



Implications Of Economic Crisis Affecting Islamic Banks

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[Khalid A. Al Bassam, Chairman
of Bahrain Islamic Bank and
former Deputy Governor of
Central Bank of Bahrain]

GCC Tackles Global Financial Crisis

OIL PRODUCING COUNTRIES ARE NOT ABOUT
TO GO OUT OF BUSINESS JUST YET WITH SOME
GOVERNMENTS GUARANTEEING STABILITY

Markets across the globe have fallen in October 2008 and GCC markets have not been able to escape this adverse global market impact. Government intervention cannot be avoided for the time being and this has been exemplified in both the United States and Europe. Many governments and central banks around the world, including the GCC, have intervened to support their financial systems. The GCC's measures have however been quite decisive and went to even guaranteeing all bank deposits and assuring the market and all the banks that any short fall in liquidity requirements by banks will be provided for. Khalid A. Al Bassam, Chairman of Bahrain Islamic Bank and former Deputy Governor of Central Bank of Bahrain, gives BUSINESS LIFE an in depth account of the inner workings of the GCC financial system in relation to the global financial crisis.



Khalid A. Al Bassam, Chairman of Bahrain Islamic Bank and former Deputy Governor of Central Bank of Bahrain

BL: Gulf Central Banks have intervened to save markets from collapse especially after the most recent decline; do you anticipate any further downfalls in the GCC stock markets?

Khalid A. Al Bassam: This intervention will address only the effects of the crisis and not its underlying causes. Therefore, other actions must be taken to prevent further unjustified market declines. Transparency in the banking system and other listed sectors in the Gulf States have to be improved. GCC countries should create venture capital funds to channel some of the excess capital into meaningful domestic startup companies, create infant industries in the high tech and IT sectors, and help create an investor class. Finally, the development of integrated equity markets in the GCC region would require greater coordination of regulatory and supervisory frameworks and an easier flow of capital between the countries.

BL: How do you analyze the crisis in the banking sector and on Wall Street? Would it affect the global economy, what is the way out of this collapse, and when would it end?

Khalid A. Al Bassam: The financial crisis that started in August 2007 after the collapse of the U.S. sub prime mortgage market entered a tumultuous new phase in late September 2008 that has badly shaken confidence in the global financial institutions and markets. Most dramatically, intensifying solvency

concerns have triggered a cascading series of bankruptcies, forced mergers, and public interventions in the United States and Western Europe, which has resulted in a drastic reshaping of the financial landscape. Moreover, interbank markets have been virtually locked up as trust in counterparties has substantially reduced. Responding rapidly, the U.S. and European authorities have announced far-reaching measures aimed at supporting key institutions, stabilizing markets and bolstering confidence, but markets have remained highly unsettled and very volatile.

In order to gradually take the world economy out from this crisis, governments, central banks and regulators need to continue their support measures, and strengthen them where necessary, to restore the normal functioning of the critical interbank and money markets. Both U.S. and European authorities need to formulate frameworks for bank resolution and recapitalization.

Financial firms need to move forward to raise additional capital and strengthen their business practices to help restore confidence in the financial institutions and markets. Macroeconomic policies need to be supportive of the immediate goal of stabilizing markets within a broad framework consistent with medium-term objectives of renewed growth with price stability.

BL: Presently, what concerns most GCC investors?

Khalid A. Al Bassam: While it is true to say that the direct and real exposure of Gulf banks to the subprime mess has relatively been limited, there are many reasons why Gulf investors are not immune to the current crisis. First, Gulf investors share the panic and jitters felt worldwide due to concerns regarding the crisis and its potential impact on local shares, real estate, corporate earnings and currencies. Second, some GCC institutions and investors hold securities affected by the subprime crisis directly or indirectly. Third, high volatility in commodity prices, including oil, increases the Gulf's uncertainty. This volatility makes Gulf institutions particularly nervous, as sustained energy prices are the backbone of the region's revenues and the driver of increased liquidity and growth. The Gulf's vulnerability to the global financial crisis is evident in a number of ways. GCC equity markets have lost significant

value and investor confidence has weakened. The global trend of "de-leveraging" (a forced reduction of the debt-to-equity ratios of financial institutions, corporations, and households) will almost certainly manifest itself in the Gulf as well. It is however important to note that the GCC economies still remain in a sounder and lesser structural problem than the US and Europe. This is evidenced by the strong economic growth in the last 4 to 5 years.

BL: How do you find the progress so far in the process of mergers and acquisitions among the GCC banking sector?

Khalid A. Al Bassam: There are moves towards national and regional consolidation in the GCC banking industry. In Oman, for example, the central bank has been actively promoting mergers among banks, which are among the smallest in the region. Moreover, the crises in the global financial markets have produced a flurry of bank mergers, acquisitions and full or partial state takeovers not witnessed for decades with implications for Gulf banking structures.

Besides the economies of scale and other economic benefits that merged units may reap, mergers, especially among Gulf banking units will help expand the range of banking services and allow the merged units to provide financial services throughout the Gulf region. Therefore, the merged units can provide a lead in developing the efficiency of financial intermediation within the GCC, and in addition to better facing international competition. Mergers should not be just an issue for endless debate; process must be initiated to make them a reality. With further implementation of the common market in the Gulf, we are expecting mergers and acquisitions across GCC borders as a greater necessity.

For all the above, I anticipate increased mergers and acquisitions among the Gulf banking and financial institutions in the near future. I am a strong believer that with the right complementing strategic mergers and partnerships will serve to create stronger financial institutions which will help to create a stronger financial system.

BL: What are your comments on the Asian markets? Will they cope with this storm?

Khalid A. Al Bassam: As we all now, the Asian countries are a big market for US outsourcing, the technological products being manufactured in Asian companies find their way largely into the US market, and financial needs of Asians have been more or less satisfied by US banks. In such circumstances, it is obvious that Asia also has to bear the brunt. The volatility of market and uncertainty,

which gripped the world around, is surely going to have long lasting consequences. Whether it is India, China, Singapore or any other Asian country, the financial market of each and every economy has registered recession due to the US meltdown. In China, the low-end contract manufacturers are scrambling for their survival. Whatever the exact impact of the financial crisis on various Asian countries, how the continent's major economic powers understand and deal with it will have immense consequences for the rest of the world.

BL: As a financial figure in the region and abroad what is your outlook on the GCC's financial and real estate sectors?

Khalid A. Al Bassam: Regarding the financial sector, this sector has been instrumental in development and economic growth. The supervisory and the regulatory frameworks have been strengthened, and banks have improved their capital position in line with international standards on capital adequacy. In addition, the participation of foreign banks through joint ventures with local banks and the development of the offshore market in Bahrain have enhanced the depth and sophistication of the banking sector in the GCC countries. In my opinion, the Banking sector in the GCC has been among the leading, contributing, and most advanced, sectors.

Apart from a few Gulf banks that have a direct exposure in the subprime market, the Gulf banking system is not expected to be affected directly by the financial crisis because it holds no key stakes in the collapsed banks. GCC central bank governors also confirmed the stability of their banking systems. However, there certainly is serious concern over the other major US financial institutions in which significant Gulf investors hold important stakes.

As the domestic financial system would be expected to provide a key supportive role in the process of economic diversification and growth, there are a number of issues to be considered in order to strengthen its intermediation role such as further liberalization of the sector, serious consideration of competitive auctioning of short-term as well as long-term government debt instruments to tap private savings, and develop alternative instruments of assets diversification (e.g., mutual funds), as well as further enhancing sound banking practices and regulatory frameworks.

Regarding the real estate market, the current liquidity and credit crunch being witnessed in the US and other parts of the World is sure to have its impact across property markets across the world, particularly with banks

getting more cautious to lend. Property companies in the Gulf were enjoying an economic boom due to high oil prices that have been untouched until recently. However, continued decline in oil prices and a reluctance by banks to lend in the region could hinder \$2.3tn infrastructure, and thereby, real estate investments across the region. Many analysts warn that increasing borrowing costs and tightening liquidity could affect the developer investment and buyer interest in the GCC. This advance perception of risk will limit the ability of raising funds by the Bank, and will also affect their ability to finance future real estate investment and mortgages. Higher mortgage cost may also slow buyer demand.

Stable real estate and mortgage markets are a key underpinning to a healthy economy. They not only strengthen middle classes but also have a ripple effect on the economy, leading to increased demand for construction materials, appliances, consumer goods and other related services. The mortgage market also serves to bolster banking systems and spur the creation of secondary markets. In the United States, for example, banks have historically invested in mortgages and mortgage backed assets as a cornerstone of their treasury management. In addition, the availability of mortgage products led to steady increases in home ownership and real estate values.

Therefore, future stability and continued growth in the GCC real estate and mortgage markets will require a broader base of market capital from private institutions and secondary market investors. Institutional interest in mortgage assets requires confidence that stable and transparent mortgage finance laws and regulations are in place to protect investor cash flows and principal investments. A key factor for the advancement of the mortgage industry in the GCC is the creation of stable secondary markets for the sale and trading of mortgages. Within the context of the GCC, and particularly Shari'ah compliant finance, the long-term growth of secondary mortgage markets is predicated upon the successful issuance of asset backed sukuk. The advancement of foreclosure laws and the enhancement of delinquency related penalties will also serve to bolster secondary markets for the GCC real estate industry.

BL: What are the prospects of the Islamic financial industry?

Khalid A. Al Bassam: The Islamic financial industry continues to witness uninterrupted rapid growth, as it becomes widely accepted with flow of revenues and recycling of such revenues into various development projects.

At the global level, the assets of the Islamic banking industry estimated to have reached US\$520 billion taking into account Islamic financial institutions and banks only, and this figure increases to a trillion dollars after adding Islamic windows in conventional banks, investment Funds and Islamic insurance. Growth in 2007 is estimated at 25%, which proves that Islamic financial institutions have become an important component of the international financial system; also at the level of Arab and Islamic countries, which witnessed substantial movement from conventional financial institutions to Islamic financial institutes. Islamic financial institutions are leaders in the banking industry and at the forefront in regards to contribution to the economic development. So far, almost all Islamic banks in the region who announced their 3rd quarter results were showing substantial growth in profitability despite the global financial turmoil.

Islamic banks are required to enhance their capabilities to enable them to respond to the competition and other challenges that they are facing and to maintain the momentum they achieved during the last thirty years. The primary elements of success for Islamic banks are enhanced financial resources, development of the specialized and qualified human resources and a more effective utilization of technology.

Furthermore, the economies of Islamic countries are required to achieve certain tasks such as the diversification of income/revenue sources, attracting direct investment and providing job opportunities for their citizens. Here, the role of Islamic banks becomes more obvious in encouraging the establishment of private equity based investment projects and funds that are directed to serve such goals. In other words, Islamic financial institutions are required to be involved directly, in co-operation with major investors and high net worth individuals, in promoting economic and development projects in the region instead of just concentrating on establishing funds that invest abroad.

Islamic banks, like the conventional banks, stand today to face the challenges of the Basel II requirements in terms of enhancing their capital resources, improving their transparency and complying with international banking standards and regulations. The challenges also include diversifying the risks in the business environment, innovating competitive instruments to manage short-term liquidity, introducing modern technologies, increased competition because of the liberalization of the markets and dealing with all such matters in accordance with the framework of Islamic banking principles.