking systems (Figure 12). Although CARs remained well above regulatory requirements,<sup>8</sup> international experience indicates that exceptionally high credit growth in economic upturns renders banking systems more susceptible to credit losses during a downturn. This is most relevant to Qatar and the U.A.E. (Figure 13). These developments made banking sectors in the GCC more vulnerable to reversals in asset prices, a slowdown in economic activity, and the availability of foreign financing. On the corporate sector side, the boom was associated with a rise in leverage, increasing the sector's vulnerability to funding availability and cost (Figure 14).



<sup>8</sup>Currently, the minimum regulatory CAR is 8 percent in Saudi Arabia, 10 percent in Oman and Qatar, 11 percent in the U.A.E., and 12 percent in Bahrain and Kuwait.

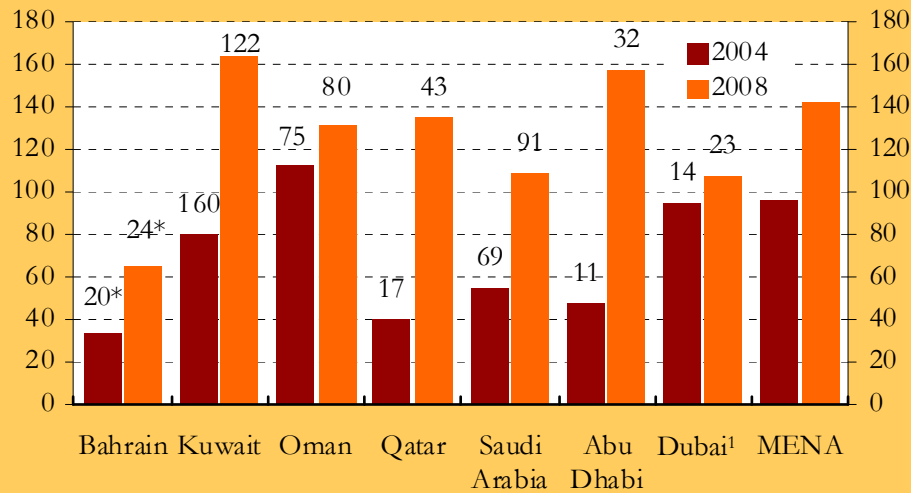
**Figure 13. Credit Growth and Capital Adequacy Ratios in Selected Emerging Countries**



Sources: Country authorities; and IMF staff estimates.

¹For the GCC, GDP is non-oil GDP. Country abbreviations are as follows: BHR: Bahrain, EST: Estonia, KAZ: Kazakhstan, KWT: Kuwait, LVA: Latvia, LTU: Lithuania, OMN: Oman, QAT: Qatar, SAU: Saudi Arabia, U.A.E.: United Arab Emirates, and UKR: Ukraine.

**Figure 14. GCC: Debt-to-Equity Ratios for Listed Companies (In percent)**



Sources: Zawya; and IMF staff estimates.

\* Number of companies.

¹Ratio for Dubai does not include unlisted government-related companies (GREs). Listed GREs included in the ratio are DP World, Dubai Financial, Emaar, and Tamweel.



## The Impact of the Global Crisis and Policy Responses<sup>9</sup>

*As global shocks tightened financing conditions, and oil production and prices declined, the global financial crisis took its toll, particularly on the U.A.E., Kuwait, and Bahrain, given their linkages with global equity and credit markets. Across the region, economic activity contracted in the second half of 2008 and the first half of 2009, and was accompanied by a decline in credit, broad money growth, and inflation. Decisive policy actions by the authorities have helped moderate the effect of the crisis, although its full impact, particularly on the financial sector, may not have materialized yet.*

### Impact of the Crisis

#### ***Declining oil prices and global liquidity shortages***

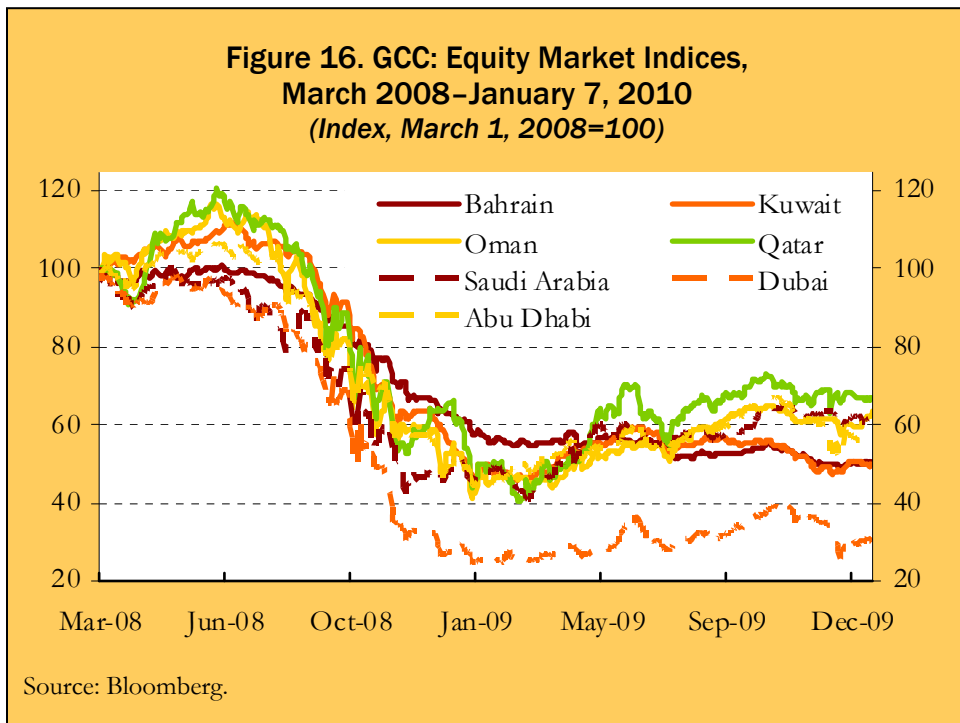
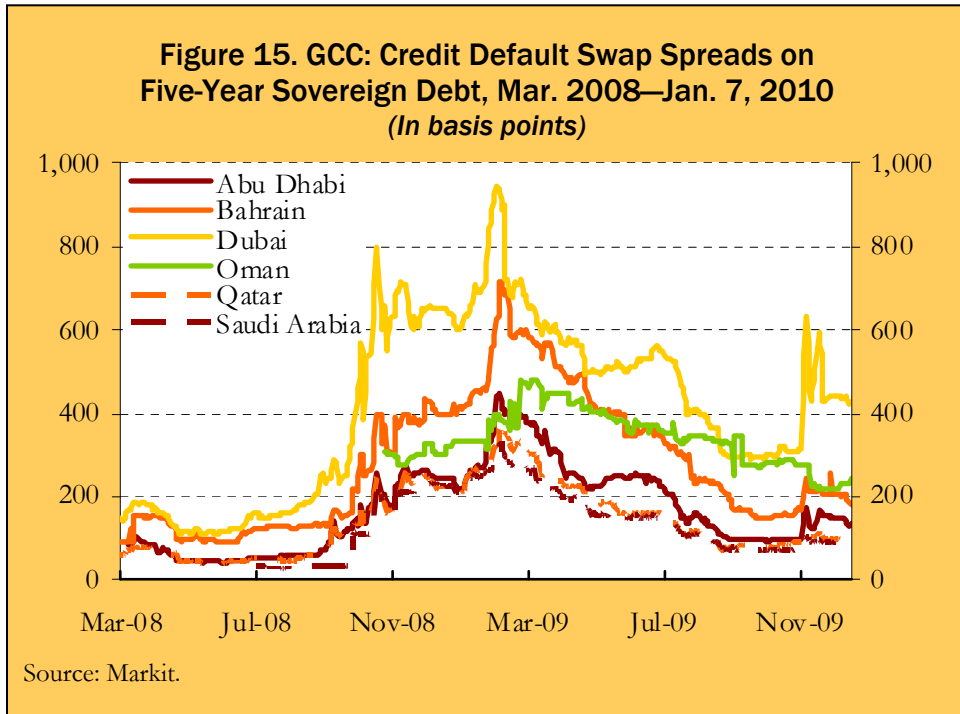
The GCC countries have been hit by the decline in oil prices and production, as well as by liquidity shortages in global financial markets. The direct impact from U.S. subprime assets, however, was limited, given a relatively low direct exposure of GCC commercial banks to these assets. Oil market developments affected government finances and external positions directly, but they also had an indirect impact on banking and corporate liquidity and funding costs as speculative capital inflows reversed and investor confidence in the GCC declined. This, together with global liquidity shortages, triggered a steep fall in asset prices and weakened financial systems' balance sheets, prompting governments' intervention in the financial sector.

#### ***Plunging asset prices and higher CDS spreads***

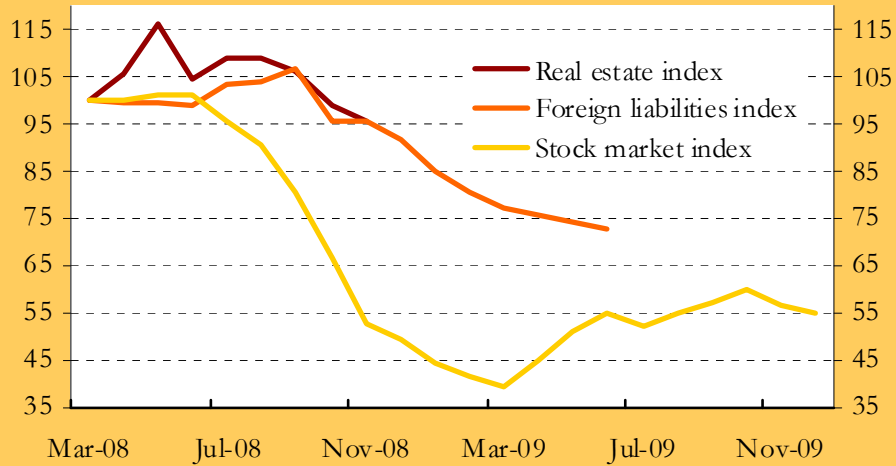
Similar to other emerging markets, the impact of the crisis on the GCC manifested itself in plunging stock and real estate markets and higher CDS spreads (Figures 15–18). The region's stock market capitalization fell dramatically—by 41 percent (\$400 billion) between the collapse of Lehman Brothers in September 2008 and end-2008—and volatility increased.<sup>10</sup> As contagion from the global crisis became a dominant factor, the average correlation of GCC markets with global markets turned positive, compared with a negative correlation during January 2007–September 2008 (Table 4).

<sup>9</sup>See also the *Regional Economic Outlook: Middle East and Central Asia*, October 2009, IMF, and IMF country reports for Kuwait (No. 09/153), Qatar (No. 09/28), and the U.A.E. (No. 09/124), available at [www.imf.org](http://www.imf.org).

<sup>10</sup>The standard deviation of daily average returns doubled between August 2008 and February 2009, compared to the period January 2007 to August 2008. Volatility since late 2008 has been lowest in Bahrain and highest in Abu Dhabi and Dubai.

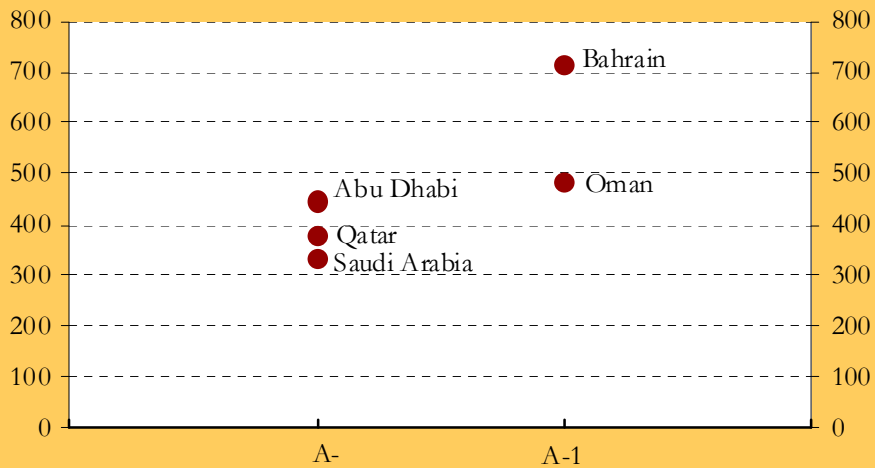


**Figure 17. GCC: Stress Indicators, March 2008–December 2009**  
(Indices, March 2008=100)



Sources: Mazaya; Bloomberg; and staff estimates of PPP-weighted GCC index for foreign liabilities.

**Figure 18. GCC: Current Sovereign Short-Term Ratings and Maximum CDS Spreads, Since Mar. 2008**



Sources: Markit; and S&P.

**Table 4. Correlation in Stock Markets<sup>1</sup>**

Average correlation within GCC, before Sept. 10, 2008	0.86
Average correlation within GCC, after Sept. 10, 2008	0.90
Average correlation with S&P before Sept. 10, 2008	-0.56
Average correlation with S&P after Sept. 10, 2008	0.85

Sources: Bloomberg; and IMF staff estimates.

<sup>1</sup>Correlations before Sept. 10, 2008 cover the period Jan. 1, 2007–Sept. 10, 2008, and correlations after Sept. 10 cover the period Sept. 10, 2008–Jun. 17, 2009.

GCC SWFs were also affected by the decline in international asset prices, with losses estimated by market analysts at between 20–30 percent in 2008. Real estate prices fell significantly; the correction was very pronounced in Dubai, where they had risen more sharply. While CDS assessments increased across the board, risk assessments for Dubai, and to some extent Bahrain, were more unfavorable than for other GCC countries.<sup>11</sup>

Mirroring global developments, equity markets have displayed greater confidence since March 2009, but this trend has reversed more recently. During the first 10 months of 2009, GCC equity market indices gains (except for Bahrain and Kuwait), although stock market levels remained significantly below pre-Lehman collapse levels. CDS spreads have also declined markedly, indicating an improvement in global investor sentiment. More recently, pressures on the highly leveraged Dubai quasi-sovereign entities culminated in the announcement of the Government of Dubai that DW would seek a standstill on debt at the holding level and for its two property subsidiaries (Nakheel and Limitless) until May 2010 (Box 1). These developments have regenerated pressures on the region's equity markets. CDS spreads on the Dubai government and entities have also increased as a result, but CDS spreads for the rest of the region have been only marginally affected.

### ***Pressures on bank funding and liquidity led to tight credit conditions***

The reversal of speculative short-term inflows linked to exchange rate speculation, combined with global deleveraging and widening emerging market spreads, resulted in significant liquidity pressures and increased funding costs. Commercial banks drew down their reserves with central banks, and short-term interest rates spiked sharply, albeit temporarily.<sup>12</sup> Timely response by the authorities, including through the infusion of liquidity and deposit guarantees, helped stabilize interest rates and liquidity conditions (Figures 19–21). External funding for the banking system was strongly affected, except for Qatar, and is yet to recover (Figure 22).

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<sup>11</sup>This could be attributed to the relatively high international leverage of Dubai corporates, the interlinkages of the Bahrain wholesale banking sector with global financial markets, and lower oil wealth of Dubai and Bahrain.

<sup>12</sup>In the post-September 2008 period there were also sporadic events that exacerbated liquidity pressures, such as the announcement of losses by a Kuwaiti commercial bank due to customer derivative transactions and signs of increased risk aversion among private depositors.

**Box 1. The Consequences of Dubai World's Debt Developments**

*The announcement last November that Dubai World (DW)—a holding company owned by the Government of Dubai (GD)—would seek a debt standstill was a surprise to financial markets. Support provided recently by the Government of Abu Dhabi has helped to calm down markets, but uncertainties remain as the GD is still developing a strategy to put its corporate sector on a viable path. Although the impact of the debt event will depend on the eventual scope and modalities of the debt restructuring, it could have a significant effect on the repricing of sovereign risk throughout the region and beyond.*

On November 25, 2009, the GD announced that DW and its two property subsidiaries (Nakheel and Limitless) would seek a debt standstill until May 2010. The standstill was to affect \$26 billion worth of loans and bonds, including a Nakheel 09 *sukuk* maturing on December 14. However, on that date the Government of Abu Dhabi extended a loan to the GD, who stated that it intended to use these resources to: (i) repay in full and on time the Nakheel 09; and (ii) cover payments to contractors, working capital, and interest expenses through end-April 2010, conditional on a standstill agreement being reached between DW and its creditors.

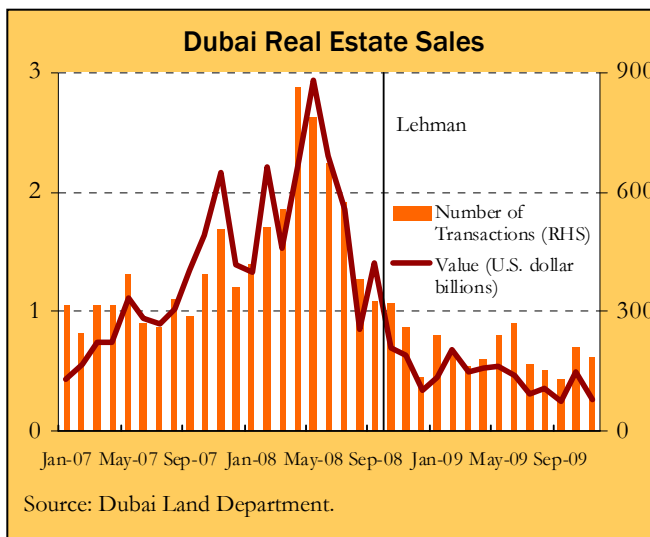
The November announcement came as a surprise to markets. The bursting of Dubai's real estate bubble in 2008, coupled with the post-Lehman shut-down of international capital markets, had heightened concerns about Dubai's ability to service its debt, particularly in the case of highly leveraged real estate enterprises. But in the several months leading to November 25, Dubai had been able to roll over market debt falling due, in part with financial support from the central bank. That had reinforced the perception of sovereign support for Dubai-based entities, leading to a substantial tightening of GD credit default swap (CDS) spreads and an increase in the value of Nakheel bonds.

**The Federal Structure of the U.A.E.**

The U.A.E. is a federation of seven emirates formed in 1971. Core functions of government, such as defense, foreign policy, and central banking, are handled at the Federal level. However, each emirate has autonomy over economic policies, debt issuance, laws, and control over land and natural resources. The richest emirate is Abu Dhabi, which owns 95 percent of the U.A.E.'s hydrocarbon wealth, accounts for half of its GDP, and has accumulated substantial net external financial assets. Dubai is the second largest emirate and accounts for around 35 percent of the U.A.E.'s GDP. Most of the U.A.E.'s external debt is reportedly with Dubai entities.

**Roots of the Crisis**

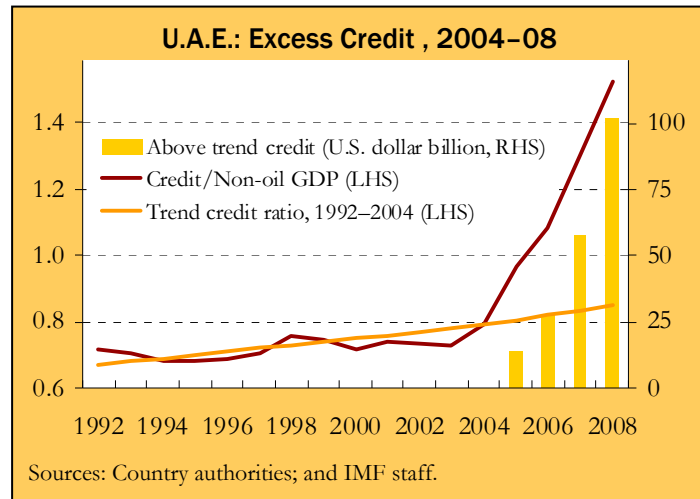
Dubai's economy is dominated by Dubai Inc., a web of commercial corporations, financial institutions, and investment arms owned directly by the GD or the ruling family under the umbrella of three major holding companies (Dubai Holding, DW, and the Investment Corporation of Dubai). Each of these holding companies includes several property developers and is involved in assorted property ventures in Dubai and around the world. They also have significant operations in trade and services (such as ports, logistics, transportation, and tourism), which continue to do well.



**Box 1 (continued)**

Dubai Inc. borrowed extensively in 2004–08 to fund a major push into commercial and residential property. A significant increase in leverage ensued, followed by a real estate bubble.

Between 2004 and 2008, liabilities to global banks as a ratio to non-oil GDP more than doubled as did domestic credit to nonoil GDP. Credit growth was among the fastest in emerging markets, with U.A.E. banks extending about \$100 billion of credit in excess of the historical trend. Banks remained highly rated throughout the period, reflecting government ownership or implicit government backing.



**Market Reaction**

The debt standstill announcement had a pronounced impact on Dubai’s credit risk as market participants could no longer assume an implicit sovereign guarantee. The Nakheel09 traded at about 50 cents, down from 111 on November 23; CDS spreads on the GD rose to 675 bps from around 320 bps before the announcement; and Dubai government-related entities (GREs) were downgraded by several notches, most to non-investment grade. Although CDS spreads declined after December 14, they still remain elevated. Stock markets in Dubai and Abu Dhabi dropped significantly; those in the rest of the GCC experienced higher volatility, and other countries’ CDS spreads widened marginally in the week after the announcement.

Global stock market reactions to the initial announcement were strong but brief, with bank stocks most affected—especially for banks believed to be exposed to DW or other firms with direct links to Dubai. The decline in stock prices also reflected global market fragilities, low liquidity ahead of holidays in the U.S. and the Middle East, and end-of-year effects.

**Implications for the U.A.E.**

The ramifications of the Dubai event are still unfolding, as it will take some time for the GD to develop a strategy to restructure its corporate sector. The analysis is complicated by the lack of information on DW’s and many Dubai GREs’ financials. A full-fledged restructuring could involve operational restructuring, asset sales, debt relief, or equity injections. It may also require further financial support from Abu Dhabi or the federal government, on a case-by-case basis, as external funding for Dubai is likely to become more expensive and limited. About \$50 billion of bonds and syndicated loans to Dubai-based nonbank entities are expected to fall due over the next three years.



**Box 1 (continued)**

**Five-Year CDS Spreads  
(In basis points)**

	Monday 23-Nov <sup>1</sup>	Friday 27-Nov <sup>2</sup>	Change (bps) <sup>3</sup>	Monday 14-Dec <sup>4</sup>	Thursday 14-Jan <sup>5</sup>
<b>U.A.E.</b>					
Dubai Holding	670	1450	780	1599	1346
Dubai	317	675	358	428	420
DP World	355	740	385	454	414
Abu Dhabi	100	183	83	153	136
<b>Other GCC Countries</b>					
Bahrain	175	260	85	209	178
Saudi Arabia	74	107	33	95	79
Qatar	94	110	16	99	86
<b>Other Economies</b>					
Turkey	194	224	30	192	168
Hungary	217	250	33	230	232
Russia	191	220	29	192	167
Lebanon	258	278	20	279	235
Egypt	221	235	14	241	241

Source: Bloomberg.

<sup>1</sup>Immediately prior to the Dubai World standstill announcement.

<sup>2</sup>Three days following the Dubai World standstill announcement.

<sup>3</sup>Change in CDS spreads between 27-Nov and 23-Nov.

<sup>4</sup>Immediately after the announcement of the Abu Dhabi assistance package and decision to fully pay the Nakheel09 *sukuk*.

<sup>5</sup>Most recent.

**Dubai: Publicly Held Debt in the Form of Bonds and Syndicated Loans by Maturity Date  
(In millions of U.S. dollars or U.S. dollar equivalents)**

As of: January 2010	2010	2011	2012	Total
Dubai World and subsidiaries	5,369	6,647	7,593	19,609
DW standstilled debt	5,169	4,647	1,850	11,666
Other DW subsidiaries (DP World, etc.)	200	2,000	5,743	7,943
Other Dubai Inc. Debt.	10,161	17,774	11,424	39,359
<b>Total</b>	<b>15,530</b>	<b>24,421</b>	<b>19,017</b>	<b>58,968</b>

Sources: Dealogic; Zawya; Bloomberg; Datastream; arabianbusiness.com; BIS; and IMF staff.

**Box 1 (concluded)**

**The banking sector.** Banks have enjoyed full backing of the central bank and federal government during the global financial crisis. More recently, the central bank has introduced an additional liquidity facility, although banks have not seen unusual deposit outflows in the aftermath of the announcement. Banks' liabilities (deposits and interbank loans) have been under a 3-year federal government guarantee since September 2008. Depending on the terms of the debt restructuring and individual bank exposure to DW, some banks may need further capital injections, possibly from the government. The federal government still has \$5.5 billion left for bank capital support under a program of \$19 billion introduced post-Lehman.

**Economic growth.** Given the scale of construction and property-related activity in Dubai (25 percent of Dubai's GDP), Dubai's economic activity is likely to be affected, depending on how protracted is the corporate debt restructuring. Ongoing large fiscal spending by Abu Dhabi will help cushion the impact.

**The Dubai model.** Overall, the event is expected to lead to modifications and a refocusing of Dubai's development model, and a marked reduction in leverage. Dubai has achieved an impressive degree of diversification and become a major trading and services entrepot. However, the global financial crisis has exposed the vulnerabilities associated with Dubai's highly leveraged property development and put into question the sustainability of those aspects of the development model.

**Implications for the GCC Region and Beyond**

The main channel of transmission to the rest of the GCC would be through the balance sheets of banks and other financial institutions. Although developments are still unfolding, available information so far indicates that the impact is likely to be limited, assuming that the debt restructuring remains contained. From a country-specific perspective, the known direct exposures of regional financial institutions seem to be manageable. The impact through real channels is also likely to be limited: Dubai's economy accounts for less than 10 percent of GCC GDP, and intra-GCC trade is less than 10 percent of total GCC trade.

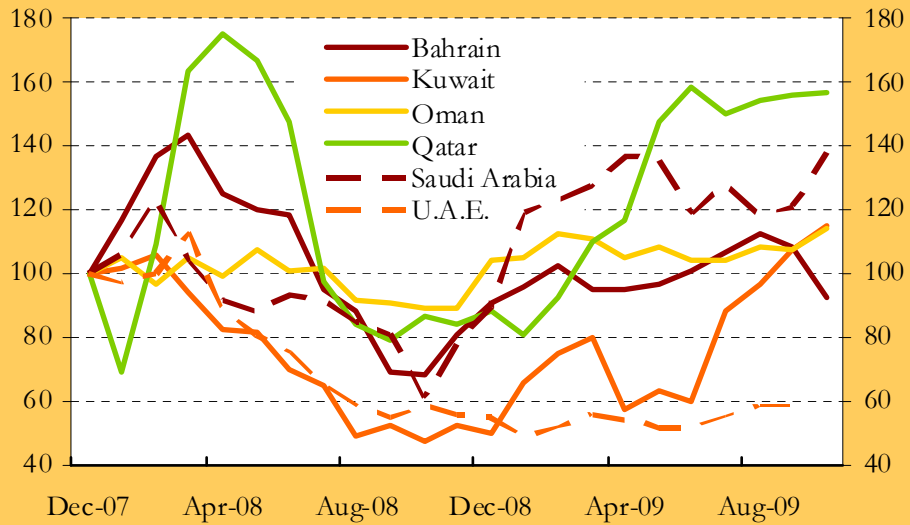
**Implications for Financial Markets**

Markets are likely to revisit the assumption of implicit guarantees in pricing quasi-sovereign and private risks, which may result in an increase in the cost of borrowing and reduced access to international capital markets by some GCC entities. The event has also underscored the need for enhanced communication and transparency in both public and private sectors.

Additionally, although the Nakheel *sukuk* was paid in full, the event underscored existing concerns regarding the legal enforceability of *sukuk*, which could undermine the *sukuk* market.

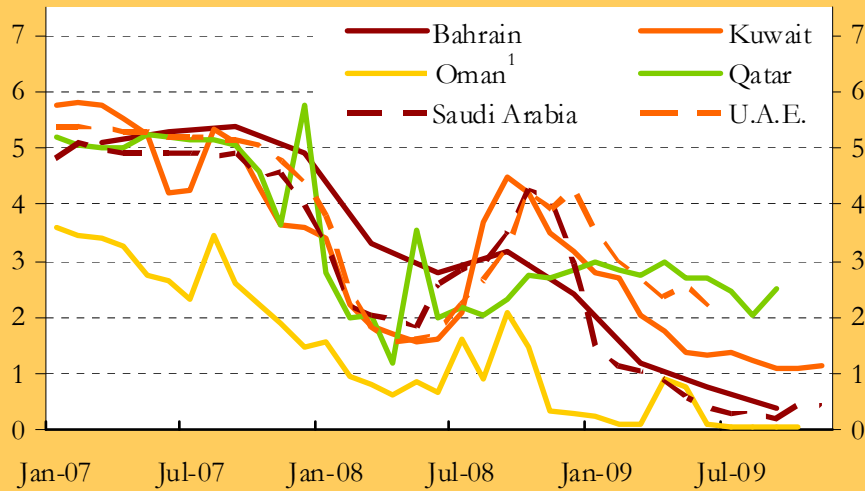
Indirect spillovers from cross-border foreign direct investment and remittance flows could also have an impact on the wider region as well as the Indian subcontinent.

**Figure 19. GCC: Commercial Banks' Reserves with Central Bank, December 2007=100**



Sources: Country authorities; and IMF staff estimates.

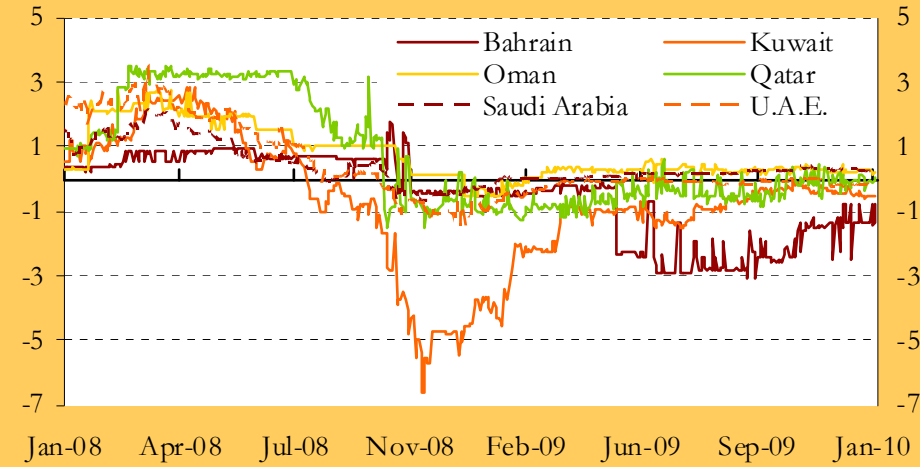
**Figure 20. GCC: Three-Month Interbank Rates, January 2007–November 2009 (In percent)**



Sources: Country authorities.

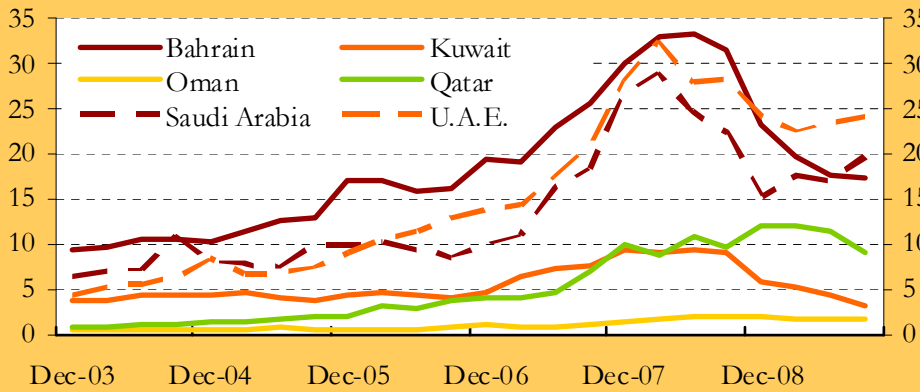
<sup>1</sup>Overnight interbank rate.

**Figure 21. GCC: One-Year Currency Forward Premiums, January 2008–January 2010**  
(In percent of spot price)



Source: DataStream.

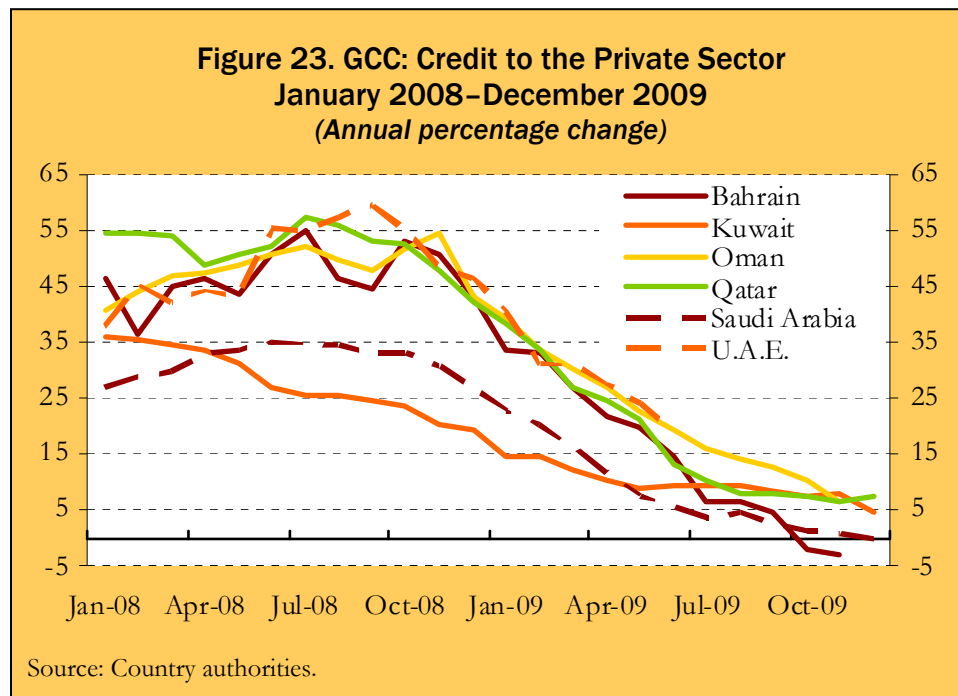
**Figure 22. GCC: Banks' External Financing,<sup>1</sup> December 2003–September 2009**  
(In billions of dollars)



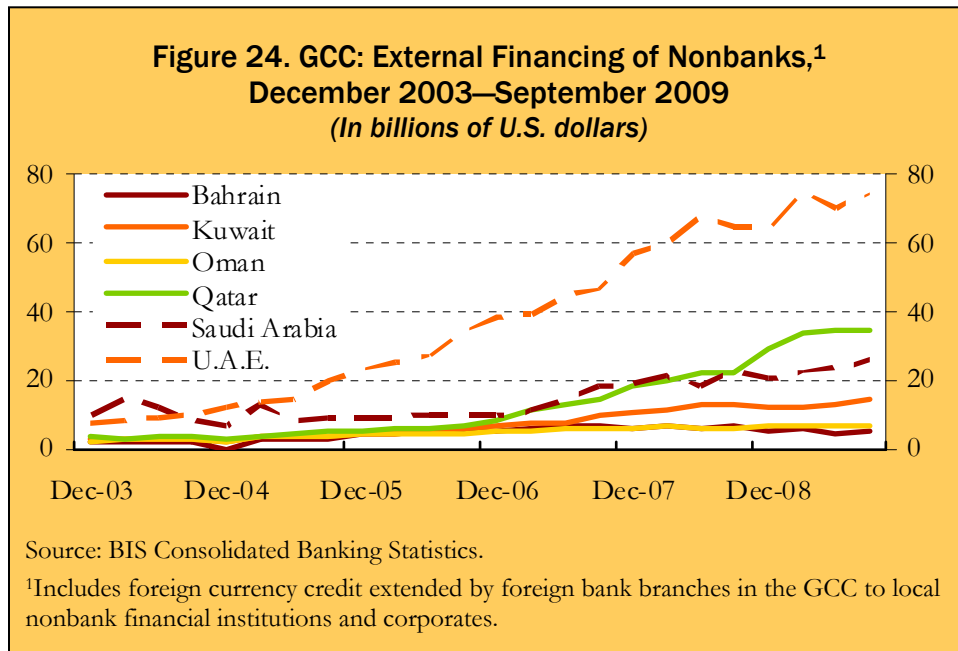
Source: BIS Consolidated Banking Statistics.

<sup>1</sup>Includes foreign currency interbank lending extended by foreign bank branches in GCC countries.

After September 2008, in response to tighter liquidity conditions, higher asset losses, and perceptions of higher credit risk, banks became more reluctant to lend and some were forced to deleverage. Although liquidity conditions have improved significantly since then, credit expansion has continued to slow, largely reflecting weaker economic activity coupled with banks' reluctance to lend (Figure 23).<sup>13</sup> External funding for the nonbank private sector also tightened in late 2008 (Figure 24), although it has shown some recovery in 2009. Nonbank external financing for Qatar remained robust throughout.



<sup>13</sup> Additionally, the number of initial public offerings (IPOs) within the GCC decreased in 2008, with no IPOs taking place between August and December 2008. In 2006, 2007, and 2008, GCC IPOs amounted to \$7.5 billion, \$12.0 billion, and \$11.7 billion, respectively. Total bond issuance by GCC corporates dropped by more than 40 percent (to about \$16.5 billion) in the 12 months through June 30, 2009, relative to the same period of 2007–08. The decline was driven by a dramatic drop in *sukuk* issuance of around 73 percent (to \$4.34 billion) on concerns regarding *sukuk* market liquidity and contract enforcement. In contrast, conventional bond issuance increased by more than 17 percent, to about \$13 billion.

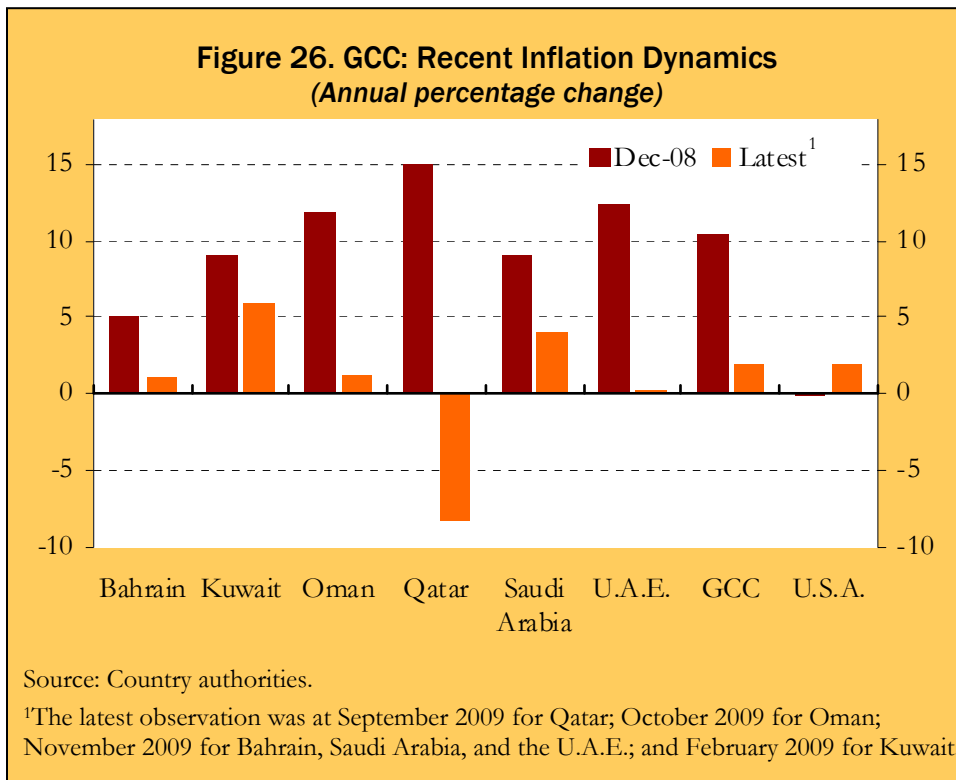
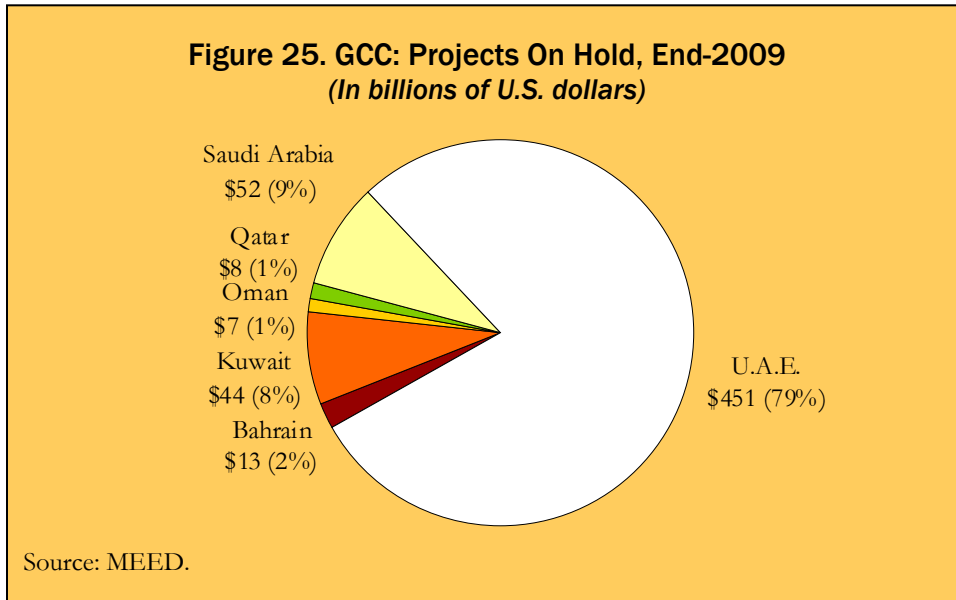


A negative feedback loop between tight credit markets and economic activity emerged. Of an estimated \$2.5 trillion of projects in different stages of implementation and/or planning as of end-2008, around 23 percent (\$575 billion) had been placed on hold by end-2009 (Figure 25).<sup>14</sup> Also, weaker domestic and external demand adversely affected corporate sector profitability, with net profits of 409 locally listed companies in the GCC declining by about 30 percent in 2008, and by 48 percent year-on-year in the second quarter of 2009.<sup>15</sup> Profitability in the third quarter of 2009 showed some improvement, with an overall decline of 25 percent year-on-year. Real non-oil GDP growth is now estimated to average just below 2.8 percent in 2009, down from an estimated 6.7 percent in 2008.

<sup>14</sup>Based on MEED database. About one third of currently active projects are in the implementation stage, with 40 percent being developed by the private sector. Around 80 percent of projects put on hold are in the construction sector and two-thirds are private.

<sup>15</sup>Global Investment House, Global Market Report—GCC.

Weakening import prices and deflating house prices in the wake of the economic slowdown helped reverse inflationary trends starting in the first half of 2009. GCC inflation declined to 2 percent by the third quarter of 2009 from 10½ percent at end-2008 (Figure 26).



## A Forceful Response Contained the Impact of the Crisis

### *Forceful response by the GCC authorities*

Following the tightening of liquidity conditions in the last quarter of 2008, the authorities took measures to stabilize the financial system and mitigate the impact on credit expansion (Table 5, and Annex I). Central banks infused liquidity into the financial system through repos, and governments provided direct liquidity injections via the placement of long-term deposits. All central banks—except in Qatar, where inflation remained high until end-2008—reduced policy interest rates, and some lowered or modified reserve requirements (Bahrain, Oman, and Saudi Arabia). To shore up investor confidence, some governments provided deposit guarantees (Kuwait, Saudi Arabia, and the U.A.E.), and certain SWFs were asked to support domestic asset prices (Kuwait and Oman) and provide capital injections to banks (Qatar). The government also provided capital injections in Kuwait and the U.A.E. Additionally, in Qatar, the government purchased banks’ holdings of equity and real estate assets. These measures had a favorable effect on market conditions, helped preserve stability in the financial system, and limited the impact on banks’ long-term ratings.<sup>16</sup>

**Table 5. GCC Policy Response to the Global Crisis**

Country	Central Bank Deposit Guarantees <sup>1</sup>	Central Bank Liquidity Support	Long-term Government Deposits	Capital Injections	Bank Asset Purchases	Stock Market Purchases	Monetary Easing
Bahrain		✓	✓				✓
Kuwait	✓	✓	✓	✓		✓	✓
Oman		✓	✓			✓	✓
Qatar		✓	✓	✓	✓		
Saudi Arabia	✓	✓	✓				✓
U.A.E.	✓	✓	✓	✓			✓

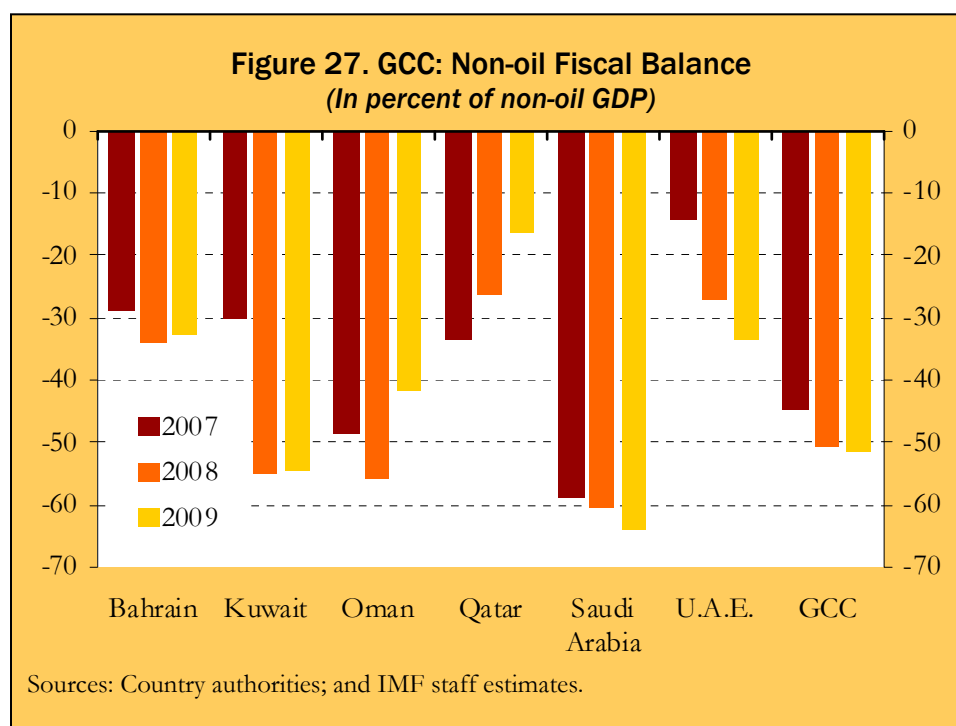
Source: Data provided by country authorities.

<sup>1</sup>Includes expansion of retail deposit insurance and guarantee of wholesale liabilities.

Despite lower fiscal and external surpluses, GCC countries largely maintained their previous levels of spending to counter the impact of the crisis on economic activity (Figure 27). Saudi Arabia passed a stimulus package—the highest among the G-20 in terms of share to GDP—that forms part of a five-year \$400 billion investment plan that will contribute to the global effort to revive demand, given its high share of imported goods (around

<sup>16</sup>Fitch Ratings stated that although the region and the banks are feeling the impact of the global crisis, banks’ long-term issuer default ratings are unlikely to change, as they remain driven by the probability of support from their respective sovereigns (Fitch Ratings, Impact of the Global Economic Crisis on GCC bank ratings, December 2008.)





55 percent). The GCC's supportive policies also had an important stabilizing impact on the other economies of the MENAP (Middle East, North Africa, Afghanistan, and Pakistan) region by contributing to workers' remittances, foreign direct investment (FDI), and to a lesser extent, imports (Box 2). The slowdown in GCC growth in 2009 has weakened financial flows from the region, but these are expected to rebound partially in 2010.

These efforts have been generally well received by markets, although further coordination on country measures could have been helpful, particularly in the early stages of the crisis (for example, on deposit guarantees). Weaknesses in coordination have also been a challenge at the global level as countries underestimated the extent and momentum of the crisis and tended to address emerging issues, first and foremost, at the national level because of the fiscal dimension of bank support policies. The lack of clarity regarding the severity of the impact of Lehman Brothers' collapse also undermined coordination and resulted in ad hoc measures.

***Adverse impact on financial institutions, but no systemic risk***

The sharp downturn in global asset prices and tight liquidity conditions led to defaults by a few GCC nonbank financial institutions, but these were isolated, owing partly to swift actions taken by countries to ensure stability.

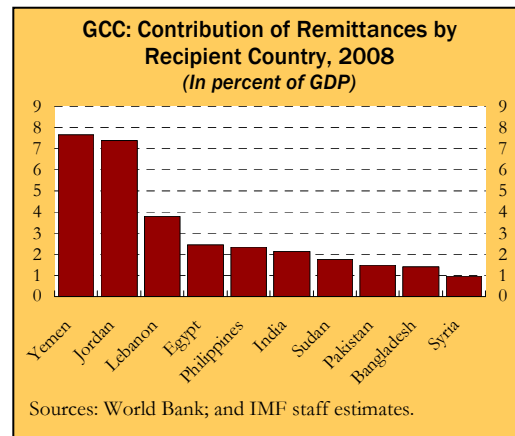
### Box 2. GCC Financial Flows: Regional and Global Spillovers

Remittances from GCC countries remained resilient in 2008, as migrants' employment was largely maintained at previous levels. During 2001–08, outward remittances from the GCC region—a major source of financial inflows for some partners—grew by 7 percent on average per year, totaling \$250 billion. The main receiving countries were Bangladesh, Egypt, India, Jordan, Lebanon, Pakistan, Philippines, Sudan, Syria, and Yemen. In view of the impact of the crisis on global growth, global remittances are expected to decline by 7–10 percent in 2009 (Global Development Finance, World Bank, July 2009). For the GCC, staff estimates outward remittances to decline by 4 percent in 2009, to \$46 billion, before recovering partially in 2010.

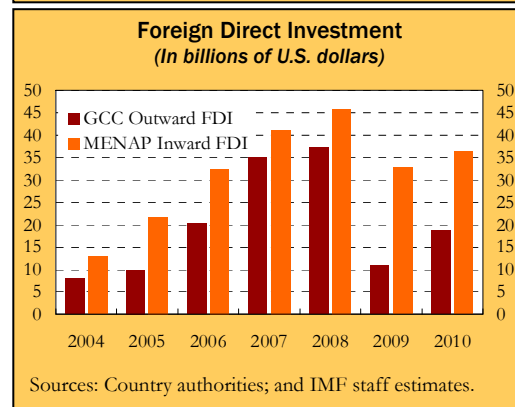
**GCC: Cumulative Outward Remittances (2001–08)**

	Amount U.S. \$ Billion	Share to Total Percent
Bahrain	10.4	4.2
Kuwait	24.8	9.9
Oman	18.1	7.3
Qatar	21.2	8.5
Saudi Arabia	125.1	50.1
U.A.E.	50.3	20.1
Total	249.8	100.0

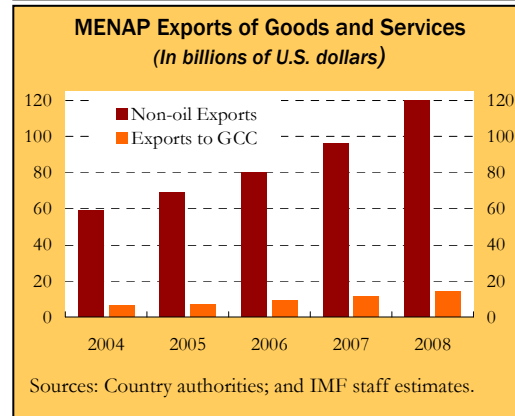
Sources: World Bank; and IMF staff estimates.



Global FDI flows have also been affected strongly by the current crisis. UNCTAD (January 2009) estimates world FDI flows to have declined by 21 percent in 2008, mainly due to a sharp drop in the fourth quarter. The World Bank (2009) estimates that in the fourth quarter of 2008, flows to 25 middle-income countries—including Egypt, Jordan, and Pakistan—declined to their lowest level since the fourth quarter of 2006. It projects world FDI inflows to drop by 30 percent in 2009. While outward FDI flows from the GCC and FDI inflows to the region remained strong in 2008, they are expected to fall sharply in 2009 in the context of lower growth and global uncertainty.



The strong fiscal spending in the GCC, including the large fiscal stimulus in Saudi Arabia, will continue to support global demand, with the GCC's share of global imports expected to increase from 2.6 percent in 2008 to close to 3.4 percent in 2009 and 2010. GCC non-oil imports play a small role in the MENAP (Middle East, North Africa, Afghanistan, and Pakistan) region, as they represented only 12 percent of the region's exports in 2008.



Investment companies (ICs) in Kuwait and wholesale banks in Bahrain were most affected, given their direct exposure to global markets. Two Bahrain-based wholesale banks—the International Banking Corporation and Awal Bank—owned by Saudi conglomerates, were placed into administration by the Bahraini authorities, after falling into default in May and June 2009, respectively. Two Bahrain-based wholesale banks, Gulf International Bank (GIB) and the Arab Banking Corporation (ABC), have incurred large cumulative impairment charges (GIB: \$1.3 billion, ABC: \$1.2 billion) over the past two years, but they continue to be well capitalized.

In Kuwait, by January 2009, Global Investment House, the largest IC, was in default on the majority of its debt, estimated at \$3 billion, but reached a debt restructuring agreement with its creditors in October 2009. In May 2009, Investment Dar, another of Kuwait's large ICs, defaulted on a \$100 million *sukuk*. The company reached a restructuring agreement with its creditors in December 2009. Some of these institutions have important linkages to the banking sector (Box 3).

The impact was also felt in the U.A.E., largely as a result of falling real estate prices and liquidity pressures. The U.A.E. federal government took over two Dubai-based Islamic real estate finance companies (Amlak Finance and Tamweel) that faced financing difficulties. In addition, Abu Dhabi's Real Estate Bank and Emirates Industrial Bank were merged. Credit rating agencies have taken several negative rating actions on GCC banks.

### ***Moderate impact on overall GCC bank profitability***

So far, the GCC banking sector has been relatively resilient, with the most recent available FSIs remaining generally strong (Table 6). These indicators show that banks had CARs above the required regulatory norms and low nonperforming loan (NPL) levels.<sup>17</sup>

While some banks showed losses in the fourth quarter of 2008—reflecting higher loan provisioning and mark-to-market valuations in investment portfolios—banks continued to be profitable in 2008 and the first half of 2009, albeit at lower levels than in previous years (Table 7 and Figure 28).<sup>18</sup>

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<sup>17</sup>However, FSIs should be interpreted with caution. Since they represent the average performance of the sector, they could mask individual banks' vulnerabilities. FSIs are also backward looking and might not provide a clear indication of future trends. Additionally, some FSIs are affected by the rate of asset growth and do not readily show the underlying trend in asset quality. For example, higher NPLs and loan provisioning in the fourth quarter of 2008 were not manifested in the NPL and provisioning ratios as they probably were masked by the high rate of credit growth in 2008.

<sup>18</sup>Only one commercial bank, Gulf Bank (Kuwait), ended up with losses in 2008 on account of customer-related foreign exchange derivatives transactions. The bank was recapitalized through a combination of capital injections by shareholders (68 percent) and the government (32 percent) via the Kuwait Investment Authority.

### **Box 3. Cross-Sectoral and Cross-Border Linkages in the GCC**

Cross-sectoral linkages are most pronounced in Bahrain, Kuwait, and the U.A.E. in view of the presence of some systemic financial institutions (see Annex II for a description of the structure of the GCC financial system). In Kuwait, investment companies' (ICs) on- and off-balance sheet assets comprise more than 100 percent of GDP, with about 40 percent of GDP (around half of banking sector assets) in proprietary trading (on-balance sheet). Kuwaiti banks are highly exposed to this sector: bank loans to ICs amount to 11 percent of total bank lending, and to close to 56 percent of banking sector equity. While ICs are generally not highly leveraged (the capital-to-assets ratio is around 35 percent), they are dependent on foreign funding, which amounts to about 25 percent of their liabilities. Furthermore, their profitability is linked to the performance of capital markets, both domestically and abroad. As this sector suffered significant losses on its investments between July 2008 and May 2009, and also had difficulties refinancing maturing obligations,<sup>1</sup> the impact threatened to spill over to the banking sector, given its exposure to ICs.

Wholesale banks in Bahrain are also linked to the global economy and have exposures to the region, a cross-border channel that is important, given the nature and size of Bahrain's financial center. The exposure of the retail banks to the rest of the financial sector is low, but since wholesale banks contribute heavily to the country's GDP, shocks affecting this sector inevitably spill over to the retail banking sector through their effect on the real economy via job losses.

In the U.A.E., the two major mortgage finance institutions have been merged and placed under restructuring. The combined mortgage lending of the two companies is about 16 percent of banks' real estate lending and 3 percent of banks' private sector credit.<sup>2</sup> This sector has been hit by the decline in domestic real estate prices and liquidity shortages. If the restructuring of these institutions is not managed effectively, it could have an impact on the availability of housing finance in the U.A.E. However, the impact would be of limited scale, in light of the relatively small size of this sector.

There are also some cross-border linkages that arise from the operations of GCC conglomerates. These were highlighted by the failure of two wholesale banks in Bahrain that are part of the Alghosaibi and Al-Saad groups, two prominent Saudi business groups. A number of GCC and global banks have announced that they had significant exposures to the two groups.

On the real side, while intra-GCC exports were not affected during the third and fourth quarters of 2008, most recent data for 2009 show some signs of a slowdown. However, intra-GCC exports are relatively small, accounting for less than 3 percent of the GCC's GDP.

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<sup>1</sup>In the ten months after its peak at end-July 2008, the stock of foreign financing for conventional ICs dropped by around 24 percent. In contrast, foreign financing for Islamic ICs have increased by about 11 percent in the first five months of 2009 (see "Kuwaiti Banks: Annual Review and Outlook," *Fitch Ratings*, July 2009 available at [www.fitchratings.com](http://www.fitchratings.com)).

<sup>2</sup>As Islamic institutions, the companies' mortgage book is a combination of rental and lease instruments, not directly comparable to housing mortgages provided by conventional banks.

**Table 6. Banking Sector Performance and Soundness**  
(In percent)

	Nonperforming Loans		Capital Adequacy		Provisioning Rate		Return on Assets		Return on Equity	
	2007	Latest	2007	Latest	2007	Latest	2007	Latest	2007	Latest
Bahrain <sup>1</sup>	2.3	2.3	21.0	18.1	74.0	84.0	1.2	1.3	18.4	16.9
Kuwait <sup>2</sup>	3.2	3.1	18.5	16.0	92.0	84.7	3.4	3.2	28.1	27.8
Oman <sup>3</sup>	3.2	2.4	15.9	14.7	107.6	119.3	2.1	2.3	14.3	14.1
Qatar <sup>3</sup>	1.5	1.2	13.5	15.6	90.7	83.2	3.6	2.6	30.4	21.5
Saudi Arabia <sup>3</sup>	2.1	1.4	20.6	16.0	142.9	153.3	2.8	2.3	28.5	22.7
U.A.E.	2.9	2.5	14.0	17.6	100.0	101.5	2.0	2.3	22.0	21.1

Source: Country authorities.

<sup>1</sup>Latest data is for end-2008. Indicators are only for conventional retail banks.

<sup>2</sup>Latest data is for end-September 2008.

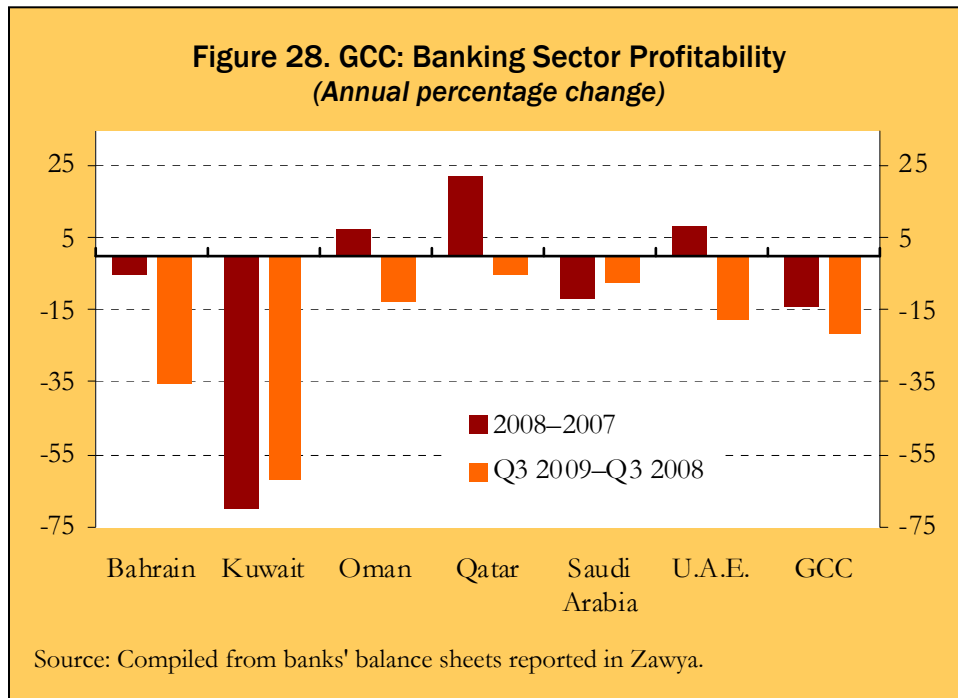
<sup>3</sup>Latest data is for end-2008. For Oman, return on assets and return on equity for 2008 are staff estimates.

<sup>4</sup>Latest data is for end-June 2008, except for CAR, which reflects end-June 2009.

**Table 7. GCC: Banking System Profitability (Listed Banks)**  
(In billions of U.S. dollars)

	No. of Banks	2007	2008	Q3 2008	Q3 2009	Change (%)	
						2008–2007	Q3 2009–Q3 2008
Bahrain	8	0.8	0.7	0.8	0.5	-4.8	-35.7
Kuwait	9	3.7	1.1	3.2	1.2	-70.1	-61.7
Oman	6	0.5	0.5	0.4	0.4	7.2	-12.8
Qatar	8	2.2	2.7	2.2	2.1	21.7	-5.5
Saudi Arabia	11	7.8	6.9	6.4	5.9	-11.8	-7.3
U.A.E.	12	4.6	4.9	4.6	3.8	7.9	-18.0
Total	54	19.6	16.9	17.6	13.9	-13.7	-21.2

Source: Compiled from banks' balance sheets reported in Zawya.



Islamic banks were less affected than conventional banks by the initial impact of the global crisis, but mid-year 2009 results indicate slightly larger declines in profitability for Islamic banks in some countries, which could be attributed to the second-round effects of the crisis on the real economy and real estate (Annex III). The full impact of the crisis on GCC banks, however, is still unfolding, including expected additional provisions against the two Saudi groups and, potentially, Dubai-related debt.

***The impact on growth was moderated by supportive policies***

The impact of the crisis on GCC growth was moderated by supportive financial, monetary, and fiscal policies of the GCC countries. The medium-term economic outlook remains broadly positive. In the short term, lower oil production is estimated to have led to a contraction of 3.8 percent in real oil GDP in 2009, but real non-oil GDP growth is estimated to have remained positive at 2.8 percent, leading to overall real GDP growth of 0.8 percent (Figure 29). A rebound is expected for 2010, mirroring recovery in advanced countries albeit at a stronger pace. The short-term outlook, however, may be clouded by recent developments in Dubai.

**Figure 29. GCC: Selected Macroeconomic Indicators, 2008–10**



Sources: Country authorities; and IMF staff estimates.

Due to lower oil revenues, the fiscal and external balances of GCC countries have weakened in 2009 and are expected to have a partial recovery in 2010, in line with the expected oil price increase. Despite the impact of the crisis, all countries have observed the GCC monetary union convergence criteria in 2009.<sup>19</sup>

## Taking Stock: What Has the Crisis Revealed?

As discussed above, the impact of the crisis on the GCC was mitigated by forceful government intervention and strong banking sector supervision and regulation. However, the crisis exposed a number of areas that should be addressed to limit future disruptions.

**The banking sector.** Overall, the GCC banking sector has been resilient to the crisis, indicating adequate risk management practices and strong regulation and supervision. Accordingly, banking sector prospects remain positive. However, NPLs—which are still low—are expected to rise as the full impact of the crisis on banks’ portfolios works through banks’ balance sheets. Fortunately, CARs in most countries were high to start with, and some countries have provided capital injections for additional cushions. Stress tests conducted by staff suggest that GCC banking systems can absorb relatively strong credit and market events, and that it would take a substantial increase in NPLs before the need arises for significant additional bank recapitalization.<sup>20</sup>

However, the crisis revealed some vulnerabilities related to banks’ exposures to asset markets, their increasing dependence on foreign financing, and a general weakness in their liquidity management frameworks. It also exposed instances of weak supervisory enforcement. For example, the severe liquidity shortages that banks faced in 2008 were due, to a large extent, to the use of short-term speculative capital inflows to finance rapid credit growth. In many cases, banks violated—by a large margin—regulatory loan-to-deposit ratios. Additionally, the manner in which some banks managed the speculative short-term liquidity inflows of 2007 seems to point to moral hazard issues, where banks appear to expect to be “bailed out” when needed.

**The nonbank financial sector.** The crisis also revealed weaknesses in the regulatory and supervisory frameworks of nonbanks. The systemic importance of nonbank financial institutions in many GCC countries has increased in recent years with the rise in their number, activities, and market share. However, similar to the international experience, the development of regulatory and supervisory

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<sup>19</sup>The 2009 fiscal deficits for Bahrain and Saudi Arabia are estimated at 4.5 percent and 4 percent of GDP, respectively. The convergence criteria allows for a fiscal deficit of 5 percent when oil prices are low, as opposed to a 3 percent limit in normal conditions.

<sup>20</sup>Stress tests for Kuwait and Saudi Arabia took into account, directly or indirectly, the impact of stress on listed nonbank corporate balance sheets.



frameworks for nonbanks has lagged behind, resulting in a buildup of vulnerabilities in some cases. Examples include asset/liability maturity mismatches and high loan-to-value ratios in mortgage finance companies in the U.A.E.; and maturity mismatches, high exposure to market risk, and weak disclosure in ICs in Kuwait. Tight liquidity conditions and asset price deflation have exposed these institutions' vulnerabilities, resulting in high losses and some defaults.

**Offshore financial centers.** Given the nature of their operations and their high exposure to global markets, OFCs can transmit global shocks to domestic markets through their impact on the economy or the interbank market. In the current crisis, the largest losses were incurred by banks operating as wholesale (offshore) institutions in Bahrain. In addition, the default of two Bahrain-based wholesale banks affected the region's retail banking system through interbank exposures.<sup>21</sup> However, overall, OFCs have shown resilience to the crisis and the impact of losses has been limited.

**Resolution frameworks.** All GCC countries have explicit legal powers to intervene in, or liquidate, problem banks. However, regulators may need greater flexibility in the resolution approaches for banks, particularly in complex cases. As regards nonbanks, this issue is most important in Kuwait and the U.A.E., given the systemic relevance of ICs in the former and mortgage finance companies in the latter. Both countries have already initiated measures in this area. Kuwait's Financial Stability Law addresses weaknesses in the resolution framework for ICs (Box 4), and the U.A.E.

#### **Box 4. Financial Stability Laws**

The use of temporary financial stability laws has been extensive in emerging Europe in the current crisis. Some countries opted for this approach to address gaps and deficiencies in the existing legal framework for bank resolution and provide temporary powers to the government and/or supervisory authorities to address the current crisis efficiently. These laws are typically used to set aside fiscal resources to deal with potential banking issues and to establish the needed legal power and ex-ante government approval to recapitalize or nationalize banks quickly, provide bank guarantees, buy banks' "toxic" assets, and conduct a variety of bank restructuring/resolution operations that would not have been possible under existing laws.

The Financial Stability Law in Kuwait establishes support measures for banks, including guarantees for shortfalls in banks' loan provisions. It also provides for guarantees for bank lending to investment companies (ICs) and productive economic sectors. The law supports the restructuring of viable and solvent ICs that are under stress and facilitates the exit of insolvent institutions. The law was issued by an Emiree Decree and is currently in effect, unless rejected by Parliament. So far, other countries in the GCC have not seen the need for similar laws.

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<sup>21</sup>It should be noted, however, that the defaults by the parent groups of the two banks have had a more significant impact on regional banks than the defaults by the banks themselves.

Ministerial Committee has recently obtained cabinet approval to revise the bankruptcy law. Furthermore, the Ruler of Dubai issued a decree effective December 13, 2009 to establish a special insolvency regime to facilitate the reorganization and restructuring of DW and its subsidiaries.

**Excess liquidity and asset price bubbles.** Despite a wide-ranging set of prudential regulations adopted by GCC central banks to contain the expansionary impact of the oil boom (Box 5), the GCC economies experienced a prolonged period of excess liquidity conditions in 2003–08, during which asset markets appreciated significantly, only to deflate again as oil prices declined. Asset price cycles have traditionally affected the real economy via the wealth effect and consumer and investor confidence. With the increasing role of the financial sector, the recent collapse of the asset price bubble was also transmitted through its impact on the financial system and credit growth.

#### **Box 5. GCC: Banking Sector Prudential Measures<sup>1</sup>**

Prior to the crisis, several countries (Kuwait, Oman, Qatar, Saudi Arabia, and the U.A.E.) had in place loan-to-deposit prudential ratios to encourage banks to seek stable sources of funds and limit credit growth. In addition, some countries attempted to slow the growth of credit to the real estate sector (Qatar and the U.A.E.) through caps on real estate lending, and caps on personal loans sought to slow consumer lending (Oman and Saudi Arabia). Maximum limits on debt/income or debt service ratios for individuals were also used to control the buildup of debt in household balance sheets (Kuwait, Qatar, and Saudi Arabia). GCC countries also moved to the Basel II framework, which included more rigorous capital standards.

<sup>1</sup>Annex II provides a summary of the institutional structure for financial sector regulation and supervision, and key banking sector prudential regulations.

**Dubai World event.** This event has underscored risks related to high leverage (especially to finance property developments), increased the focus on the legal enforceability of *sukuk*, and brought to the forefront issues related to transparency and disclosure in the GCC. Most importantly, the market's assumption of implicit guarantees on government-owned entities, commonly associated with the GCC, has been called into question. This is likely to have a prolonged impact on the U.A.E.'s (particularly Dubai's) access to capital markets, and may affect the pricing of quasi-sovereign risks more widely. It might also result in a general reassessment of real estate risk in the GCC.

**Corporate governance and transparency.** Improving corporate sector transparency has become a priority. The corporate sector in the GCC is largely owned by family business groups or GCC governments.<sup>22</sup> This has

<sup>22</sup>Some market participants estimate that family businesses represent about 90 percent of the corporate sector in the region. There are at least 5000 companies that hold combined assets of more than \$500 billion and employ 70 percent of the workforce. The decision-making process in family firms in the GCC is often informal

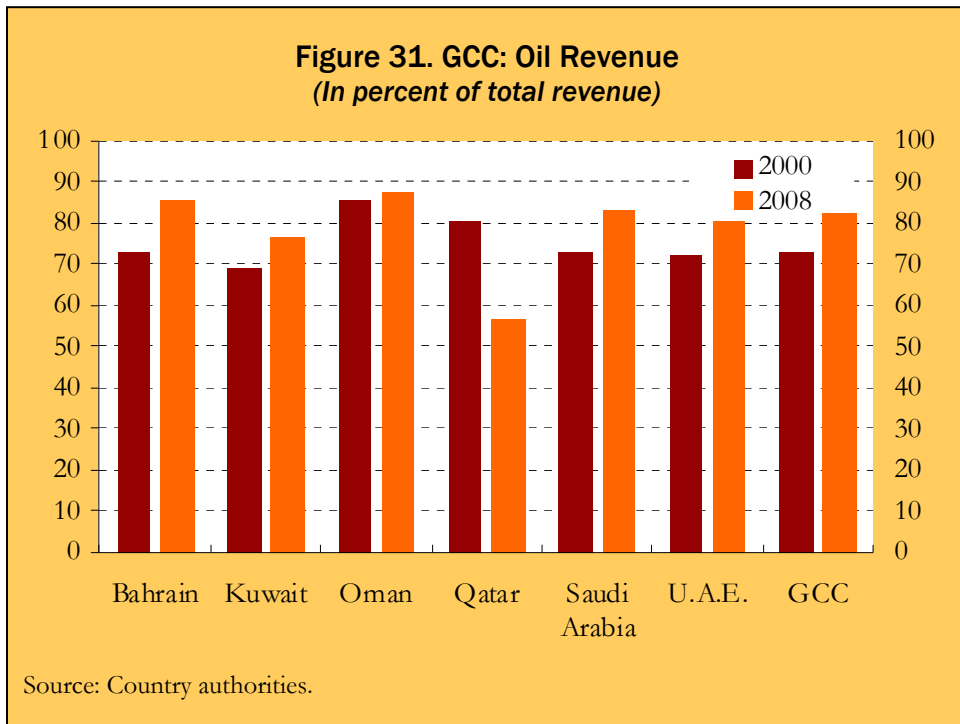
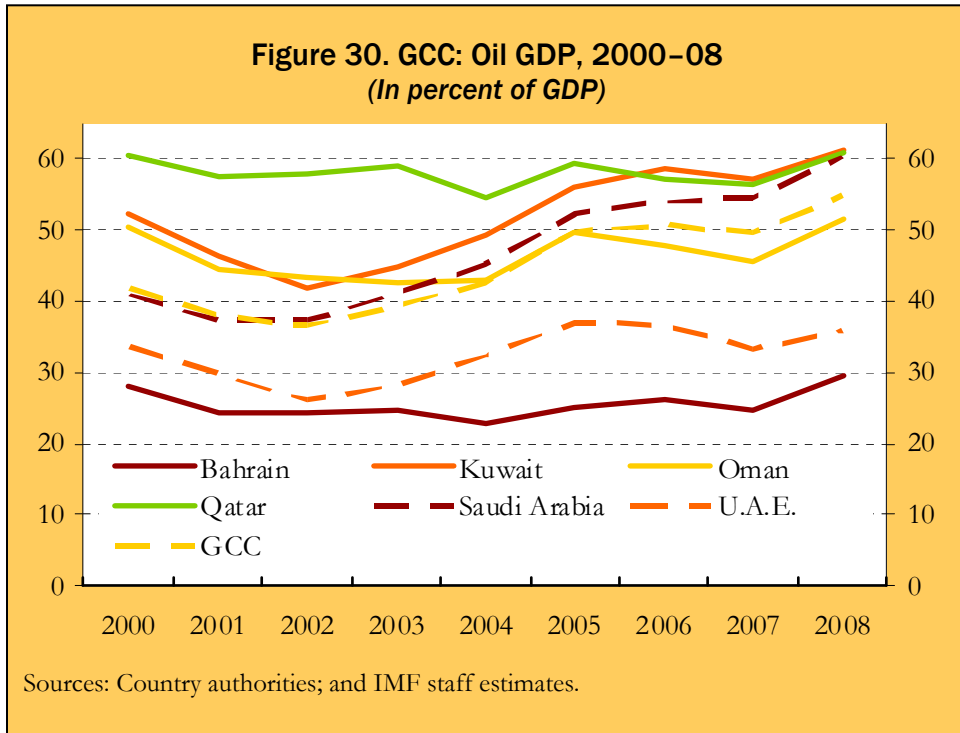
tended to decrease overall disclosure, internal controls, and corporate governance, particularly in view of the limited disclosure requirements for unlisted companies. While these groups had comfortable access to credit prior to the crisis, both domestically and externally, lenders are now putting pressure on them to enhance disclosure, particularly in view of the default of the two Saudi conglomerates and DW developments.

**Communication.** Communication during the crisis showed some weaknesses. For instance, the experience with liquidity support in the U.A.E. early in the crisis was mixed because banks were not provided with clear guidelines on extraordinary liquidity access, which delayed their ability to make use of these facilities. In addition, some countries' decisions on bank recapitalization measures were provided in a piecemeal fashion, without clear information about the authorities' intentions or target banks. More recently, a more prompt release of information on bank exposures to the two Saudi Conglomerates could have avoided market uncertainties. Finally, weak communication has exacerbated the negative market reaction to DW developments. The initial announcement on the debt standstill did not include key details, there was no effective follow-up with market participants, and official statements came with some delay.

**Fiscal policies and diversification.** The crisis has re-emphasized the risk of high dependence on oil revenues and the importance of revenue diversification and rationalization of fiscal spending. Notwithstanding progress made by the GCC in diversifying economic activity in the past two decades, the oil sector continues to contribute heavily to total GDP and is the main source of fiscal revenue (Figures 30 and 31). The volatility of oil revenue and production also underscores the importance of accumulating fiscal savings during economic upturns to allow for countercyclical fiscal policies during downturns.

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in nature and is made by owners and top-tier management with little or no accompanying structure or framework. The large growth in the number of listed companies in the GCC region in recent years does not indicate significant changes in the legal status of family business groups; it reflects, to a large extent, either the privatization of publicly owned institutions or legal constraints that force companies to go public. See Ithmar, Dow Jones Private Equity, 2007, "The Impact of Private Equity on the GCC Family Businesses."





## Managing the Crisis and Beyond: Some Policy Recommendations

*While prospects for the GCC are favorable, important challenges remain. The immediate challenge is to complete the cleaning up of banks' balance sheets and facilitate the restructuring of the nonbanking sector in some countries. This should be accompanied by enhancements to regulatory, supervisory, and resolution frameworks, where needed. Over the medium-term, these measures should be accompanied by improved disclosure; an expanded set of macroprudential tools to support monetary and fiscal policy; and regulatory and supervisory frameworks that focus on the stability of the financial system as a whole.*

### Immediate Measures: Addressing Emerging Financial Sector Challenges

#### ***Enhanced communication could improve policy effectiveness***

Clear communication on policy actions, objectives, and rules and procedures governing authorities' actions would help ensure their success and speed up recovery. Improved communication would also help ease investor uncertainty and reduce speculation and market volatility.

#### ***Continued vigilance in the banking sector is needed***

The immediate challenge—for maintaining public confidence in the banking sector and supporting credit growth—is to ensure that the process of cleaning up of the banks' balance sheets is completed smoothly, based on continued upfront recognition of losses and immediate bank recapitalization. This should be accompanied by enhancements to regulatory, supervisory and resolution frameworks, where needed. Specifically:

#### **Continue to be forward looking regarding banking sector**

**recapitalization needs.** The GCC appears to have adopted a strategy of upfront recognition of losses and immediate bank recapitalization. For example, the U.A.E. and Qatar conducted preemptive bank recapitalizations using public funds, which were useful in addressing market concerns. In the period ahead, GCC countries should conduct periodic reviews of banks' asset quality, in addition to stress testing, to determine whether the level of capital support is sufficient. To the extent possible, recapitalization should be based on private sector capital injections to minimize moral hazard. The authorities should maintain a transparent and comprehensive fiscal accounting of intervention and should reverse public sector injections as soon as market

conditions allow it. Assessments of the impact of continued and additional distress, including a further deterioration in real estate markets, would be key. Stress tests could also be used to guide the authorities' decisions on bank asset purchases, if necessary. Some GCC countries have already initiated stress testing (Bahrain, Kuwait, Qatar, and Saudi Arabia).

**Enhance bank supervision and monitoring and act promptly to address bank infractions of prudential regulations.** As the effect of the crisis continues to work through banks' balance sheets, supervisors should monitor banks closely, with attention focused on the larger banks and groups of banks that share similar high risks, such as exposure to real estate.

**Specify rules for bank interventions triggered by objective criteria, i.e., a PCA framework, to help protect supervisors and ensure that banks address emerging problems quickly** (Box 6). In view of the impact of the crisis in Kuwait and the U.A.E., the two countries have already taken the initiative to reform their regulatory frameworks. To that end, Kuwait issued a Financial Stability Law and the U.A.E. plans to amend the banking law to enhance the central bank's enforcement power.

#### **Box 6. Developing a Prompt Corrective Action Framework in the GCC**

The need to develop an appropriate PCA framework has increased in light of the rise in the risks facing financial institutions in the region. This framework essentially entails an explicit set of measures with increasing severity that would be imposed on a bank and triggered by certain indicators of the bank's capital adequacy, liquidity, and/or quality of management. Under this framework, troubled banks would be required to comply with a minimum set of corrective actions, including a regularization plan. If banks fail to comply with these measures, a quick resolution would be important to avoid disruption to the rest of the banking system. Currently, none of the GCC countries has a PCA framework in place.

**Continue to develop contingency plans on a bank-by-bank and system-wide basis.**<sup>23</sup> This process will help facilitate discussions among different agencies (including central banks, ministries of finance, securities commissions, and SWFs/government investment funds) and define their respective roles. This is particularly important, as most GCC countries have limited experience with banking sector resolution.

**Develop speedy and efficient restructuring and resolution frameworks.** Supervisors should review resolution frameworks with a view to introduce more efficient, speedier, and cost-effective options that allow for the reorganization of viable firms and the speedy exit of non-viable ones. These

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<sup>23</sup>Contingency plans should identify vulnerable banks (in terms of liquidity, solvency, or both), their systemic risk, and the strategy to address their weaknesses as they evolve, including the probability of additional capital injections by core shareholders.

could include purchase and assumption transactions, good bank/bad bank legal structure, and bridge bank arrangements.<sup>24</sup> Legal frameworks for corporate restructuring and bankruptcy would also need to be reviewed.

**Avoid a premature exit from extraordinary support measures.** As noted earlier, these actions have been instrumental in containing the financial crisis and should be sustained until the recovery is entrenched.

### *Weaknesses in the nonbank financial sector should be addressed*

Reforms in the nonbank sector should receive high priority in Kuwait and the U.A.E. in light of the systemic importance of nonbank institutions. In this regard, authorities should facilitate the restructuring of nonbank institutions, including by recapitalizing systemic and viable ones while ensuring a smooth exit of nonviable ones. Furthermore, to address weaknesses in the regulatory and supervisory framework of nonbanks, the authorities should (i) strengthen oversight of the risk management practices of those institutions; (ii) adopt tighter conditions for granting licenses; (iii) introduce an appropriate minimum set of *fit and proper* criteria for the appointment of managers and board members; and (iv) enhance disclosure. These measures, if strictly enforced, would enhance soundness, encourage consolidation, and provide a quality hurdle to entry, leading to fewer and well-managed institutions.

## Key Medium-Term Reform Priorities

### *Enhanced corporate governance and transparency is needed*

On the public sector front, there is a need for better corporate governance of state-owned/affiliated enterprises, with greater attention given to managing quasi-sovereign balance-sheet risks, transparency, and excessive leverage. Regarding the banking sector, GCC countries should make FSIs available on a timely basis as delays increase speculation and complicate the market's ability to conduct timely analysis.

As regards the private sector, the incentive structure for companies to improve disclosure and governance needs to be strengthened, and impediments for listing family businesses need to be removed. Banking regulations on large exposures could be amended by linking single-obligor exposure limits to borrowers' listing or rating status. Establishing a second-tier stock market listing with less restrictive requirements could also encourage family businesses to go public.

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<sup>24</sup>See “*An Overview of the Legal, Institutional, and Regulatory Framework for Bank Insolvency*,” April 17, 2009, IMF, available at [www.imf.org](http://www.imf.org).

***Improving the policy framework to address excess liquidity and asset price bubbles***

The international experience with the current crisis has underscored the importance of expanding central banks' traditional mandate to better incorporate financial stability as a complementary objective. Central banks need to react not only to traditional indicators of inflationary pressures, but also to signs of emerging vulnerabilities in banks', corporates', and households' balance sheets, which are typically associated with high credit growth and asset price bubbles. In view of their pegged exchange rate regimes, it is conceivable that GCC countries will be faced with renewed speculative capital inflows as oil prices recover. This could lead to a resumption of overheating pressures and a resurgence of high credit growth and asset price inflation. Given the limitations of monetary policy, fiscal policy would need to be supported by an adequate set of macroprudential tools.<sup>25</sup> The authorities already have in place a number of prudential measures that have helped mitigate the impact of capital inflows and economic booms, such as ceilings on loan-to-deposit ratios and sectoral exposures. These tools would need to be strictly enforced. Reserve requirements should also be actively used, and consideration could be given to widening their base to include banks' short-term foreign liabilities. Other policy options could also include the introduction of a capital gains tax on property and equity transactions.

***A macroprudential approach to regulation and supervision***

The current crisis has shown that focusing exclusively on the financial strength of individual institutions is insufficient for securing financial stability. Accordingly, a "macroprudential" approach that focuses on the stability of the financial system as a whole, as well as its links to the macroeconomy, is warranted. In the GCC, financial stability calls for policies that attempt to insulate the financial system from the oil cycle—both on the liquidity and solvency fronts—and dampen channels by which the oil cycle is transmitted to the non-oil sector and asset prices. Excessive corporate sector leverage, both private and public, should be avoided, and the buildup of balance sheet vulnerabilities should be monitored. Additionally, spillover risks from OFCs should be examined and addressed, cross-border cooperation should be enhanced, and the timeliness and coverage of financial and macroeconomic data should be improved to enable the authorities to conduct effective surveillance.

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<sup>25</sup>Issues related to the choice of exchange rate regime for the GCC countries are analyzed in a recent IMF Board paper, "The GCC Monetary Union—Choice of Exchange Rate Regime," August 28, 2008, available at [www.imf.org](http://www.imf.org).



**Minimizing the impact of the oil cycle on financial sector liquidity.**

Countries should evaluate how best to provide incentives for banks to manage liquidity more efficiently and minimize volatility associated with the oil cycle. Clearly, the fiscal stance has important implications for liquidity. On the monetary policy side, central banks should avoid persistent excess liquidity conditions when oil prices are high by actively using reserve requirements to absorb excess structural liquidity.<sup>26</sup> Additionally, thought should be given to building larger stocks of central bank certificates of deposit or treasury bills to help develop domestic interbank markets to enable banks to manage their liquidity more effectively. Developing the corporate bond market would also help banks reduce their asset/liability maturity mismatches.

**Examining countercyclical approaches to bank capitalization and provisioning practices.**

The objective is to ensure that revised regulations promote prudent provisioning—similar to the case of Saudi Arabia, which has already been implementing countercyclical provisioning policies—and capital buffers over the business cycle. Specifically, capital buffers and provisions should be built up during the boom years to be drawn upon during economic downturns. Saudi Arabia has been implementing countercyclical provisioning policies since the early 2000s and therefore banks have already built a stock of provisions that could be used in the current downturn. Amendments to regulations should be based on the Basel Committee’s revisions to the Basel II framework, which are currently under preparation. Revisions would be better done jointly within the GCC to ensure a level playing field, especially in light of open capital accounts in the region.

**Avoiding excessive leverage in the corporate sector.** Buoyant economic activity and excess liquidity conditions generally associated with high oil prices generate incentives, for both lenders and creditors, to increase leverage. The result is higher corporate sector vulnerability to economic downturns and adverse credit conditions, and large bank exposures to highly leveraged borrowers. The Dubai debt issue is a case in point. Prudential regulations, particularly large exposure limits, should be adequately set and fully enforced to mitigate these risks.

**Strengthening cross-border cooperation.** The need to exchange information among cross-border supervisors has not been critical so far given the still limited number of GCC banks with cross-border operations. However, cross-border cooperation should be strengthened in light of the changing regional financial landscape and increased integration. Harmonization of regulation and supervision within the GCC will also be

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<sup>26</sup>See Alexandre Chailloux and Hakura, Dalia, “Systemic Liquidity Management in the U.A.E.: Issues and Options,” IMF working paper, forthcoming.

essential to avoid regulatory arbitrage in both offshore and onshore banking activities.

**Strengthening regulation and supervision of OFCs.** Key elements would be a stricter licensing policy and closer supervision, which also call for continuous efforts to enhance the number and quality of on- and off-site supervisory staff in charge of OFCs. A high degree of cross-border supervisory cooperation will be crucial to ensure that all aspects of foreign activities that affect the soundness of onshore banks, directly or indirectly, are addressed.

**Improving the timeliness and coverage of data, both on the financial and macroeconomic fronts.** While much information exists in the banks' internal data and management systems, the challenge for the authorities is to improve data aggregation, timeliness, and interpretation for purposes of policy action. Financial data collection should focus on:

- Improvements in classification of sectoral credit exposures to detect concentration, for instance, in the real estate sector.
- Improvements in credit bureau design and use to track concentrated exposures to ultimate obligors, taking into consideration the ownership structures of conglomerates.
- Monitoring of funding, particularly from cross-border sources, of core financial institutions to detect its concentration and maturity structure.
- Measurement and monitoring of leverage in financial institutions, the corporate sector, and households.
- Awareness of complex structures (e.g., cross-border structures, hard-to-value instruments, off-balance sheet vehicles) that currently render some aspects of risk-taking difficult to supervise.

In addition to the above, the authorities should speed up the harmonization of macro data and enhance its timeliness.

### ***Structural reforms to support long-term diversification objectives***

Ongoing initiatives to diversify financing channels away from banks should be pursued. Development of local or regional debt markets for large corporates will allow banks to increasingly concentrate on financing small- and medium-size enterprises that will create the bulk of future jobs. It will also help corporates improve their debt maturity profile, with a positive impact on their liquidity positions, and could enhance corporate governance as debt issuance will demand more rigorous financial disclosure and

transparency. In time, the development of debt markets could also provide new venues for public policy to counteract the adverse impact of banking distress on credit provision to the economy. By directly supporting these markets (for example, through asset purchase programs) during periods of crisis, governments may have more chances to restart the flow of credit than via the sole provision of liquidity and capital to banks.

The experience of emerging markets over the past few years suggests that the development of private bond markets requires government commitment to issue its own debt securities in a full range of maturities and in a fairly systematic way.<sup>27</sup> Fiscal surpluses in the GCC may have made such course of action difficult to justify. However, other countries with sustained fiscal surpluses, such as Norway, Singapore, and Australia, have found ways to keep a critical mass of government debt outstanding as a public good to ensure a reference yield curve and sustain interest by investors and a core number of dealers.

On the fiscal side, countercyclical measures should continue to focus on capital spending to facilitate their future reversal, with the view that private sector demand should replace public sector spending in driving non-oil growth over the medium term. This should be accompanied by structural reforms aimed at promoting the role of the private sector, further streamlining business registration procedures, and reducing administrative barriers to investment.

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<sup>27</sup>For example, Moody's notes that in March 2009, Abu Dhabi issued a \$3 billion bond in international markets, although it did not have an underlying financial need to do so. The issuance assisted Abu Dhabi in establishing a yield curve that could potentially be used as a benchmark for further corporate issuance, and could therefore assist the development of the local bond market. (See *Moody's Global Corporate Finance*, "Gulf Corporates: The Flip-Side of Globalization," June 2009.)

## Intervention Measures Adopted by GCC Countries

Country	Central Bank Liquidity Support	Interest Rate Cuts	Liquidity support via LT Government Deposits	Capital Injection	Deposit and Liability Insurance	Monetary/ Prudential Measures	Stock Market Intervention	Other
<b>Bahrain</b>	CBB deposits of \$150 million in three retail banks.  Introduction of a short-term dollar swap facility at no penalty to banks (October 2008). The term of the facility was extended more recently to one week and one month maturities.	Reduction in repo and discount rates.	Use of oil-export proceeds to raise government deposits in banks with liquidity shortages.			Lowering of reserve requirements.  Expansion in October 2008 of acceptable collateral for overnight funds to include government Islamic securities (Ijara Sukuk).		
<b>Kuwait</b>	Short-term repo of varying tenors.	Reduction in repo and discount rates.	Placement of direct deposits by Government institutions in banks.	Financial Stability law addresses possible bank undercapitalization through a combination of capital injections and government guarantees.	Full protection for customer deposits of local banks.	Increase in prudential loan-deposit ratio from 80% to 85%.	Investment in stock market by KIA through mutual funds.	Financial Stability Law to provide support to financially sound liquidity-constrained investment companies backed by guarantees.

Country	Central Bank Liquidity Support	Interest Rate Cuts	Liquidity support via LT Government Deposits	Capital Injection	Deposit and Liability Insurance	Monetary/ Prudential Measures	Stock Market Intervention	Other
<b>Kuwait</b> (cont'd)	Central bank forex swaps.			In Q3 2008, KIA injected capital in Gulf Bank (private sector participation 68%, KIA participation 32% or around \$145 million).		Increase in bank-specific caps on credit growth.  Reduce the liquidity ratio from 20% to 18% in April 2008.		Investment firms permitted to borrow from government bodies.  Imposition of penalties on banks if they liquidated stocks held as collateral.  The Financial Stability Law encourages lending through partial government guarantees for new loans from local banks to economic productive sectors.
<b>Oman</b>	Central bank forex swaps.	Reduction in repo rates.	Government deposits increased by 30% in the 12 months to June 2009.			In October 2008, the central banks reduced effective reserve requirements by broadening the eligible classes of assets. In January 2009, it reduced the reserves requirements and restored the original asset class for reserves.	The government established a \$400 million facility to support equity prices.	

Country	Central Bank Liquidity Support	Interest Rate Cuts	Liquidity support via LT Government Deposits	Capital Injection	Deposit and Liability Insurance	Monetary/ Prudential Measures	Stock Market Intervention	Other
						Deferment of the planned tightening of the lending ratio.		
<b>Qatar</b>	Central bank overnight liquidity window  Central bank forex swaps	Policy rates kept unchanged since the crisis.	Increased government deposits in banking sector.	Investment in phases by QIA up to 10–20 percent of listed bank's enhanced capital. To-date, \$1 billion has been injection as opposed to the announced \$5 billion.				Purchase of investment portfolio of listed local banks shares by Government, conducted in April 2009 (amount is up to \$2 billion). Purchase of real estate portfolio of banks by Government, conducted in June 2009 (amount up to \$4 billion).  QIA subscribed to the share capital of First Finance Company, an investment company, by \$70 million.
<b>Saudi Arabia</b>	Central bank injection of liquidity to banks through repos and direct deposits.  Central bank forex swaps	Reduction in repo rates	Placement of direct deposits by Government institutions in banks		Deposits and inter-bank liabilities	Lowering reserve requirements.		Government-backed specialized credit institutions to step up lending to the private sector .

Country	Central Bank Liquidity Support	Interest Rate Cuts	Liquidity support via LT Government Deposits	Capital Injection	Deposit and Liability Insurance	Monetary/ Prudential Measures	Stock Market Intervention	Other
<b>U.A.E.</b>	Introduction of several liquidity support facilities (LSF) in September 2008 for AED liquidity, and for dollar liquidity in December 2008 (swaps).	Reduction in repo rate and in LSF rates.	Quantitative easing: CBU purchased bond in October 2008 from federal gov; proceeds placed with banks. These will mature in late 2013 Q4.	February 2009: Fed gov deposits of October 2008 can be converted to tier 2 capital; Abu Dhabi government injects \$4.4 billion to recapitalize five of its banks.	September 2008: All deposits and inter-bank lending guaranteed for 3 years.			Committee to develop policy responses to the crisis comprising the economy minister, central bank governor, and minister of finance.

Country	Central Bank Liquidity Support	Interest Rate Cuts	Liquidity support via LT Government Deposits	Capital Injection	Deposit and Liability Insurance	Monetary/ Prudential Measures	Stock Market Intervention	Other
U.A.E. (cont'd)								<p>Dubai launched a \$20 billion bond program and sold the first \$10 billion tranche to the U.A.E. central bank.</p> <p>Real estate developers permitted to access up to \$2.2 billion from escrow accounts to cover construction commitments.</p> <p>Increased capital adequacy ratio for banks to 11 percent effective September 30, 2009. The ratio to be increased to 12 percent by June 2010. Tier 1 capital to 7% (2009) and 8% (2010).</p>

Source: Based on official press releases and news wires.

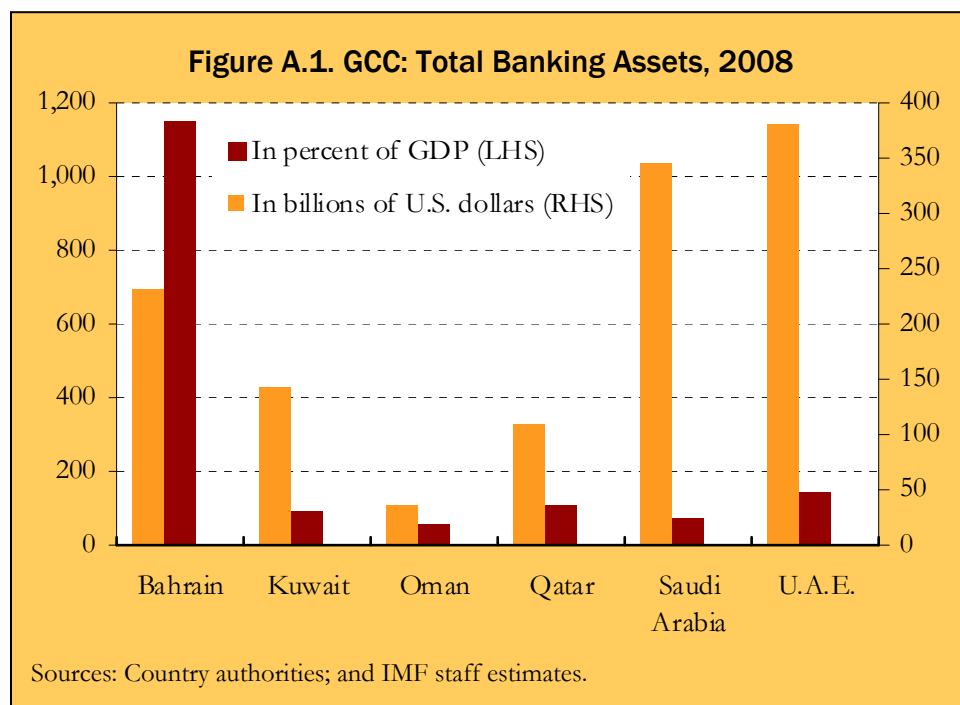


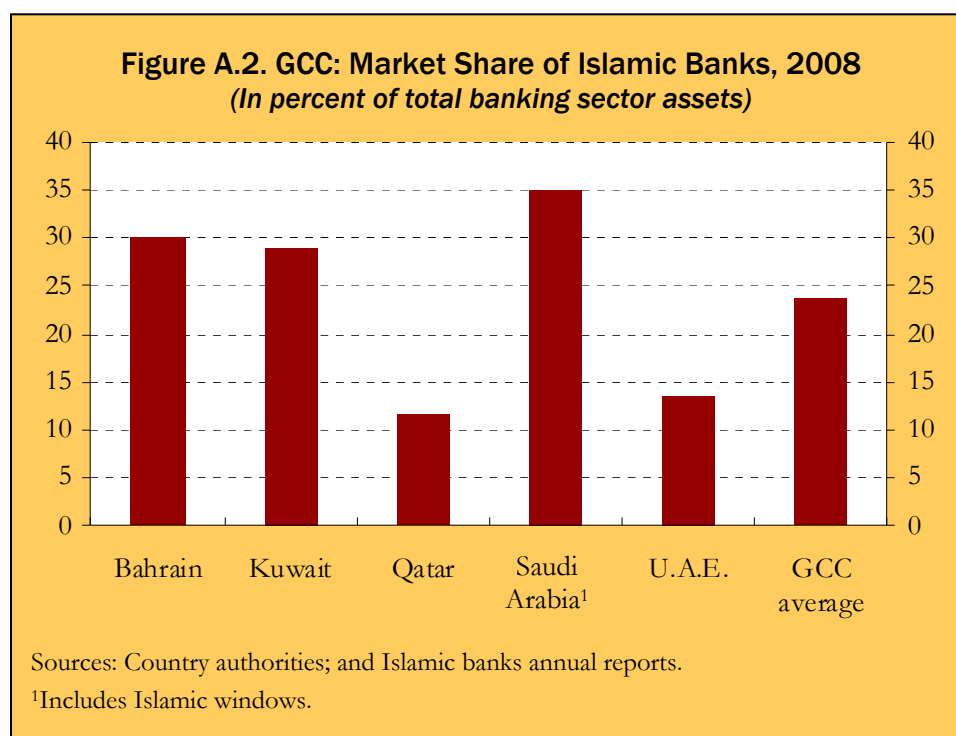


## The Landscape of GCC Financial Systems

### Structure of the Financial System

GCC financial systems remain bank-based, and the importance of Islamic banking is growing. Similar to other emerging countries, the financial systems in the GCC are dominated by banks, although the size of the banking systems varies considerably among countries, with bank assets of around 40 percent of GDP in Oman and 1200 percent of GDP in the case of Bahrain's financial center (Figure A.1). Sizes are higher when expressed in terms of non-hydrocarbon GDP, often viewed as the more relevant metric because the hydrocarbon sector has required little domestic financing in recent years of high oil prices. In addition to Islamic windows in conventional banks (the largest operations are in Saudi Arabia), there has been a growing presence of banks that are exclusively Islamic. At end-2008, Islamic bank assets in the GCC, including Islamic windows in Saudi Arabia, averaged around 24 percent in total banking sector assets (Figure A.2).

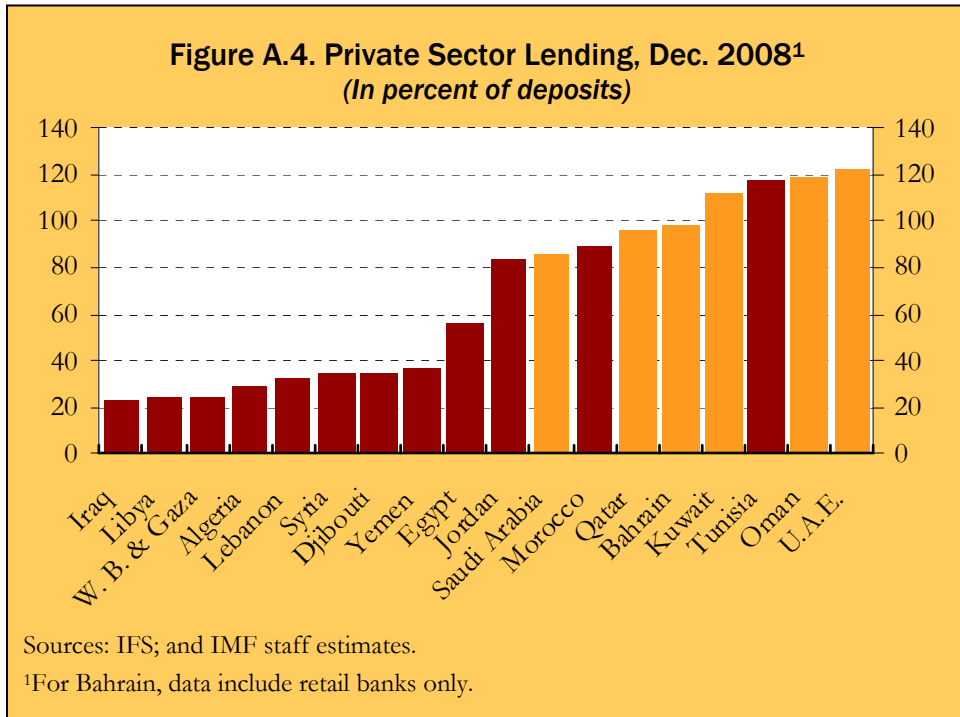
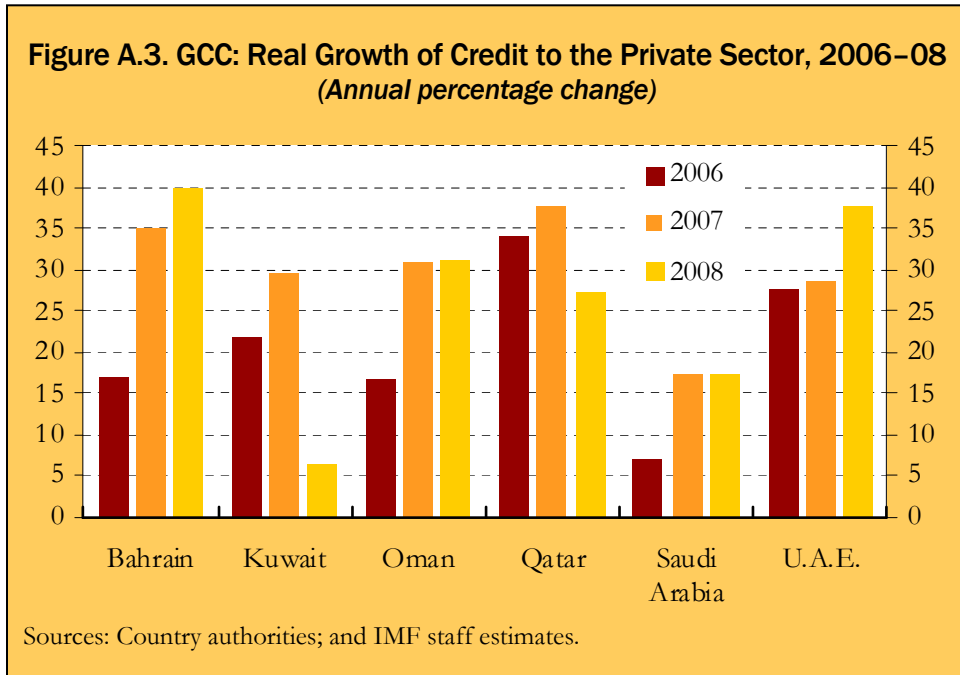




GCC banks retain, by and large, a focus on intermediating local deposits into local lending, except in Bahrain. GCC banks, with the exception of Bahrain, have generally not been involved in the export of the region's surplus capital as this has been done through government-dedicated vehicles such as SWFs, investment funds, or central banks. Banks in faster growing economies, such as Qatar and the U.A.E., have more recently increased their funding from international markets to supplement local deposits to meet strong demand for credit. By contrast, the vast majority of banks in Bahrain—those with a wholesale (as opposed to retail) banking license—do not serve the local economy. The financial center has long been a base for merchant banks doing business in the broader region—including Saudi Arabia's project finance market, investment banks channeling private wealth into non-GCC assets or, more recently, banks pursuing retail strategies in the broader MENA/South Asia region. Financial center strategies are evolving in Qatar and the U.A.E., with off-shore institutions located in those centers being regulated by dedicated authorities.

Credit growth has been brisk in recent years as governments have recycled an increasing share of hydrocarbon export receipts into local economies and accelerated diversification strategies away from oil. Credit growth has been highest in Qatar and the U.A.E. (Figure A.3), and credit as a percent of non-hydrocarbon GDP has grown the most in U.A.E. Credit growth has on occasion translated into increased concentration risk, either in the form of larger exposures to traditional corporate clients or in the form of sectoral

concentration, such as real estate/construction or ICs. Additionally, credit growth resulted in lower bank liquidity and increased dependence on foreign financing as loans exceeded deposits in a number of GCC countries (Figure A.4).



Several GCC countries maintain restrictions on foreign ownership of banks. Foreign ownership is highest in Bahrain, U.A.E., and Oman, where restrictions are fewer. Market shares of foreign-owned banks by total assets are Bahrain (57 percent), U.A.E. (21 percent), Oman (12 percent), Qatar (10 percent), Kuwait (10 percent), and Saudi Arabia (2 percent).

Formal state ownership of banks is low, though informal channels of influence can be significant. Bahrain, Kuwait, and Qatar had limited public sector ownership of banks prior to the intensification of the crisis in 2008 (Table A.1), although Qatari banks have recently received extensive support, and one bank in Kuwait was recapitalized, partly with public sector funds. Oman and Saudi Arabia have a relatively higher public sector component when including quasi government. U.A.E. domestic banks stand out in the GCC, either in the form of direct government ownership or via royal families' ownership. More recently, key Abu Dhabi and Dubai banks received significant public support in the form of equity injections to mitigate the impact of the current crisis. Regardless of formal ownership arrangements, de facto state influence over domestic banks remains pervasive wherever hydrocarbon wealth is important. In these countries, state control over hydrocarbon resources fundamentally determines activity in the non-hydrocarbon sectors of the region, including through strong connections between state and core industrial and financial groups.

**Table A.1. GCC: Ownership Structure of the Domestic Banking System, End-2007**  
(In percent of total assets)

	Public				Private Domestic Total	Private Foreign		
	Total	Government	Quasi Government <sup>1</sup>	Domestic Royal Family		Total	GCC	Non-GCC
Bahrain	20.4	9.0	11.4	...	41.8	37.8	34.7	3.1
Kuwait	13.0	12.0	1.0	...	87.0	...	...	...
Oman	30.0	10.0	19.0	1.0	40.0	30.0	14.0	16.0
Qatar	20.7	20.4	0.3	...	75.6	3.7	3.7	0.0
Saudi Arabia	35.0	18.0	17.0	...	52.0	13.0	...	13.0
U.A.E.	52.3	41.5	0.5	10.3	47.6	0.2	0.2	...

Source: A Topography and Analysis of the GCC Banking Systems, by Abdullah Al-Hasan, May Khamis, and Nada Oulidi, IMF working paper, forthcoming.

<sup>1</sup>Quasi government includes public pension funds and social security.

Investment funds have been growing rapidly in several countries, though they tend to remain largely focused on domestic equity and real estate. There are 95 ICs in Kuwait, with total assets under management of around 102 percent of GDP—around 42 percent of which is proprietary—close to the size of the banking sector (end-2008). Investment banks in Bahrain are fewer, but larger. Mainly bank-owned mutual investment funds have some

presence in Bahrain, Saudi Arabia, and U.A.E.<sup>28</sup> In Saudi Arabia, the Capital Market Authority has actively promoted the growth of the industry to reduce the dominance of retail sentiment in the stock market. Nonbank finance companies, such as mortgage companies, are few and far between. This sector is most important in the U.A.E., although the two largest companies, now in restructuring, had lending worth only close to 3 percent of the banking sector's loans. Overall, GCC asset management is dominated by government-linked investment vehicles, such as SWFs and, to a lesser extent, public pension funds. The insurance sector remains small and is focused on property/casualty risks.

Contractual savings are underdeveloped. Public pension systems usually represent the largest portion of contractual savings, and are mainly defined benefit, "pay-as-you-go" schemes. They are unfunded and contribute little to the accumulation of long-term resources for investment.<sup>29</sup> Where reserves exist, they are usually invested in debt of government-related entities, and therefore do not contribute to financing long-term private sector investment. In years to come, the financing of public pension schemes (for nationals) could pose problems, and alternative retirement schemes, such as private sector pension funds and life insurance, should be developed.

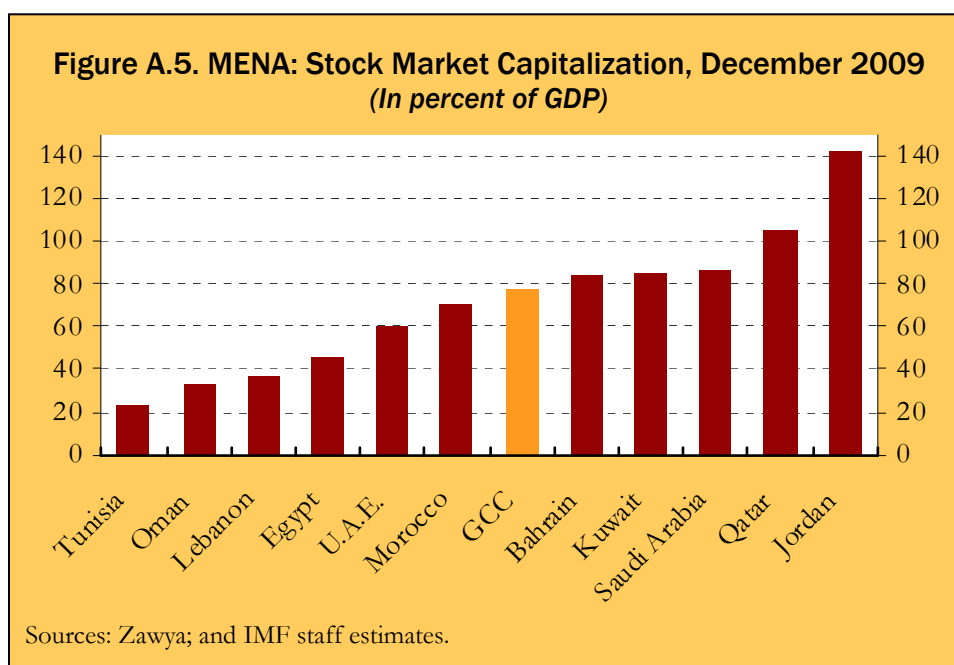
Stock market capitalization has grown strongly in recent years, reflecting limited free float, diffusion of government oil revenues to household incomes, and some underpricing of IPOs. GCC market cap leapt from \$117 billion (29 percent of GDP) in 2003 to \$1.1 trillion (177 percent of GDP) in 2005 but fell back to \$650 billion (73 percent of GDP) by mid-2009 (Figure A.5). GCC markets generally lack institutional investors whose long-term horizons help dampen volatility. A key factor deterring large institutional investors is the limited free float in leading stocks. The explosion in market capitalization until 2005 reflected also the part-privatization of state entities through underpriced IPOs. In several countries, governments underpriced these offerings significantly as a mechanism to share oil wealth with retail investors, most of which were new to stock investing. Some underpricing contributed to frenzied trading by retail accounts, volatility, and a neglect of fundamentals analysis.<sup>30</sup> As investors realized that stock returns could not be sustained, the market corrected sharply, and the advent of the global crisis has delayed any significant shift from retail to institutional accounts. A recent important development in the region is that some stock exchanges are establishing strategic partnerships with Western exchanges (Qatar and, under consideration in Kuwait), and improving the regulatory

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<sup>28</sup>Mutual fund assets amount to 4.3 percent of GDP in Saudi Arabia and 80 percent in Bahrain.

<sup>29</sup>For example, pension fund assets amounted to 3.2 percent of GDP in Saudi Arabia (end-2007), 2.7 percent in U.A.E. (end-2007), and 20.5 percent in Bahrain (end-2006).

<sup>30</sup>Trading by high net worth individuals classified as retail investors is often larger than that of institutional investors.



frameworks for the equity market (Kuwait, Qatar, and Saudi Arabia). This could help integrate the markets. At present, cross-listed shares are few and barely trade in secondary listing. Integration is plagued by the absence of links among custodian arrangements, and the lack of harmonization of regulatory frameworks and business processes.

The undeveloped local debt markets reflect cyclical government funding needs and ample bank liquidity in recent years. Some of the GCC states have long histories of issuing either conventional or Shariah-compliant instruments on a regular basis. However, as their fiscal stances improved during the period of increasing hydrocarbon prices, most of those governments drew down outstanding debt and ceased new issuance activity.<sup>31</sup> Such cyclicity impeded the emergence of reliable yield curves. Furthermore, the still largely family-based corporate groups may be unwilling to comply with disclosure rules of private debt markets. Developing a mortgage bond market would also help manage maturity mismatches in bank balance sheets.

GCC issuers boosted the use of *sukuk* until mid-2008.<sup>32</sup> *Sukuk* issuance worldwide grew from around \$5 billion per year in 2001–04 to \$32 billion in

<sup>31</sup>This was at a time when local currency markets became the fastest growing segment of the emerging market debt asset class. Emerging market corporates began displacing sovereigns for the dominant share though sovereigns continued to play the role of benchmark. These developments were supported by a doubling in size of pension fund assets since 2002.

<sup>32</sup>*Sukuk* are sale-and-leaseback obligations based on issuers' tangible assets, often land. *Sukuk* special purpose vehicles avoid interest payments, which instead take the form of rents. *Sukuk* have become popular with Western fixed-income funds looking for regional diversification and yield pick-up.

2007, then fell to \$15 billion in 2008, most of it dollar-denominated by GCC entities.<sup>33</sup> While *sukuk* were insignificant a decade ago, as of mid-2009, a quarter of outstanding debt obligations issued by GCC entities were *sukuk*, a share that reaches one third for sovereigns (Table A.2). *Sukuk* are still a small corner of the global bond market, but they have allowed issuers to target Islamic investors in the GCC, South Asia, or out of London. However, Shariah rules still make these structures highly customized. Lack of standardization hampers market development, adding issuance costs in normal times and amplifying risks in stressful times, including because of uncertain Shariah compliance of certain structures. With the onset of global financial turmoil, issues surrounding tradability and enforceability have contributed to significantly wider spreads (in excess of 50 percent wider) for *sukuk* than conventional GCC bonds.<sup>34</sup> In the 12 months through June 30, 2009, GCC *sukuk* issuance dropped to \$4.4 billion. Nevertheless, issuance could rebound, as continued infrastructure spending in the Gulf ensures a steady need for medium-term finance, and Islamic banks are looking to invest liquidity because of dwindling demand for their real estate-related loans.

**Table A.2. GCC: Share of Sukuk in GCC Debt Markets, Mid-2009**  
(Debt outstanding, in billions of U.S. dollars)

	Issuers			Total
	Sovereigns	Financials	Nonfinancials	
Sukuk	1.9	5.5	6.4	13.8
Conventional	3.4	19.3	19.3	42.0
Sukuk share (percent)	35.8	22.2	24.9	24.7

Sources: DIFC; and IMF staff estimates.

## Prudential Regulation and Supervision

The overall systems for banking system supervisory surveillance in the GCC are well developed and reflect international practices to a large extent. However, nonbank regulatory and supervisory frameworks are still fragmented and lag in development (Box A.1). While there are no significant gaps in the banking sector supervisory approaches among the GCC countries, there is room for further harmonization, including by adopting a unified ratings system to ensure that supervisory decisions and corrective

<sup>33</sup>Although Malaysia remains the largest single market, Malay *sukuk* are denominated mostly in MYR. Source: Moody's, January 2009.

<sup>34</sup>Kuwait-based Investment Dar Company defaulted on its \$100 million in December 2008, the first *sukuk* default in the Gulf. Saudi-based Saad Trading Contracting and Financial Services Company have initiated debt restructuring discussions (\$650 million due May 2012) with creditors in May 2009. Dubai-based real estate developer, Nakheel, announced that it was seeking a standstill on its *sukuk* (\$3.5 billion due December 2009) on November 25, 2009.

### **Box A.1. GCC: The Institutional Structure for Financial Sector Regulation and Supervision**

In the GCC, institutional responsibility for banking regulation and supervision is well-entrenched in the various central banks, but supervision of the nonbank financial sector is either fragmented (in the case of capital markets and institutions) or lacks independence and is less developed (in the case of the insurance sector).

**Bahrain.** The Central Bank of Bahrain is responsible for regulating and supervising the whole of Bahrain's financial sector, including the retail and wholesale banking systems, the insurance sector, investment firms, brokers, investment advisors, the Bahrain Stock Exchange, finance companies, and other financial services. As regards credit information, in 2005, the Benefit Company (owned by seventeen commercial banks in Bahrain) launched the first phase of a Credit Reference Bureau that deals with personal credit. A future phase will deal with corporate credit. Finally, Bahrain has a deposit insurance scheme.

**Kuwait.** The Central bank of Kuwait (CBK) regulates and supervises banks, investment companies (ICs), mutual funds, and domestic exchange companies. The supervision of the securities market lies with a number of bodies and is therefore fragmented. The Market Committee and the Kuwait Stock Exchange are responsible for the supervision of the securities secondary market, while, as noted above, the CBK supervises ICs. The Company Department of the Ministry of Commerce and Industry (MOCI) supervises the primary securities market (the issuers). Supervision of the small insurance sector rests with the Insurance Department in the MOCI. A credit bureau, Ci-Net, owned by 17 banks and ICs, operates a retail registry in Kuwait since 2002.

**Oman.** The Central Bank of Oman regulates and supervises the banking system, investment and merchant banks, and leasing and finance companies. The Capital Market Authority supervises the Muscat Securities Market in regard to listed securities, but not government securities. Insurance supervision is conducted by the Ministry of Commerce and Industry. Oman has a private credit bureau, the National Bureau Commercial Information, which was established in 2008, and collects retail and corporate information. Similar to Bahrain, Oman operates a deposit insurance scheme.

**Qatar.** The Qatar Central Bank (QCB) regulates and supervises the banking sector, ICs, finance companies and mutual funds. The Doha Securities Market (DSM) regulates the stock exchange and its participants, mainly listed companies and brokerage firms. Responsibilities for the supervision of the securities market are therefore fragmented between the QCB and the DSM. The Qatar Financial Center (QFC) is regulated by the QFC Regulatory Authority. The QCB maintains a registry with only partial credit histories to which commercial banks have access. Commercial banks, retailers, and finance companies are collaborating to launch a private credit bureau with QCB encouragement, which should permit more comprehensive collection and sharing of data on SMEs and individuals.

**Saudi Arabia.** The Saudi Arabia Monetary Agency regulates and supervises the banking system and the insurance sector. The capital market authority regulates and supervises the securities market. A Saudi retail credit bureau, SIMAH, was established by the Saudi commercial banks in 2004.

**U.A.E.** The CBU regulates and supervises the banking sector, investment funds, ICs, investment advisors, brokers, moneychangers, and finance companies. The securities market in the U.A.E. consists of the Dubai Financial market, the Abu-Dhabi Securities Market, and the Dubai Gold and Commodities Exchange, all regulated by the Emirates Securities and Commodities Authorities. The insurance sector is supervised by an Insurance Commission under the Ministry of Economy. The Dubai International Financial Center (DIFC) is regulated and supervised by the Dubai Financial Services Authority, which is an independent regulator. An independent credit bureau for both retail borrowers and corporates, EMcredit, was established in 2006 and is licensed in the DIFC.



actions are based on consistent analysis across the region. On the prudential side, there is room for harmonization of capital requirements under Basel II, and regulations governing general provisions and large exposures and connected lending (Table A.3).

Overall, GCC countries have an adequate range of remedial and enforcement powers for bank resolution that include issuing Memoranda of Understanding (MoUs) to banks, temporary restrictions on business activities, replacement of management, temporary management, receiverships, and liquidation. However, further harmonization of bank resolution regimes would be useful to support financial integration, in addition to harmonization in arrangements for lender-of-last-resort, deposit insurance, and crisis management more generally.

No formal mechanisms for the exchange of information among GCC supervisors, and only limited arrangements with other domestic supervisors, are in place. Some bilateral MoUs exist: Oman has MoUs with the U.A.E. and Bahrain, and Bahrain has signed a MoU with the Dubai International Financial Center regulatory agency.

**Table A.3. GCC: Selected Prudential Regulations**

	Bahrain	Kuwait	Oman	Qatar	Saudi Arabia	U.A.E.
<b>1. Liquidity Requirements</b>						
a. Loan-to-deposit ratio	A voluntary 60–65% for most banks and 70–75% for those without large investments outside loans.	80%, but relaxed to 85% in response to liquidity pressures.	87.5%	90%	85%	There is no loan/deposit ratio. Instead, credits cannot exceed stable resources, defined as 85% of customer deposits of less than 6 months, 100% of deposits and market funding over 6 months, and free own funds. Credits include interbank placements of more than six months. Limit has to be met at quarterly frequency.
b. Liquidity ratio	Liquid assets/total assets: 25% .	Liquid assets/customer deposits in domestic currency: 18% .		Current assets/current liabilities: 100%.	Liquid assets/total assets: 20%	
c. Liquidity management	Maturity mismatch approach.	Maturity mismatch approach.	Maturity mismatch approach.	Maturity mismatch approach.		Maturity mismatch approach.
<b>2. Reserve Requirements</b>	5 % of total deposits, based on end-of previous month data, to be maintained on a daily basis.	None.	5% on total deposits.	4.75% of total deposits to be met on average of balances between the 16th of each month to the 12th of the following month.	7% on demand deposits. 4% on time and saving deposits.	14% of demand deposits to be met on average over a weekly cycle.

	Bahrain	Kuwait	Oman	Qatar	Saudi Arabia	U.A.E.
<b>3. Sectoral Exposure Limits</b>						
a. Real estate sector	In October 2009, the CBB established a 30% cap on real estate lending of banks as share of total bank lending. Also, banks' own investment in real estate was capped at 40 percent of the capital base. This Directive was suspended shortly afterwards, in November 2009.			Real estate lending not to exceed 150% of bank's capital and reserves or 15% of total customers' deposits, whichever is less. For Islamic banks, weighted average of 150% of bank's Tier 1 capital and 15% of total customers' deposits.		Limit on lending for the purpose of constructing residential and commercial buildings: 20% of deposits.
b. Other		Limit on loans for purchasing securities is 10% of total loans, or 25% of bank capital, whichever is less.	There are limits on total loans to retail customers in the measure of 40 percent of total banks loan portfolio for personal loans, and 10 percent for housing finance.	Proprietary holding of stocks capped at 30% of capital plus reserves.	Consumer lending limit: 30% of banks' total loans and advances.	
<b>4. Household Lending Limits</b>		Total monthly repayments should not exceed 40 percent of borrower salary and 30 percent of income for pensioners.  Real estate mortgages are capped at KD 70,000 per person.		Credit to individuals capped at 50 percent of monthly salary and allowances, not to exceed QR 2.5 million per person.	Total monthly repayments (for both loans and credit cards) should not exceed 30% of a borrower's salary.	

	Bahrain	Kuwait	Oman	Qatar	Saudi Arabia	U.A.E.
<b>5. Capital Adequacy Ratio</b>	12%	12%	10%	10%	8%	10% prior to the crisis. CAR was raised to 11 percent effective September 30, 2009 and to 12%, to become effective June 30, 2010.
<b>6. General Provisions for Credit Risk</b>	none	1%	1% (2% for personal loans)	2%	1%	1% allowed but not required
<b>7. Definition of NPLs</b>	90 days	90 days	90 days	90 days	90 days	180 days for corporates; 90 days for individuals
<b>8. Loan Loss Provisioning</b>	Based on IAS 39	Substandard: 20% Doubtful: 50% Loss: 100%	Substandard: 25% Doubtful: 50% Loss: 100%	Substandard: 20% Doubtful: 50% Loss: 100%	Substandard: 25% Doubtful: 50% Loss: 100%	Substandard: 25% Doubtful: 50% Loss: 100%
<b>9. IFRS Provisioning vs. Regulatory Provisions</b>	IFRS	The higher	The higher	The higher	The higher	The higher
<b>10. Large exposure (as % of total capital and reserves)</b>	15% individual  800% total	15% individual  400% total	15% individual  600% total	25% individual, not to exceed QR 3 billion to single customer group  600% total	25% Individual limit  800% total (for all exposures exceeding 10%)	7% individual. Permitted exposures to government commercial obligors or banks are generally higher.  800% total
<b>11. Connected Lending (as % of total capital and reserves)</b>	10% individual 20% total	15% individual 50% total	10% individual 35% total	7% individual 35% total	10% individual 50% total	5% to Directors 7 % to individual borrower group of companies

	Bahrain	Kuwait	Oman	Qatar	Saudi Arabia	U.A.E.
<b>12. Other</b>				Loan-to-value ratio of 65 percent for commercial real estate.  Loans for securities investments not to exceed 50 percent of value of stocks purchased from external markets and 40 percent for shares purchased from DSM.		
Source: Country Authorities.						



## Islamic Banks in the GCC: How Did They Fare Compared to Conventional Banks?

*Islamic banks were less affected than conventional banks by the initial impact of the global crisis, likely reflecting a stronger first-round impact on conventional banks through mark-to-market valuations on securities in 2008. For 2009, H1 data indicate slightly larger declines in profitability for Islamic banks, which could be attributed to second-round effects of the crisis on the real economy and the real estate market. Islamic banks are better poised to face additional shocks due to their larger capital and liquidity buffers. Looking ahead, the risk-sharing aspect of Shariah-compliant contracts could add to this buffer.*

### Islamic Banks Have Grown Substantially in Recent Years

Reflecting a strong increase in the demand for Shariah-compliant products, both in the region and globally, the Islamic banking industry has witnessed significant growth, with assets currently estimated at close to \$850 billion (Table A.4).

**Table A.4. Market Share and Average Annual Asset Growth of Islamic and Conventional Banks in Selected Countries**  
(In percent)

	Share of Islamic Banks' Assets in Total Assets in 2008	Growth Rate of Assets (Islamic Banks)	Growth Rate of Assets (Banking System) <sup>1</sup>	Period
<b>Saudi Arabia<sup>2</sup></b>	35.0	33.4	19.0	2003–08
<b>Bahrain<sup>3</sup></b>	29.9	37.6	9.6	2000–08
<b>Kuwait</b>	29.0	23.2	14.3	2002–08
<b>U.A.E.</b>	13.5	59.8	38.1	2001–08
<b>Qatar</b>	11.5	65.8	31.9	2002–08
<b>GCC average</b>	23.8	44.0	22.6	2000–08
<b>Jordan</b>	10.3	20.6	11.2	2001–08
<b>Yemen</b>	30.2	26.5	22.7	2004–08

Sources: Central banks; and Islamic banks' annual reports.

<sup>1</sup>Including Islamic banks.

<sup>2</sup>Including Islamic windows.

<sup>3</sup>Growth rate is calculated for the total of wholesale and retail while market share is for retail only.

## **Did Islamic Banks Face Different Risks Going into the Global Crisis?**

Islamic banks and conventional banks face similar risks in that (i) the risk profile of Shariah-compliant and conventional contracts are comparable and (ii) credit risk is the main risk for both types of banks. Unlike conventional banks, however, Islamic banks are not permitted to have any direct exposure to financial derivatives or conventional financial institutions' securities—which were hit most during the global crisis. Interestingly, an analysis of the GCC top 50 banks<sup>1</sup> indicates that conventional banks also had this advantage going into the crisis—direct exposure to equity investments (and derivatives in the case of conventional banks) were very low in both types of banks (a mere 1 percent of total assets in conventional banks and 2 percent for Islamic banks in 2008).

The main difference in risk exposures appears to be related to the concentration risk of Islamic banks in certain countries. While Islamic banks' exposure to the risky real estate and construction sectors is lower in Saudi Arabia, Kuwait, and Bahrain, it is significantly higher than the system's average in the U.A.E. and Qatar.

## **How Did the Banks Fare During the Crisis?**

GCC banks' profitability fell in 2008 and the first half of 2009, with a largely similar overall impact on Islamic and conventional banks (Table A.5). Islamic banks were less affected than conventional banks by the initial impact of the global crisis, potentially reflecting a stronger first-round effect on conventional banks through mark-to-market valuations on securities in 2008. For 2009, H1 data indicate slightly larger declines in profitability for Islamic banks compared to conventional banks, which could be attributed to second-round effects of the crisis on the real economy and the real estate market.<sup>2</sup> There are, however, differences in the relative impact on Islamic banks within the GCC countries, reflecting variations in exposures to risky asset categories. In particular, the weaker performance of Islamic banks in 2009 was largely driven by the U.A.E. and Qatar, where they had a considerably higher exposure to real estate and construction sectors. Banks are expected to post additional provisions in 2009. Accordingly, a more complete view of the impact of the crisis on the two groups of banks is unlikely to become available before early 2010.

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<sup>1</sup>Based on Bankscope data. The sample for the sector includes the top 49 banks (conventional and Islamic). The Islamic banks' sample includes the top 18 Islamic banks.

<sup>2</sup>Relatedly, a Passport Capital report concluded that Islamic banks in the GCC appeared to have been as exposed to the global environment as conventional ones. See Florence Eid and Lea Chaftari, September 2009, "Is the Cup Half Empty or Half Full? A Summary Report on 2nd Quarter Results from GCC banks."

**Table A.5. GCC: Selected Indicators for GCC Islamic Banks and the Banking System  
(In percent; 2008)**

	Saudi Arabia <sup>1</sup>		Kuwait		U.A.E.		Bahrain		Qatar		GCC Average <sup>2</sup>	
	Islamic	All	Islamic	All	Islamic	All	Islamic	All	Islamic	All	Islamic	All
Capital adequacy ratio	22.1	16.0	21.7	16.0	12.8	13.3	24.5	18.1	17.9	15.6	19.8	15.7
Change in profitability (2007–08)	2.0	-11.8	-42.7	-70.1	0.7	7.9	14.7	-4.8	4.5	21.7	-7.6	-14.2
Change in profitability (H1 2009–H1 2008)	2.9	-11.9	-71.9	-65.3	-34.2	-19.5	-57.6	-36.8	0.0	5.1	-29.3	-23.3
Change in profitability (2008 and H1 2009 compared to 2007) <sup>3</sup>	4.3	-7.2	-49.7	-65.8	-0.8	10.0	1.4	-3.4	2.8	25.4	-9.7	-10.5
Return on assets	3.7	2.1	1.6	3.2	1.7	2.2	2.6	1.3	6.6	2.6	3.2	2.3
Exposure to real estate and construction <sup>4</sup> (as percent of total loans)	5.6	7.3	22.1	31.4	25.7	12.9	11.3	26.2	38.3	18.4	20.6	19.2

Sources: Authorities; banks' financial statements; Zawya; and IMF staff estimates.

<sup>1</sup>The analysis for Saudi Islamic banks does not include Islamic windows in conventional banks.

<sup>2</sup>Simple average except for change in profitability.

<sup>3</sup>Based on average monthly profitability.

<sup>4</sup>It is not clear from published data whether exposures to real estate and construction include household mortgages. Exceptions comprise the Islamic bank data for Qatar, where it is clear that household mortgages are included, and banking sector data for Kuwait, which do not include household mortgages. This renders the comparability of exposures difficult.

## Which Group of Banks Is Better-Positioned to Withstand Adverse Shocks?

With larger capital and liquidity buffers, Islamic banks are better-positioned to withstand adverse market or credit shocks. On average, Islamic banks' CARs in the GCC are higher than those for conventional banks (except in the U.A.E.). The risk-sharing aspect of Shariah-compliant contracts adds to this buffer, as banks are able to partially compensate their losses by providing lower returns to their investors. However, the higher capital buffers can be somewhat counteracted by the faster credit growth for Islamic banks in recent years. Islamic banks tend to maintain high liquidity on their balance sheets in the form of short-term international Mudarabah and central bank deposits. It should be noted, however, that this is attributed to the fact that liquidity risk and management is generally more challenging for Islamic banks, as there is still a shortage of liquid Islamic instruments that Islamic banks can utilize, both in the interbank market and at the various central banks.



**Impact of the Global Financial Crisis on the Gulf Cooperation  
Council Countries and Challenges Ahead**

