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The internationalisation of the Arab Gulf banks.

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THE INTERNATIONALISATION OF THE
ARAB GULF BANKS

by

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TO THE MEMORY OF MY FATHER

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LIST OF ABBREVIATIONS

AAIB	Arab African International Bank
Arlabank	Arab Latin-American Bank
CAII	Compagnie Arabe et Internationale d'Investissement
Frab	Banque Franco-Arabe d'Investissements Internationaux
OBUs	Offshore Banking Units
UAE	United Arab Emirates
UBAF	Union de Banques Arabes et Francaises

ABSTRACT

The main theme of the research is to analyse the major reasons behind the international expansion of a large number of Arab Gulf banks. An attempt is made to examine the role of oil revenues of the 1970s in the development and international expansion of Arab banks. The study also analyses the role played by the financial markets of the region (i.e. Kuwait and Bahrain) in encouraging the regional and international expansion of Arab banks.

Because of the unique features of the Gulf region a historical approach has been adopted to support an understanding of the present bankign practices of the Arab banks. The study follows the development of Arab Gulf banks since their inception in the 1950s and 1960s, and includes a survey investigating the expansion of these banks into the major international financial centres of Western Europe, the United States and more recently Tokyo. A comparative analysis to the operational aspects of Arab and other international banks is also provided.

The survey was carried out through personal interviews with the senior managements of several Arab banks in London, which allows a comparison to be made between the factors that led to the international expansion of Arab Gulf and western banks.

The involvement of Arab banks in the syndicated lending and eurobond markets, is closely examined. The study demonstrates that Arab banks' success in the euromarkets was not necessarily based on oil revenues as often assumed, but rather the trade finance of these banks that fuelled their international expansion.

CHAPTER 1

INTRODUCTION TO THE ARAB GULF REGION

1.1 INTRODUCTION

The aim of this chapter is to provide a general study on the Arab Gulf region. This includes; area, population, political developments and the general trends in the economies of the Arab Gulf countries. Because of the unique features of the region, a historical approach is taken which will help in understanding the present banking practices of these countries.

The Gulf Co-operation Council, which is better known as the GCC, was formed in 1981 by the six oil-producing Arab Gulf states. These states are Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates (UAE).

The main objective of the GCC formation was to promote stability and co-operation in the region. Through its short existence it has already co-ordinated the economic and defensive efforts of its member countries. The potential benefits of the GCC would be great if they were to be fulfilled without any obstacles. Such benefits would include economic and monetary integration, a regional stock exchange in which all the GCC citizens would be able to trade in the shares of the region, and the creation of large financial institutions through the merger of the large number of small banks that already exist in the region. However, obstacles to such a system do exist and will be explained in the course of this work.

1.2 AREA AND POPULATION

The GCC region occupies a total area of over 1 million square miles (2,563.1 million square kilometres (sq. km)) as Table 1.1 illustrates. The largest political division is the Kingdom of Saudi Arabia, followed by Oman, UAE, Kuwait, Qatar and Bahrain. One of the most noticeable observations from Table 1.1 is the small number of inhabitants that occupy the large areas of the region, and the large number of non-nationals (Arab and others) that live in the region. Despite the large number of immigrants to the Gulf region since the early 1970s, its total population according to the 1988 estimates is less than 19 million inhabitants. This means that the average population density for the region as a whole, is about 7-8 persons per square kilometer. This will be reduced to only 5 persons per square kilometer if foreigners are excluded.

Many other observations can be drawn from Table 1.1. Firstly, with the exception of Saudi Arabia, all other GCC members are newly independent states. The majority of these states (except Oman) were under British influence until the early 1960s and 1970s, when the treaties of protection were replaced by friendship treaties with Great Britain. It is worth mentioning, however, that the various sections of the region have seldom been united under one government. In the 16th century, for instance, the Ottoman Empire was able to conquer most of the region, but it could take neither the interior nor the south east. In the 19th century, Great Britain and the Ottoman Empire controlled large parts of the region, but the central interior remained independent under the Saudis (Hitti, 1970).

Table 1.1 GCC basic data

State	Date of independence	Form of government	Population 1988 (000)	Area (sq km) (000)	Density (persons per sq km) (1988)	Ethnic composition (%)			Religious affiliation (%)	
						N[1]	A[2]	F[3]	Muslim	Non-muslim
Bahrain	1971	monarchy	421	0.691[4]	609.4	68.0	4.1	27.9	85.0	15.0
Kuwait	1961	constitutional monarchy	1,958	17.8	109.9	40.1	37.9	22.0	91.5	8.5
Oman	1970	monarchy	1,372	300.0	4.6	77.0	-	23.0	86.0	14.0
Qatar	1971	constitutional monarchy	420	11.4	36.8	20.0	25.0	55.0	92.4	7.6
Saudi Arabia	1927	monarchy	12,972	2149.6	5.8	82.0	13.0	5.0	98.8	1.2
UAE	1971[5]	monarchy	1,774	83.6[4]	22.8	30.7	56.4	12.9	94.9	5.1

Sources: Britannica World Data, Nations of the World, vol. 13, 1988
Gulf Co-operation Council in Figures, National Bank of Kuwait publication, 1988/1989, p.7
World Development Report 1988, published for the World Bank by Oxford University Press, June 1988

Notes:
1 denotes nationals
2 denotes Arabs
3 denotes foreigners
4 including the islands
5 Ras al-Khalma joined the UAE in 1972

All of the GCC members are, or have been, monarchies, based largely on principles of religious legitimacy. This explains their relative internal political stability compared to other Arab countries in the Middle East. The ruling families in these countries have been in power for many decades or even centuries. In Bahrain, the Al-Khalifa family have been in power since 1782; in Kuwait, the Al-Sabah family have been ruling the country since 1756; in Oman, the Al-Busaid family assumed power in 1744, and have ruled to the present day.

Secondly, the dominance of muslims and the Islamic religion in the constitutions of the GCC countries. On average, muslims account for about 90 per cent of the total population, varying from 99 per cent in Saudi Arabia to 85 in Bahrain. This dominance, has meant that Islam is the main religion in the Gulf states, and the courts of law in most states (notably Saudi Arabia and the UAE) rely almost entirely on Islamic teaching, and Islamic Sharia is a major source of legislation. This factor has had influence on the banking habits and the banks' operations in some GCC countries, as will be seen later.

1.3 PRODUCTION TRENDS IN THE GCC ECONOMIES

The GCC members are, as mentioned earlier, recently independent developing countries with small populations, and enjoy one of the largest oil reserves in the world. The economies of all GCC countries (with varying degrees, are characterised by their heavy reliance on the oil sector, imported labour and imported goods to compensate for the lack of diversity in their economies, and for their high consumption. Furthermore, these countries are also characterised by being capitalist and relatively free compared to other countries in the Middle East. There are no foreign exchange controls and no taxes.

1.3.1 The oil sector

All GCC countries rely exclusively (like Saudi Arabia and the UAE) or partly (like Bahrain) on the export of oil and other petroleum products to finance their budgets. The first Gulf country in which oil was discovered was Bahrain in 1932. The oil discovery in Bahrain inspired an intense search in other states in the region which resulted in the discovery of oil in Saudi Arabia and Kuwait in 1938, Qatar in 1940; Abu Dhabi in 1960 and Oman in 1964.

The high dependency on the oil sector in the Arab Gulf region is reflected in the exceptionally high ratios of oil exports to total exports of the six GCC members, as shown in Table 1.2,and the high share of the oil sector in the gross domestic product of the GCC countries (Table 1.3). The dependency on oil is at its highest in Saudi Arabia and Oman where oil constituted over 99 per cent of exports during the period 1975-1985. Bahrain is the only GCC country where the export of oil represents on average less than 90 per cent; this is due to the low oil reserves in Bahrain compared to other states in the region. For the GCC as a whole, however, the average ratio of oil export to total export is in excess of 95 per cent, for the period 1975-1985.

Such great dependency on one sector of the economy, reflects the ineffectiveness of other sectors particularly the industrial and agricultural sectors.

Table 1.2 Ratios of oil exports to total exports for GCC countries 1975-84

percentage

Year	Saudi Arabia	Kuwait	UAE	Qatar	Oman	Bahrain	GCC
1975	99.3	93.6	97.8	97.2	99.8	82.4	97.6
1976	99.7	92.5	96.5	96.7	99.7	77.4	97.4
1977	99.6	91.6	95.3	98.3	99.7	78.5	97.3
1978	99.2	91.8	94.7	96.6	99.4	79.9	96.7
1979	99.1	94.0	94.4	95.1	99.4	81.7	97.0
1980	99.2	92.3	94.8	94.5	99.6	88.9	97.4
1981	99.3	87.2	93.7	94.0	99.6	89.3	97.0
1982	98.8	82.7	93.1	93.5	99.4	85.1	95.9
1983	97.7	87.1	87.0	91.2	99.2	82.9	93.6
1984	98.5	89.7	88.0	93.0	98.8	88.2	94.3

Source: Arab countries, statistical publication, Arab Monetary Fund, no. 4, December 1987
International Monetary Fund, International Statistics Yearbook, Washington, various issues

For reasons which will be explained in Chapter 4, there was a massive surge in oil prices during the 1970s, which was followed by a sharp increase in oil revenues. Considering that proceeds from oil exports accrue directly to the governments of the region, and considering the lack of diversity in the region's economies, the oil revenues clearly dominate the government's total income.

The high share of oil revenues from total government revenues in the Gulf region is shown in Table 1.4. As the table illustrates, the highest average share of oil revenues from GCC countries' total revenues for the period 1976-1984, is that of the UAE with 93 per cent, followed by Oman and Qatar with 89 per cent, Kuwait with almost 77 per cent and Saudi Arabia with 76 per cent.

Table 1.3 GCC gross domestic product at current prices, 1982-86

	Saudi Arabia		Kuwait		UAE		Qatar		Oman		GCC*	
	1	2	1	2	1	2	1	2	1	2	1	2
1982	152.3	64.7	20.8	46.2	31.8	47.9	7.6	54.2	7.6	53.6	220.1	59.8
1983	119.2	50.1	20.3	51.4	27.5	41.4	6.5	45.8	7.9	49.4	181.4	48.7
1984	104.5	42.9	20.8	55.1	28.1	45.2	6.7	44.2	8.8	46.2	168.9	45.0
1985	90.3	38.4	19.0	52.3	26.3	44.9	6.3	44.3	10.0	46.6	151.9	42.0
1986	76.4	33.7	16.4	38.5	21.3	na	5.0	30.8	6.4	38.6	125.5	na
Average		48.6		49.1		44.9		44.9		46.9		49.5

Sources: Gulf Co-operation Council in Figures, National Bank of Kuwait publication, December 1988
World Bank Development Report 1988, published for the World Bank by Oxford University Press, June 1988

Note: * except Bahrain which has been excluded for lack of data

Key: 1 Total GDP at current prices (US billion)
2 Share of the oil sector from total GDP (%)

Table 1.4 GCC government revenues and the share of oil, selected year 1976-84

percentage

Year	UAE	Oman	Qatar	Saudi Arabia	Kuwait
1976	98.3	93.3	93.4	90.8	89.1
1977	98.9	92.6	91.5	84.8	87.3
1978	95.2	85.8	90.2	83.2	87.5
1979	98.0	91.7	92.8	85.8	70.1
1980	93.3	90.0	91.8	70.4	70.1
1982	92.3	92.3	89.3	70.8	75.8
1983	82.5	82.5	83.9	61.7	70.3
1984	86.6	84.8	78.8	60.1	64.7
Average 1976-1984	93.1	89.1	89.0	76.0	76.8

Sources: IMF Surveys, 21 November 1983, 26 March 1984, 21 January 1985, 29 June 1987, 7 June 1982 and 23 March 1987
Atif Kubursi, The Economies of the Arabian Gulf (A Statistical Sourcebook), Croom Helm Publishers, 1984

This high dependency on oil revenues has meant that changes in oil production or oil prices determine the pace and degree of economic growth in the non-oil sector. This stems from the fact that government expenditure stimulates domestic demand and, thus, encourages domestic investment activity in the non-oil sector of the economy.

The increase in oil revenues in the Arab Gulf region encouraged a large increase in government expenditure. In Saudi Arabia, for example, government expenditure rose from 5 billion in 1973, to $56 billion in 1979 and further to US $84 billion in 1981 (IMF, 1983). From 1982, however, due to a lower demand for oil and lower levels of oil production, there was a rapid decline in oil prices, and a sharp decline in oil revenues followed. These developments have, naturally, affected all GCC countries given their large dependence on the oil sector. Considering that Kuwait and Saudi Arabia are the largest producers of oil in the Arab Gulf region, they were particularly affected. In Kuwait, the crude oil production declined from a peak level of about 1.7 million barrels per day in 1980, to 1 million barrels per day in 1985, and the oil receipts declined accordingly from US $19 billion to US $9.7 billion, over the same period. In Saudi Arabia, the effect of falling oil prices was even greater, its oil production fell from around 10 million barrels per day in the late 1970s, to only 4 million barrels per day at the beginning of 1983.

The decline in oil revenues resulted in a rapid decline in government expenditure for the whole of the Arab Gulf region. Furthermore, the combined current accounts of the region were transformed from a surplus of about US $69 billion in 1981, to a deficit of US $4.6 billion in 1983, as can be seen from Table 1.5.

The table shows that the decline in oil revenues was followed by a steady reduction in the GCC government's revenues from US $155 billion in 1981 to US $80 billion in 1985. The volume of government's expenditure also witnessed a downturn from US $116 billion in 1981 to US $86 billion in 1985. It is noticeable from Table 1.5 that, although both governments' revenues and expenditure were on the decline since 1982, the decline in revenues was much steeper than that of expenditure. This was primarily due to the fact that the governments of the region were committed to a large and very optimistic development plans and projects. Therefore, a reduction in expenditure parallel to the reduction in revenues was

Table 1.5 GCC countries' national accounts, 1980-85

	1980	1981	1982	1983	1984	1985
Income	154.3	155.3	105.6	90.7	80.0	80.0
% change	-	0.6	-32.0	-14.1	-11.8	-
Expenditure	95.7	116.2	104.3	98.8	92.3	85.9
% change	-	21.4	-10.2	-5.3	-6.6	-6.9
Balance	+58.6	+39.1	+1.3	-8.1	-12.3	-5.9
Official reserves*	31.3	42.2	40.5	37.1	34.2	36.9
% change	-	34.8	-4.0	-8.4	-7.8	7.9
Current account balances	72.1	68.8	6.6	-4.6	-4.2	0.6

Sources: International Monetary Fund, Balance of Payments Statistics, Washington, 1986 Yearbook
Bank of England Quarterly Bulletin, March 1987
OAPEC Statistical Bulletin, 1984

Note: * excluding gold

not possible until 1984 and 1985, when the majority of projects were completed.

As a result of these developments, the GCC countries incurred modest deficit in their budgets of US $8 billion in 1983, which further increased to over US $12 billion in 1984. Not surprisingly, there was a balance of payments deficit of US $4 billion for each of those two years. To finance these deficits the GCC countries had to draw on their reserves and foreign investments which had been accumulated during the 1970s. Official reserves for the GCC region declined from their peak level of US $42 billion in 1981 to US $34 billion in 1984.

It ought to be mentioned in this respect that the GCC countries had embarked on a policy of acquiring foreign assets throughout the 1970s, mainly in the form of bank deposits, as will be discussed in Chapter 4. This policy was aided by a combination of factors like; the availability of greater liquidity than could be employed domestically without giving rise to inflation; the low levels of interest rates prevailing in the domestic financial markets and finally, the freedom of capital movements out of the region.

This policy of accumulating foreign assets assisted in satisfying two important purposes. Firstly, by absorbing the excess liquidity in the economy during the 1970s, inflationary pressure was eliminated. This was reflected in the fact that although there was a rapid increase in government expenditure during the 1970s, as already mentioned, inflation was kept at relatively low levels. Secondly, and more importantly, the policy of acquiring foreign assets proved to be a useful source of revenue to the region. In fact, it was the revenue generated by the accumulated foreign investments throughout the 1970s that helped greatly in compensating for the decline in oil revenues in recent years. Investment revenues of some GCC countries are shown in Table 1.6.

Table 1.6 Foreign investment revenues of some GCC countries, 1980-86*

US$ million

Year	Saudi Arabia	Kuwait	Qatar	Bahrain
1980	6.43	5.49	0.34	0.08
1981	11.00	8.40	0.45	0.30
1982	14.06	6.69	0.70	0.32
1983	15.88	5.69	0.48	0.40
1984	13.37	5.80	na	0.70
1985	12.42*	5.28*	na	0.70
1986	11.28*	8.07*	na	0.63

Sources: Figures for Saudi Arabia are from SAMA Statistical Summary, Research and Statistics Department, 1985, p. 85; IMF Survey, 21 January 1985, p. 28
Figures for Kuwait are from Kuwait Interim Economic and Financial Report, National Bank of Kuwait publication, Winter 1988, p. 27; IMF Survey, 5 April 1982, p. 105
Figures for Qatar are from IMF Survey, 26 March 1984, p. 87
Figures for Bahrain are from Gulf Co-operation Council in Figures, National Bank of Kuwait publication, December 1988

Note: * Budget figures

The table shows how revenues from foreign investments in some GCC countries increased in the early to mid-1980s, and with the decline in oil revenues, the share of foreign investment revenues from total government revenues, has been significant. In Saudi Arabia, for example, oil revenue's share of the total revenues of the kingdom, declined from over 70 per cent in 1981 to 60 per cent in 1984 as mentioned earlier. Consequently, investment revenues increased from 6 per cent to almost 21 per cent during the same period.

One of the most successful GCC countries to employ the policy of foreign investments to generate additional revenues has been Kuwait. According to published data (Table 1.6), the investment revenues that accrued to the Kuwaiti government of US $8 billion in 1986, for example, were greater than the oil revenues of Kuwait during the same year.

It is worth mentioning in this respect that figures represented in Table 1.6 should be treated with caution. This is due to the lack of actual data concerning the volumes of the region's foreign investments and the revenues generated by these investments. Therefore, the table has been compiled from different sources with wide variation in their estimates of the region's foreign investment revenues. However, figures represented in Table 1.6 may serve as a proxy for the investment revenues of the region.

To lessen the dependency on the oil sector, all GCC countries have embarked upon encouraging the production sectors in their economies. These countries, notably Saudi Arabia, opted for supporting the industrial sector through increased investments in this sector, and also through encouraging the private sector to participate in supporting the industry in the kingdom. In order to achieve greater private sector participation in industry, the Saudi authorities introduced a variety of measures and incentives. For instance, private investors are provided with up to 50 per cent of the estimated cost of their chosen projects. This finance is provided by the Saudi Industrial Development Fund (usually interest free). Furthermore, private investors in local industries are exempt from tariffs on imported capital equipment and raw materials. In addition the authorities also facilitate the provision of land for factory sites and industrial housing (Iqbal, 1985).

In general the reliance of the Gulf countries on oil is such because of the large oil reserves that these countries enjoy. The Gulf region occupies 55 per cent of the world's oil reserves (with the exception of socialist countries). Furthermore the GCC countries (except Bahrain) are among the most fortunate of OPEC members, in the sense that their oil reserves will continue for several decades, as Table 1.7 indicates. Kuwait enjoys the highest oil lifespan of over 220 years, followed by Saudi Arabia and the United Arab Emirates. Bahrain is the only GCC country where the oil reserves are expected to run out before the end of the century.

Table 1.7 Expected date of oil depletion for GCC countries, 1973 and 1984

State	Life span (years)	Depletion date 1973	Depletion date 1984
Bahrain	11	1989	1995
Oman	24	2005	2008
Qatar	24	1997	20??
UAE	80	2019	20??
Saudi Arabia	101	2036	2085
Kuwait	227	2036	2211

Source: Arab Oil and Gas, February 1985

1.3.2 The trade sector

The GCC countries, like the majority of developing countries with small populations and small industrial and agricultural bases, rely heavily on imports of capital goods, food, medicine and many other manufactured goods. The high volume of the government's expenditure following the increase in oil prices and the strong drive towards indutrialisation, have resulted in rapidly increasing consumption in the Gulf region and, hence, created a strong demand for imported goods.

Total imports by the GCC countries rose from US $11.6 billion in 1975 to over US $67 billion in 1982 as shown in Table 1.8. This, by any standard, is a substantial increase, and one which reflects the great dependency of the region on the outside world.

The majority of the region's imports originate in the industrial countries. The share of imports from the industrial countries increased from 57 per cent in 1974 to 74 per cent in 1979 and to 83 per cent in 1985. It was the need to acquire advanced technology, and the undeveloped industrial and agricultural sectors of the Gulf states that led to this rapid growth in imports from the developed countries, particularly form Japan, Western Europe and the United States, as will be seen in Chapter 3.

Despite the deliberate attempts by the GCC countries to encourage the industrial sectors of their economies, these sectors, in most GCC countries, have only made a tangible progress in the fulfilment of basic domestic consumption requirements. This is reflected in the low contribution of the industrial sectors of the GCC countries, to their combined gross domestic product and the high level of industrial imports as can be seen from Tables 1.9 and 1.10.

Table 1.8 GCC external trade*, 1975-85

US$ billion

	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
Total exports**	50.3	62.6	68.7	66.0	104.0	156.2	165.0	115.6	80.7	74.6	49.9
Less oil exports	-	24.5	9.7	-3.9	57.6	50.2	3.6	-29.9	-30.2	-7.6	-33.1
Export/GDP (%)	92.7	78.3	70.9	61.9	79.0	81.4	71.2	51.4	42.7	42.4	30.8
Total Imports	11.6	18.6	28.8	34.5	41.6	52.0	59.9	67.4	62.2	55.1	40.8
	-	60.3	54.8	19.8	20.6	25.0	15.2	12.5	-7.7	-11.4	-26.0
Import/GDP (%)	17.2	23.3	29.7	32.4	31.6	26.0	25.8	30.0	32.9	31.3	25.2
Trade balance	39.7	44.0	39.9	31.5	62.4	104.2	105.1	48.2	18.5	19.5	9.1
Exports/Imports (%)	433.6	336.6	238.5	191.3	250.0	300.4	275.5	171.5	130.0	135.4	122.3

Sources: Arab Countries, Economic Statistics, 1975-1985, AMF Publication, UAE, December 1987
IMF, International Financial Statistics Yearbook, 1987

Notes: * includes inter-GCC trade
** includes oil exports which on average constitute about 90 per cent

Table 1.9 Contribution of the manufacturing sector to total GDP, end-1986

per cent

State	% of GDP	% of labour force
Kuwait	11.1	7.5
Bahrain	11.0*	7.8
UAE	10.7	6.4
Qatar	9.9	13.7
Saudi Arabia	6.7	9.9
Oman	6.4	1.1

Source: World Development Report, 1987, published for the World Bank by Oxford University Press

Note: * 1984 figures

Table 1.9 indicates that the highest contribution to GDP by the manufacturing sector was made in Kuwait with 11.1 per cent in 1986, compared to an average of 6 per cent for the period between 1980-1984.

However, the industrial sectors of the Gulf states have made good progress, particularly in the 1970s, when the massive increase in oil revenues came about. An indication of this progress is the number of large industrial projects throughout the Gulf region initiated during that period. The most important of these projects were; Aluminium Bahrain (ALBA), a company whose original shareholders include the Bahraini government and a large number of western European and American shareholders; the Gulf Aluminium Rolling Mill Company (GARMCO), which is a joint venture between the GCC members (except Oman), and Iraq; the Qatar Fertiliser Co. plant which was opened in 1973; the Qatar Steel Company (1978) and the UAE Aluminium Smelter (1979).

In general, one of the major weaknesses of the manufacturing sector in all GCC countries, is their dependence almost entirely on imported tools, machinery and human skills. It has been argued that any further expansion of the industrial sector would imply increased imports and most importantly, would necessitate the employment of additional immigrant labour (Noursi, 1987).

Despite the encouragement of the Gulf countries to promote their industrial sectors, and despite the increased participation of the private sectors in many GCC countries in industry, domestic industrial sectors in the region contribute only to a small share of the local needs for industrial products. This is represented in Table 1.10 which shows the rapidly increasing volume of industrial products' imports, from US $8.3 billion in 1975 to almost US $48 billion in 1983. The table also illustrates the large net deficits in the balance of trade of industrial products, which grew from 7.5 billion in 1975 to over US $44 billion in 1983.

Agriculture is another sector which has contributed to the rapidly growing volumes of imports. Like the industrial sector, the major problem that faces agriculture in the Gulf region, is the low rate of production in relation to a rapidly growing demand for agricultural products.

A considerable portion of the oil revenues were employed to encourage the agricultural sectors of the region. As a result, local production generated by the agricultural sector in the region rose from US $435 million in 1972 to US $2.7 billion in 1981 and to US $4.8 billion in 1986 (World Bank, 1988).

Table 1.10 Volume of imports, exports and balance of trade of industry*, selected years 1975-84

US$ million

	1975	1978	1980	1983	1984
Imports	8,322.8	26,194.8	38,050.8	47,986.2	39,838.3
% of total imports	71.5	75.9	73.2	77.1	72.3
Exports	760.1	1,490.9**	2,919.8**	3,760.0**	2,551.1**
% of total exports	1.6	2.3	1.9	4.7	3.4
Net deficit	7,562.7	24,703.9	35,131.0	44,226.2	37,287.2
Ratio of industrial exports to imports (per cent)	9.1	5.7	7.7	7.8	6.4

Sources: Foreign Trade of GCC Countries, 1974-1985, AMF publication, UAE, no. 4, October 1987
Arab Countries: Economic Statistics 1975-1985, AMF publication, UAE, December 1987

Notes: * includes heavy machinery and other manufactured goods except food
** data for Qatar is not available

In Saudi Arabia, for example, the average annual growth rate in the agricultural sector had increased from 4.1 per cent between 1965-1980, to 10.3 per cent for the period 1980-1986 (World Bank, 1988).

In general, however, the GCC countries are net importers of agricultural products, particularly wheat. Table 1.11 indicates that during the selected years between 1975 and 1984, the balance of trade of agricultural products was negative and that this balance ranged from US $1.4 billion in 1975 to US $7.8 billion in 1984.

There are several factors responsible for the low output of the agricultural sector. They are: small area under cultivation, high dependence on rain fall, limited irrigation, limited labour force (as will be seen later in this chapter), and finally inadequate agricultural policies.

Table 1.11 Volume of imports, exports and balance of trade of agricultural products, selected years 1975-84**

US$ million

	1975	1978	1980	1983	1984
Imports	1,499.8	3,710.9*	6,728.5	7,395.1	8,191.5
% of total imports	12.9	10.8	13.0	11.9	14.9
Exports	112.2	228.8*	504.7*	424.5	426.4
% of total exports	0.2	0.4	0.3	0.5	0.6
Net deficit	1,387.6	3,482.1	6,223.8	6,970.6	7,765.1
Ratio of agricultural exports to imports (per cent)	7.5	6.2	7.5	5.7	5.2

Sources: United Nation Food and Agricultural Organisation (FAO), June 1982
Foreign Trade of GCC Countries, AMF publication, no. 4, October 1987

Notes: * Data for Qatar is not available
** For lack of detailed data, food, beverages and cereals are used as a proxy for all agricultural products

1.3.3 The labour sector

The third common characteristic among all GCC countries is their heavy reliance on imported labour. The small population of the GCC countries, coupled with the high demand for manpower for the implementation of the economic development programmes that these countries have embarked upon following the oil price increases, have made the employment of foreign labour an inevitable development. The scarcity of labour in the Gulf region also reflects the professional immigration of their qualified workers to the industrialised world. According to the United Nations statistics, between 1972-1977, almost 5,000 skilled workers from the GCC region immigrated to the United States alone.

These factors led many GCC countries, notably the United Arab Emirates, Qatar and Kuwait, to encourage the immigration of labour from other Arab countries such as Egypt, Sudan and the two Yemens. In addition, large numbers of non-Arab labour also reside in these countries. This is particularly so in Gulf states like Qatar, whereby at the end of 1988, non-Arab residents consisted 55 per cent of the total population.

The process of employing other Arab nationals in the Gulf proved to be beneficiary to the Gulf states and to the Arab labour exporting states. From the GCC countries' viewpoint, the flow of Arab and foreign labour force, has assisted these countries in lessening the effects of their small population and in enhancing the development of their countries which may result in increasing their absorptive capacity. From the suppliers of labour's viewpoint, the benefits have been greater. Firstly, by exporting labour to the Gulf states, countries like Egypt and Sudan, have managed to ease the problem of mass unemployment in their countries resulting from high population and low external resources.

Furthermore, exported labour is considered to be a major source of external finance. This, in turn, assisted these countries to finance their continuing balance of payments' deficit. In 1980, for example, total remittances of Arab workers in the Gulf region were estimated at US $8 billion, US $6.5 billion of which, went to Egypt and the Yemen Arab Republic (AMF, 1982).

However, although the Arab labour exporting countries benefited from the extra financial resources brought into their countries, this process was not without cost. The Gulf states in general, and Saudi Arabia and Iraq in particular, managed to attract most of the skilled labour in such fields as construction and agriculture. The result was a scarcity of such labour in the Arab labour exporting countries, and an inevitable rise in wages followed.

However, the overall employment situation in the Gulf region shows the dominance of foreign labour, and that this dominance has been increasing over time. In 1975, for example, foreign labour accounted for over 55 per cent of total labour, while by 1985, this proportion had increased to 71 per cent ranging from 52 per cent for Saudi Arabia to 90 per cent for the UAE (Table 1.12). The foreign labour in the Gulf is not only confined to the production sectors of the economy but, as will be seen later, the banking sector is also dominated by foreign workers with positions ranging from clerks to general managers. This section will be discussed in greater detail in Chapter 9.

Against this background, this research will study the growth of the banking systems and financial markets in the Arab Gulf countries. The research will concentrate on the international

Table 1.12 Labour force structure in some GCC countries*, selected years, 1965-85

	Population of working age, 15-64		Annual annual growth of labour force		Labour force by sector 1980			Foreign labour as % of total labour	
	1965	1985	1965-1980	1980-1985	A	I	S	1975	1985
Kuwait	60	58	6.9	6.2	2	32	67	70.9	76.1
Oman	53	50	3.8	5.2	50	22	28	58.0	69.3
Saudi Arabia	53	54	4.9	4.4	48	14	37	44.3	52.0
UAE	-	67	-	5.2	5	38	59	na	90.0

Sources: World Development Reports, 1986 and 1988
Economic Intelligence Unit (EIU), country reports, no. 4, 1986
Arab Unity Research Centre, Al-Musataqbal, 1987 (Arabic)
Atif Kubursi, The Economics of the Arabian Gulf, A Statistical Sourcebook, Croom Helm Publishers, 1984

Note: * Bahrain and Qatar were excluded from lack of data

Key:
A denotes agricultural sector
I denotes industrial sector
S denotes services sector
na denotes not available

expansion of the Arab Gulf banks into the major international financial centres.

It has been seen in this introductory chapter, that the GCC countries managed to accumulate (through the increased oil revenues) massive surpluses, the majority of which were kept in foreign markets. However, the governments of the GCC countries were committed to the development of their countries, through supporting in industrial and agricultural sectors. This, in theory, should provide the banks with an ideal business environment. It follows, therefore, that the Gulf domestic banks had little or no reason to expand overseas.

The theme of this research is to analyse the relationship between the oil surpluses and the international expansion of Arab banks. Other factors, such as the creation of the offshore centre of Bahrain and the capital market in Kuwait, and their effects on the operations of Arab Gulf banks will also be discussed.

CHAPTER 2

THE ARAB GULF BANKING SYSTEMS

2.1 INTRODUCTION

The aim of this chapter is to provide a financial review of the events that led to the creation of the banking systems of the Arab Gulf region. The chapter will concentrate on the growth and operational aspects of the commercial banks, central banks and Islamic banks. It will also include an analysis of the problems facing the implementation of monetary policies in the region.

Typically, the banking systems in most Arab Gulf countries consist of the following financial institutions; a central bank or a monetary authority, which regulates credit policies and supervises the banking system; commercial banks that accept deposits from and provide loans to the public at large; and specialised banks (industrial, agricultural and real estate banks). These institutions specialise in providing long-term loans with favourable interest rates, in order to promote the growth of such sectors as agriculture and industry. However, the chapter will concentrate on the first two financial institutions (the central and commercial banks) due to their relevance to the theme of the research.

2.2 THE CENTRAL BANKS

The central banks operating throughout the Gulf region (with the exception of Saudi Arabia) are of recent origin, they date from the 1960s and early 1970s. Prior to that, some of the functions of central banks were carried out by various currency boards. These boards were primarily money changers and had no authority over the commercial banks and no obvious role in the determination and implementation of the monetary policies. The currency boards, whose job was to issue and redeem the currencies of the region, were gradually replaced in the 1960s and the 1970s by central banks. In some Gulf states such as Saudi Arabia or Bahrain, these central banks were called monetary authorities or agencies, primarily for religious reasons.

All central banks and monetary authorities in the region are entirely government owned. This reflects the recent establishment of these institutions at a time when the economies of the region were dominated by foreign banks and companies. By having full ownership of the central banks, the governments of the region intended to take full control in directing the development of their economies.

In general, central banks in all Arab Gulf states carry out most, or all of the following functions; firstly, the issuance of national currencies and the maintaining of their stability; secondly, they advise the authorities on the implementation of monetary policies; thirdly, they act as lender-of-last-resort to the commercial banks; fourthly, they are responsible for receiving applications and granting licences for the establishment of local banks and branches of foreign banks. This function has been gaining in importance since the mid-1970s, in countries which foreign banks are allowed to enter. Such countries as Bahrain and the UAE deliberately created a free zone for foreign banks; as a result, these banks started flowing into those two countries to a degree whereby they were considered to be among the most greatly overbanked countries in the world. By 1988, the UAE, for example, had 16 local banks with almost 150 domestic branches, in addition to the approximately 50 foreign banks operating in the country, to serve a population of just over a million inhabitants.

Finally, the Arab Gulf central banks and monetary authorities also fulfil the following functions; the management of government accounts; the maintenance and regulation of commercial and other specialised banks, through the determination of the structure and capital requirements of the commercial banks and other financial institutions; finally, the investment of government reserves.

The capital requirements for commercial banks in the Arab Gulf countries are as follows; BD 0.5 million (US $1.27 million) in Bahrain; SR 2.5 million (US $0.7 million) in Saudi Arabia; KD 1.5 million (US $5.18 million) in Kuwait; QR 5 million (US $1.26 million) in Qatar and RO 0.5 (US $1.45 million) in Oman. The capital provisions may be linked to a requirement for the incorporation of domestic banks, as is the case in Bahrain, Kuwait, Qatar and Saudi Arabia. No such requirement exists in the UAE. Furthermore, no country in the Arab Gulf requires branches of foreign banks to incorporate locally.

Among the GCC central banks, the Saudi Arabian Monetary Agency (SAMA) and the Kuwaiti Central Bank are by far the most influential. Both of these institutions carry out the above mentioned functions. The major difference between the two institutions is in their foreign investments. SAMA, on the one hand, has a strong control over foreign investment and only invests in short-term foreign government securities and short-term bank deposits, while the Kuwaiti Central Bank adopts decentralised decision-making and has little influence on the private sector foreign investments.

Furthermore, the Kuwaiti Central Bank has opted for relatively riskier and more profitable foreign investments than those of SAMA, such as industry, real estate, share and corporate bonds. These differences between SAMA and the Kuwaiti Central Bank reflect the major differences between the two countries concerning their economic policy. The Kuwaitis pride themselves on being multinational in outlook, in order to diversify their sources of income away from oil revenues alone, into foreign assets managements which might provide a more stable income than the depleting oil revenues. The Saudi's, on the other hand, have concentrated on establishing a strong domestic industrial base and would wish to view the country as an industrial power in the Gulf region, as mentioned in Chapter 1.

One of the most significant measures taken by SAMA during the late 1970s, was to take control of the operations of foreign banks in the kingdom, a process which is sometimes misleadingly called 'nationalisation'. It is the conservative attitude of SAMA and the fear of losing control over the country's monetary policy that led to this development. Although the transfer of foreign banks operating in Saudi Arabia to Saudi ownership occurred in 1977, certain measures were taken much earlier to control the operations of these banks. In 1971, for example, SAMA made it obligatory for foreign banks that they should not pay dividends or remit any part of their profits abroad until their aggregate foundation expenditure together with any losses suffered had been written off.

In 1977, however, SAMA opted for gaining more control over the operations of foreign banks, as mentioned earlier. But instead of fully nationalising these banks, SAMA requested that these banks increase their capital by 60 per cent, restricting this increase to Saudi buyers. In effect this action did not affect the operations of foreign banks in Saudi Arabia; if any thing the reverse is true. The parents of these banks maintained their role as managers to their branches in the Kingdom. Furthermore, the increased capitalisation of these banks at a time of flourishing economics greatly increased their lending ability and their deposit base, so that the great increase in profits by these banks allowed the foreign owners to receive, in dividends, an amount which was virtually unchanged, or even increased (Seznec, 1987).

Apart from the traditional central bank's functions, all the central banks in the region's major activities involve the foreign investment of their countries' financial reserves, as can be seen from Table 2.1.

2.2.1 Monetary Policies

Like other central banks, the main task of the central banks in the Arab Gulf region is the implementation of monetary policies. Many factors affect the implementation of these policies in the region. Such factors as the absence of well-developed money and capital markets and the dependency on the developed countries, have made such policies like open market operations relatively ineffective. For open market operations to be applied effectively a large and active secondary market for securities must exist. Otherwise even a small scale increase of securities will lead to a significant fall in their prices (Ghatak, 1981).

Table 2.1 GCC central banks' net foreign assets, 1976-78

US $ billion

Year	SAMA[1]	CBK[2]	EMA[3]	BMA[4]	CBO[5]	QMA[6]	Total GCC
1976	51.2	1.9	2.3	0.4	0.3	0.1	56.2
1977	59.1	2.9	0.9	0.5	0.4	0.2	64.0
1978	58.5	2.6	0.9	0.5	0.3	0.2	63.0
1979	61.7	2.9	1.5	0.6	0.4	0.3	67.4
1980	86.7	4.0	2.1	1.1	0.7	0.4	95.0
1981	127.7	4.2	3.4	1.6	1.1	0.4	138.4
1982	138.0	6.0	3.6	1.6	1.3	0.4	150.9
1983	126.8	5.3	2.8	1.5	1.4	0.4	138.2
1984	111.3	4.7	3.0	1.4	1.6	0.4	122.4
1985	88.2	5.3	4.0	1.7	1.7	0.5	101.4
1986	74.8	5.4	3.8	1.7	1.4	0.6	87.7
1987	69.8	4.0	5.0	1.2	1.7	0.6	82.3

Sources: International Monetary Fund, International Financial Statistics, November 1981, September 1985, September 1986, December 1987 and September 1988.
Central banks' publications (various issues)

Notes:
1 Saudi Arabia Monetary Agency
2 Central Bank of Kuwait
3 Emirates Monetary Authorities
4 Bahrain Monetary Agency
5 Central Bank of Oman
6 Qatar Monetary Agency

Furthermore, while interest rates play a very important role in the implementation of any monetary policies, they are generally less effective in the Arab Gulf region due to their social repercussions. In addition, the powers of the central banks and monetary authorities operating in the Gulf, vary from one country to another. While SAMA is considered to be one of the most influential authorities in the region, by keeping a tight control on the number of commercial banks and the nature of their operations, the Qatar Monetary Agency has very little influence on commercial banks, and relies heavily on instruments such as moral suasion in implementing the monetary policy (Al Hamar, 1988).

However, the most common techniques that are used for the implementation of monetary policies among the Arab Gulf countries are swaps, rediscounting facilities, reserve requirement ratios and interest rates.

Swap facilities are used to satisfy the commercial banks' needs for domestic currencies, to satisfy local demand for foreign currencies (particularly at times when large spreads between foreign and domestic interest rates exist), and to stabilise interest rates. The first GCC country to introduce swap facilities was Bahrain in 1975. The BMA introduced a US dollar swap technique to inject funds by means of the same day purchase of US dollars against a forward sale at rates fixed to compensate for the differences between the US dollar and Bahraini dinar deposit rates (Moore, 1982). Kuwait followed the example of Bahrain and started using the swap technique in the late 1970s. The successful use of this technique by Kuwait and Bahrain reflects their relatively advanced capital and financial markets.

In Saudi Arabia, however, the use of such a technique is hampered by a lack of SAMA's power concerning the interest rate mechanism. Therefore, traditional measures, such as the purchases of land and shares, are often used to temporarily increase the liquidity in the market.

The use of reserve requirement ratios in the region is also limited. These ratios are used primarily to safeguard bank deposits rather than to monitor bank credit expansion. The inability of most Gulf states to successfully apply these ratios as a monetary policy tool is due to the fact that most Gulf commercial banks' managements are conservative in the sense that they maintain excessive reserves (the liquidity ratio of commercial banks in Qatar for example, is approximately 40 per cent). Therefore, the reserve requirements will not be an effective instrument of monetary control unless there is an increase in requirements. An increase sufficient to influence the level of credits may well lead to an outflow of deposits from the domestic banking system to the international financial markets, where interest rates are usually higher.

Among the GCC countries, only Kuwait successfully applies the rediscounting policy which aims to provide commercial banks with liquidity to face short-term needs.

Another monetary policy instrument which has also proved difficult to apply in the Arab Gulf region is selective credit control. This policy is usually employed by the central banks to encourage banks to finance certain sectors of the economy, such as export, agriculture and industry, and to discourage banks finance to imports, real estate and consumption.

Commercial banks in the Gulf prefer to grant short-term credit particularly to commerce. Individuals and small firms operating in the productive sectors, such as industry and agriculture often find difficulties in obtaining medium and long-term credit. Specialised financial institutions attempt to meet the credit needs of the productive sectors, but the funds at their disposal are usually limited. This feature is not unique to the Arab Gulf countries. Patel (1954) noted that 'commercial banks in developing countries are usually biased in favour of investment in construction and trade to the detriment of more productive alternatives available in industry and agriculture'.

One can conclude from the previous discussion that the instruments which are used by almost all central banks throughout the world for the implementation of monetary policies, are not effectively used in the Gulf region. The reason for this is that the banking systems of the region operate in unique economic, political and religious environments which differ greatly from those in other developed and developing countries. One factor that distinguishes the Arab Gulf region from other developing countries, lies in the open nature of their economies to the outside world as already mentioned in Chapter 1. This factor favourably affected the monetary policy implementation by finding an outlet for the excess funds that the region accumulated following the oil price increases of the 1970s, thus eliminating the inflationary pressure at times of excess liquidity in the domestic market. However, this advantage of the open economies of the region is usually offset by the disadvantages that such economies might incur. The administered interest rate structure of the region encourages the outflow of capital to the outside world, which at times of high US dollar interest rates, for example, may lead to substantial capital outflow to a degree where it creates acute liquidity problems. A typical example of a liquidity problem occurred in the late 1970s and early 1980s. That period witnessed a massive outflow of funds from the region due to the unprecedented rise on dollar deposits, which reached 20 per cent in the summer of 1980.

The central banks of the region have failed thus far to employ any instruments of monetary control effectively. In underdeveloped financial markets, the impact of instruments such as the open-market operation is insignificant, the main reason for this being the narrowness of the securities markets, as will be seen later in Chapter 6.

The second most important task of the central banks in the Arab Gulf region is the issuance of national currencies.

2.2.2 The Issuance of National Currencies

Because of the recent origin of most Gulf central banks and currency boards, national currencies of the region were only introduced in the 1960s and the 1970s. Prior to that all Gulf states except Saudi Arabia used the Indian rupee as the principle currency. Banks in the region were able to obtain the Indian rupee through the sale of gold and sterling to the Reserve Bank of India. The use of the Indian rupee continued until 1959, when India introduced the Gulf rupee which was at par value with the Indian domestic rupee (Bankers Research Unit, 1980).

The first Gulf state to introduce a national currency was Saudi Arabia. Until the 1950s, the main two currencies of use in the Kingdom were the Saudi Arabia silver riyal and the British gold sovereign, with the riyal being the main currency whilst the sovereign was only used for large transactions. The relation between the two coins could not be maintained due to the wide fluctuation in their values. This situation continued until 1952 when SAMA was established. The first action taken by SAMA was to replace the British gold sovereign by the Saudi Arabian gold sovereign. This arrangement, although successful in maintaining the stability of the currency, was short lived. In 1953, increasingly good counterfoils of the Saudi gold sovereign began to appear in the Kingdom, and as a result the sovereign was withdrawn from the economy in late 1953 and early 1954 (Edo, 1975). Furthermore, a substantial rise in the price of silver in New York in 1955, resulted in driving the silver coins out of circulation (Ali, 1971). Therefore, the silver riyal was withdrawn in 1955, and it was not until 1961 that the paper riyal was introduced.

The major currencies in the region were, as mentioned earlier, introduced in the 1960s and early 1970s, as can be seen from Table 2.2. The issuance of these currencies was enhanced by the rapid constitutional and economic changes during the late 1960s and the 1970s. The most important of these changes was the political independence of many Gulf states during that period. Therefore it was natural for those newly independent countries to establish a national monetary institution, and issue their own national currencies. Apart from the monetary implications, this action was seen as a sign of independence.

Table 2.2 Major currencies of the GCC region

Country	Currency	Year issued	Gold content at issue*	Exchange rate 1987 US $	Exchange rate 1987 SDR
Saudi Arabia	Saudi Riyal (SR)	1961	0.197482	3.746	4.794
Kuwait	Kuwaiti Dinar (KD)	1961	2.488280	0.277	0.361
Bahrain	Bahraini Dinar (BD)	1965	1.866210	0.376	0.402
Oman	Rail Omani (RO)	1970	2.132810	0.384	0.502
Qatar	Qatar Riyal (QR)	1973	0.186621	0.636	4.748
UAE	UAE Dirham (Dh)	1973	0.186621	0.676	4.789

Source: Legislation for the respective central monetary institutions.
Arab Monetary Fund, Money and Banking in the Middle East, Arabic, 1987

Note: * In grams of fine gold

As the table indicates, Kuwait followed the example of Saudi Arabia and issued its own currency in April 1961. The Kuwaiti dinar (KD) was introduced immediately after the country's independence, at par value with sterling. By May 1961, the KD became the only legal currency used in Kuwait following the withdrawal of the Gulf rupee by the Reserve Bank of India.

In Bahrain, the Bahrain Currency Board which was established in 1964, introduced the Bahraini dinar (BD) to succeed the Gulf rupee. The BD was also used as the sole currency in Abu Dhabi until 1973 when the UAE dirham was introduced. The UAE dirham also replaced the Qatar/Dubai riyal which had been in circulation in the Emirates since 1966.

Oman, which was the last Gulf state to use the Indian rupee, introduced its own currency (the Rail Saidi) in 1970. In 1972, when the Oman Currency Board was established to replace the Muscat Currency Authority, the name of the currency was changed from Rail Saidi to Rail Omani, which was at par value with the sterling.

Until the early 1970s, currencies of all Gulf states except Saudi Arabia were pegged to the pound sterling, while the Saudi riyal was linked to the US dollar. But when the sterling was devalued in 1967, the Kuwaiti Central Bank started quoting daily rates on the basis of an undisclosed weighted average formula involving the currencies of Kuwait's major trading partners, with the US dollar being the most dominant in the basket. The same happened with the Bahraini dinar, the Qatari riyal and the UAE dirham. In 1978, however, the above mentioned currencies joined the Saudi riyal in replacing the link with the US dollar with the new parity based on the IMF's special drawing rights (SDRs).

The major currencies of the Arab Gulf region are relatively stable vis-a-vis other major currencies, particularly the US dollar and the SDRs, as can be seen from Table 2.3. The stability of the Gulf currencies is partly related to the strong economies of the region, with the continuing balance of payments surpluses. Furthermore, their strength is also related to the fact that they are neither a unit of account, nor a medium of exchange in the oil market, as all oil exports are priced by the US dollar. However, the main stability of the Gulf currencies, stems from the fact that the exchange rate mechanism applied by the Gulf States is a technical device rather than a market determined relationship (Moore, 1982). This is due to the fact that, with the exception of oil, very little is produced by the Gulf states, as already explained in Chapter 1.

2.3 THE COMMERCIAL BANKS

An Arab Gulf bank refers to any financial institution undertaking the common commercial banking activities (deposit taking, loan advances, etc), and whose capital is at least 50 per cent owned by any GCC country or its nationals.

The first stage in the banking development of the Arab Gulf countries was that of the colonial period. This stage covers the period from the early to the mid-twentieth century. A major feature of this period was the dominance of the foreign banks in the region (mostly French and English banks). One of the most influential foreign banks in the Middle East was, and to some extent still is, the British Bank of the Middle East (BBME).

Table 2.3 Exchange rate of Gulf currencies against the US dollar and the SDR, 1979-87

	Bahrain		Kuwait		Oman		Qatar		Saudi Arabia		UAE	
	BD/$	BD/SDR	KD/$	KD/SDR	RO/$	RO/SDR	QR/$	QR/SDR	SR/$	SR/SDR	DH/$	DH/SDR
1979	.377	.497	.273	.360	.345	.455	3.704	4.878	3.367	4.425	3.759	4.950
1980	.376	.480	.271	.346	.345	.441	3.636	4.651	3.322	4.237	3.676	4.673
1981	.376	.438	.281	.328	.345	.402	3.636	4.237	3.413	3.968	3.676	4.274
1982	.376	.415	.289	.318	.345	.381	3.436	4.016	3.436	3.788	3.676	4.049
1983	.376	.394	.293	.306	.345	.362	3.497	3.817	3.497	3.663	3.676	3.846
1984	.376	.369	.304	.298	.345	.339	3.571	3.571	3.571	3.509	3.676	3.597
1985	.376	.413	.289	.317	.345	.379	3.650	4.000	3.650	4.000	3.676	4.032
1986	.376	.460	.292	.357	.384	.470	3.745	4.452	3.745	4.581	3.676	4.490
1987*	.376	.482	.277	.361	.384	.502	3.746	4.748	3.746	4.794	3.676	4.789

Source: IMF, International Financial Statistics, July 1987

Note: * July 1987

The special place that the BBME has occupied in the Arab Gulf countries stems from the fact that it represented the first financial institution in these countries, and remained the only one for almost two decades in states such as Oman and Dubai.

The first BBME office in the Gulf was established in Kuwait in 1942, when it was given a 30 year concession by the rulers of Kuwait. The bank's operations in Kuwait were predominantly trade-related, particularly in financing the rapidly increasing imports following the export of oil in commercial quantities. During 1961, for instance, 70 per cent of BBME's advances in Kuwait were to finance imports. Another area that proved to be profitable to BBME during the 1940s was the gold trade between India and Kuwait.

BBME in Dubai was established in the mid-1940s, and similar to the situation in Kuwait, it was the only bank operating in Dubai at that time and completely monopolised the banking business until the 1960s, when national banks were created.

In Oman, BBME started operations in 1949, with a banking monopoly until 1968. Because BBME monopolised the banking system in Oman for almost 20 years, its functions within the country exceeded those of a commercial bank. During the 1960s it acted as a central bank and was responsible for introducing Oman's first national currency when the Indian rupee was replaced by the Gulf rupee. Furthermore, BBME acted as an accountant to the Omani government and its advice was requested on matters of state finance. Even after the monopoly ended in 1968, when the National Bank was created and many foreign banks entered the country, BBME continued to dominate the banking business in Oman well into the 1970s. In 1972, for instance, BBME held 95 per cent of total bank deposits in Oman and accounted for 85 per cent of total bank advances.

It must be mentioned in this respect that, despite the fact that the BBME provided the Gulf region with many services at a time when very few national banks existed in the region, some of BBME's policies concerning the opening of national banks or employing local staff, eventually led to its nationalisation. There is no doubt that the BBME was faced with many problems when considering the employment of local staff. Most Gulf countries had no banks during the 1940s and 1950s, and the education system was very modest; therefore, it was very difficult for the bank to find the appropriate local staff; but when local staff were found they received no formal training by the BBME, and were paid less and received fewer benefits than their Indian or British colleagues who were at the same level (Jones, 1987).

Throughout the 1950s and 1960s, most of the Gulf countries remained pro-British, and the BBME was, in some Gulf states, the unrivalled financial institution until the early 1970s, as mentioned earlier. But with the discovery of oil in commercial quantities and with the first major oil price rise in 1973-74, the Gulf states' major aim was to have some control over their new found wealth. One way to achieve that was by establishing greater authority over the channels through which these funds could be deployed. Some states such as Kuwait and Saudi Arabia opted for completely nationalising all banks operating in their countries, while others such as Bahrain and the UAE preferred to create their own national financial institutions, whilst maintaining foreign banks.

The policy of nationalising the banking systems in various Arab countries reflected a number of other reasons. It was usually argued by the region's governments that a nationalised bank would look preferably at financing projects which might benefit the society without necessarily having the most profitable lending opportunities, whilst foreign or private owned banks are primarily concerned in maximising profits to satisfy their shareholders. Furthermore, since the banking system is one of the most important weapons in implementing the monetary policies in socialist states such as Iraq, Algeria and Syria, private or foreign owned banks were completely nationalised in these countries. This was out of fear that such financial institutions would bring the monetary structure under the control of other countries.

However, during that stage of Arab banking developments, very few Arab banks emerged. By 1945, there were only 5 Arab owned banks in the Middle East, with only one in the Gulf region. These banks were Bank Misr of Egypt which was established in 1920; La Banque Misr, Syria, Liban established in Beirut in 1928; the Arab Bank, established in Jerusalem in 1930; the Saudi National Commercial Bank formed in 1938 and finally the Rafidain Bank of Iraq, established in Baghdad in 1941.

The biggest advance in the development of Arab banking systems occurred during the 1960s and early 1970s. This period was of great importance because it witnessed the development of the Arab countries as major participants in world trade and finance on a global level.

With the discovery of oil in large quantities and the rise in oil prices during that period, the Arab countries' (particularly the Arab oil producing countries) major aim was to develop their economies as already mentioned in Chapter 1. An important prerequisite of the development plans was to establish a number of commercial banks to finance the development projects. Thus, a large number of Arab banks were established; in the Arab Gulf region alone nine commercial banks and other financial institutions were created during that period. The Commercial Bank of Kuwait, the Gulf Bank, National Bank of Dubai and the National Bank of Abu Dhabi are all examples of Arab banks established in the 1960s.

The third important stage in the development of Arab banking covers the period following the two major price increases in 1973/74 and in 1979. This period was characterised by a steady growth of Arab banks and Arab financial markets, and it witnessed (as will be seen in Chapter 3) the creation of a large number of Arab-Western joint ventures. Between 1973 and 1979, 42 Arab banks and joint ventures were created. Examples of the Arab banks established during that period were: The National Bank of Oman, 1973; Burgan Bank, 1975; Gulf International Bank, 1975; Saudi International Bank, 1975 and the Middle East Bank, 1976.

The most significant of the Arab banks established during the 1970s, was the Gulf International Bank. The importance of this bank which is jointly owned by the six GCC members and Iraq, stems from the fact that it represented the first large wholly-owned and managed Arab bank geared to regional and international operations. The trend of creating Arab international banks was further reinforced in 1980, when the Arab Banking Corporation was established in Bahrain. The mandate of establishing this bank was very similar to that of the Gulf International Bank (that is, to assist in the recycling of Arab funds). At the time of its establishment Arab Banking Corporation (which is jointly owned by the government of Libya with 40 per cent, Kuwait with 40 per cent and Abu Dhabi with 20 per cent) had the largest capital of any Arab bank, with an authorised capital of US $1 billion and paid-in capital of US $750 million. These two banks are primarily eurobanks, with the majority of their operations carried out in the eurocurrency market, as will be seen in Chapter 7.

The other important development that occurred during the 1970s, was the development of Bahrain and the UAE as international financial centres, and further, the emergence of Kuwait as the main capital market for the Gulf region.

At present there are over 700 foreign and domestic financial institutions serving a collective population of under 17 million. This makes the Gulf region one of the most over-banked regions in the world. Bahrain (through the establishment of its offshore banking centre) possesses the highest number of financial institutions amongst all Gulf countries, with 170 banks, 20 of which are domestic and the rest of which are branches of foreign banks. Bahrain is followed by the UAE with over 50 banks (28 of which are local); Qatar with 8 banks, 4 of which are domestic; finally Kuwait and Saudi Arabia which have no foreign banks and thus the number of financial institutions is limited in these two countries to 28 banks in Kuwait and 20 in Saudi Arabia. Table 2.4 provides details of all

Table 2.4 Domestic commercial banks and other financial institutions operating in the Gulf region, end-1983

US $ billion

Country	Number of banks	Total assets	Deposits	Loans	Paid-up capital	Net profits	Investments
Saudi Arabia	20	50.6	34.1	26.5	6.50	0.44	0.398
Kuwait	28	49.2	35.0	26.8	2.50	0.59	2.352
Bahrain	29	23.3	19.3	10.5	2.40	2.34	0.441
UAE	28	22.7	15.9	7.7	1.40	0.27	0.818
Qatar	4	2.9	1.7	0.8	0.05	0.04	0.045
Oman	11	2.1	1.2	0.8	0.19	0.03	0.002

Source: Arab Fund, basic facts and indicators for Arab banks operating in the Arab World, December 1984 domestic commercial banks and other financial institutions operating in the Arab Gulf region.

A detailed survey on the origin, number of banks and their branches, related to the domestic commercial banks operating in the six GCC countries, is shown in Appendix A. Furthermore, a list of the largest Arab Gulf banks ranked according to their total assets, total deposits and capital and reserves, is provided in Appendix B.

The domestic business of the Arab Gulf banks has traditionally been centred on trade financing, with less emphasis having been put on lending to industry. This is due to, among other factors, the fact that, by western standards, the Arab banking systems are with few exceptions, relatively unsophisticated. Long-term lending which is a pre-requisite for project financing, is undeveloped among most Gulf banks. Furthermore, the ineffectiveness of the monetary policies of these countries and the availability of less risky and more profitable foreign investment alternatives, are also to blame for this trend, as will be seen later.

However, the booming economies of the Gulf region during the mid-1970s and early 1980s, greatly enhanced banks' operations in the region. Two sectors in particular accounted for the majority of banks' business during that period; they are the construction and the trade sectors. These two sectors accounted for over 50 per cent of total banks' lending during that period. From the banks' point of view, these two sectors represent the safest and probably the most profitable options, for they are characterised by their simplicity and short-term maturity (usually 5 years or under).

The high profitability of these operations, particularly trade finance, stems from the fact that their cost to the banks is minimal. In financing trade, for example, the banks usually charge a fee on the opening of the letters of credit which averages between 1-3 per cent. Furthermore, it is common practice for Arab banks, and other banks for that matter, to keep almost 20 per cent of the total amount of the transaction as cash collateral for security reasons, and on which no interest is paid. Further sources of profits from such operations arise from overdraft facilities and foreign exchange transactions. Although it is extremely difficult to estimate the profits gained by Arab banks from trade finance, the massive growth in the level of trade following the oil price increases of the 1970s, suggests that profits to Arab banks which financed the major portion of Arab imports, were substantial.

Loans and advances to the trade and construction sectors have accounted for a major portion of total assets of the Arab Gulf commercial banks and are responsible for the rapid growth of these assets (Table 2.5).

As the table illustrates, the Arab Gulf banks have witnessed a remarkable growth rate in their total assets, a rate that is probably unmatched anywhere else in the world; from US $5.4 billion in 1973 to a total of US $128.2 billion in 1987. According to the size of their assets, the Saudi banks are undoubtedly the largest among all GCC countries' commercial banks. They accounted for an average of 35 per cent of total assets of all Arab commercial banks operating in the Gulf region. It is not surprising that the highest growth in the total assets of the Arab Gulf banks occurred in the

Table 2.5 Total assets and liabilities of the Arab Gulf commercial banks, 1973-87

US $ million

Year	Saudi Arabia	Kuwait	UAE	Bahrain	Qatar	Oman	GCC Total	GCC % growth
1973	1,340	2,559	0,878	0,307	0,212	0,118	5,414	-
1974	2,160	3,325	2,191	0,565	0,337	0,422	9,000	66.2
1975	4,315	4,099	3,620	0,880	0,573	0,519	14,006	55.6
1976	7,884	6,289	6,140	1,421	0,937	0,796	23,467	67.5
1977	11,795	9,053	7,593	1,615	1,198	0,930	32,184	37.1
1978	14,743	11,917	9,244	1,787	1,473	0,943	40,107	24.6
1979	18,481	15,528	11,374	1,957	1,716	1,183	50,239	25.3
1980	24,360	20,899	14,011	2,390	1,995	1,681	65,336	30.1
1981	32,736	27,305	18,323	2,553	2,681	2,108	85,705	31.2
1982	37,906	31,769	20,574	2,846	3,011	2,571	98,677	15.1
1983	38,126	34,285	21,701	3,266	3,141	2,915	103,434	9.8
1984	41,631	32,374	24,963	3,531	3,660	3,528	109,687	6.0
1985	42,274	30,097	26,650	3,874	4,073	3,753	110,721	0.9
1986	45,019	31,836	27,556	4,128	4,616	3,321	116,476	5.2
1987	51,017	35,592	28,967	4,022	5,360	3,258	128,216	10.1

Sources: International Monetary Fund, International Financial Statistics (various issues)
Gulf Co-operation Council in Figures, National Bank of Kuwait Publication, 1988/89

1970s, following the massive oil price increases, as will be discussed later in Chapter 5.

The economic boom that followed, created favourable business conditions for the commercial banks. A major feature of the region's economies during that period was the rapid growth in imports, as mentioned earlier, and the large scale establishment of infrastructural projects. These business conditions did not only provide ample opportunities for Arab banks, but also attracted a large number of foreign banks into the Gulf region, whereby in 1987 there were over 200 foreign banks operating there.

A breakdown of the assets figures of the Arab Gulf commercial banks, reveals major similarities between banks operating in all GCC member countries. The most important feature that these banks have in common is the high proportion of foreign assets. Generally over 40 per cent of total assets of all the region's banks are in the form of foreign assets. During the period 1980-85, these ratios were 48 per cent for Saudi banks, 46 per cent for Qatari banks, 45 per cent for Emirate banks, 39 per cent for Bahraini banks, 33 per cent for Kuwaiti banks and finally 28 per cent for Omani banks. These unusually high rates of foreign assets reflect many factors governing the economies and the financial and legal systems in the Gulf region. Firstly, and most importantly, is that administered low interest rates prevail in most Gulf countries. These rates do not provide sufficient return to attract local capital. This explains the reasons behind the rise of foreign assets held by the commercial banks during the early 1980s, when returns were particularly high on US dollar denominated assets, as mentioned earlier.

Secondly, is the low absorptive capacity of the Gulf economies which is reflected in the limited domestic lending opportunities. The growth of foreign assets of the Gulf commercial banks has almost always been accompanied by a decline in their domestic lending. For instance, the decline in domestic lending of all GCC members from almost 45 per cent of total assets in 1980 to 37 per cent in 1986, was offset by the rise of foreign assets from from 39 per cent to 43 per cent for the same period.

Thirdly, is the open nature of the Gulf economies, where no foreign exchange controls exist in any of the GCC countries. This has been the major reason behind the growth of foreign assets of commercial banks in Kuwait and Bahrain, where the public are relatively experienced in terms of investment opportunities available outside the region. Therefore, for banks in these countries to attract local deposits they have to offer returns that would match those available in the international financial markets. Thus banks in these countries are forced to invest a major portion of their assets abroad to maintain profitability.

Finally, the risk/return ratios for lending domestically are not attractive enough for banks to commit themselves to the domestic markets. This is particularly true for Saudi Arabia, where a conflict arises between the objectives of the state and those of the banks. The Saudi authorities on the one hand, are preoccupied with establishing a strong industrial base in order to prepare the country for the post-oil era, while the banks' main concern is that of the viability and creditworthiness of the industrial projects. The returns from lending to industrial projects normally matches those attainable from the interbank market. Therefore, Saudi banks opted for the latter due to the fact that the former represent high risk and long maturities.

It ought to be mentioned in this respect that SAMA has taken several measures to encourage local banks to lend to the industrial sector. These measures were designed to eliminate the role of Saudi banks in the offshore market of Bahrain; These measure will be further discussed in Chapter 5.

However, after almost a decade since the introduction of those measures by SAMA, one can safely conclude that they did not achieve the ultimate objective of encouraging the commercial banks to lend to the manufacturing sector. By eliminating the role of Saudi banks from participating in the syndicated lending market, SAMA was hoping to achieve two important targets; firstly, to eliminate the use of the Saudi riyal in international transactions; secondly, to encourage local banks to lend domestically. While SAMA achieved the first target, the second target has proved to be far more difficult to accomplish.

Initially, domestic lending by Saudi banks increased from US $11.2 billion in 1980 to US $16.6 billion in 1984, but this increase was mainly due to the growth in short-term lending to the trade and transport sectors, whereby their share grew from US $5.3 billion in 1981 to US $6.6 billion in 1984. Lending to industry for the same period only grew marginally from US $1.4 billion to US $1.7 billion. Furthermore, there was no decline in the volume of the foreign investments made by Saudi banks, in fact, they had risen from US $32.2 billion in 1981 to US $67.2 billion in 1984.

One of the largest constraints that prevents the Arab Gulf banks in general, and the Saudi banks in particular, from committing themselves to the domestic market, is the controversial issue of interest. Because of the religious barriers surrounding the issue of interest where it is considered as usury according to the Islamic law, and due to the fact that the legal system in Saudi Arabia is based on the 'Quran' the holy book of Islam, interest is not recognised in Saudi courts. It is a common practice in Saudi Arabia and the UAE, for a bank's customer to take the bank to court, which in turn rules against any payment of interest. This practice has proved to be costly for Saudi and other Gulf banks, and is considered to be a major factor responsible for the low levels of bank lending to the private sector. Therefore, it was a sensible exercise for these banks to invest heavily in foreign assets, where the banks are assured that they can rely on courts to safeguard their loans and interest. The issue of interest and its treatment in Islamic law will be further discussed later in this chapter.

Another important feature of most Gulf commercial banks is that, collectively they are regarded to be among the most heavily capitalised banks in the world. The average equity to assets ratio for all GCC commercial banks was over 9 per cent for the period 1980-86, varying from 13.6 for the UAE banks, 10 per cent for Bahraini banks, 9.3 per cent for Omani banks, 8.8 per cent for Kuwaiti banks, 7.8 per cent for Qatari banks, and 6.9 per cent for Saudi banks. The capitalisation of Arab banks will be further discussed in Chapter 8.

2.3.1 Commercial Banks' Deposits

The domestic commercial banks in the Gulf attract deposits from two main sources, the public and the private sector. The public sector deposits in the Gulf usually fall into some or all of the following categories; the government, semi-government bodies and public corporation. The last two sectors are usually referred to as 'official entities'. Although the public sector usually maintain their major deposits with the central bank, they also maintain smaller accounts with the commercial banks to benefit from their services. This is particularly true in areas where no branch of the central bank exists. Deposits of the public sector with the commercial banks, represent a small portion of the banks' total deposits and depend entirely on government policies concerning public expenditure. They only represented an average of 7.5 per cent of total commercial banks' deposits during the period 1976-86, as Table 2.6 shows.

The largest depositor with the commercial banks in the Gulf is the private sector. During the period 1976-86, the deposits of the private sector with the commercial banks represented 92.5 per cent of their total deposits. A unique feature about private sector deposits in some Gulf states, such as Saudi Arabia and to a lesser extent Qatar, is that they are held mostly in interest free demand deposits. This reflects the religious barriers against earning as well as paying interest. It also indicates that the level of public sophistication in terms of dealing with the banks, is much lower than that of the Bahrainis or Kuwaitis.

Table 2.6 GCC commercial banks' deposits by category of depositor 1976-86

Year	Private sector*		Public sector**		Total deposits	
	US $ billion	% of total	US $ billion	% of total	US $ billion	% growth
1976	14.6	91.25	1.4	8.75	16.0	-
1977	18.9	92.65	1.5	7.35	20.4	28
1978	24.1	93.77	1.6	6.23	25.7	26
1979	26.5	92.01	2.3	7.99	28.8	12
1980	34.1	90.21	3.7	9.79	37.8	31
1981	45.3	90.42	4.8	9.58	50.1	33
1982	52.1	90.29	5.6	9.71	57.7	15
1983	57.0	94.21	3.5	5.79	60.5	5
1984	63.4	93.79	4.2	6.21	67.6	12
1985	64.0	93.98	4.1	6.02	68.1	1
1986	67.0	95.44	3.2	4.56	70.2	3

Sources: Compiled from IMF, International Financial Statistics (various issues)
Central bank publications and commercial banks' annual reports

Notes: * Includes savings, time, demand and certificates of deposit of residents in local and foreign currencies
** Includes governments and official entities deposits

The ability of the major Saudi banks to attract funds from the public at cheap rates, has enabled them to operate profitably even on low margins in recent years. But the picture is changing, and the Saudi public is becoming more used to dealing with banks, and the majority do accept interest on their accounts. This is reflected in the gradual increase in the ratios of savings and time deposits to total deposits, as Table 2.7 illustrates. As the table indicates, the ratios of time and savings deposits to total deposits of most GCC banks are relatively high, which reflects the increased awareness of the Gulf nationals to the usage of banks and the acceptance of interest payments on deposits. This is particularly true for Kuwaiti and UAE nationals with average ratios of 80.5 per cent and 81.4 per cent for the period 1980-86, respectively. Saudi Arabia, as mentioned earlier, is the only notable GCC country with an average ratio of 49.7 per cent over the same period. However, there has been a noticeable improvement in the banking habit of the Saudi private sector, as the ratios of time and saving deposits to total deposits have increased rapidly, from only 35 per cent in 1980 to 61 per cent in 1986.

However, commercial banks in the Gulf region are still relatively ineffective in attracting deposits from the public at large, and the banking habit among all GCC nationals is not widely spread. Religion, as mentioned earlier, prevents people from taking part in transactions involving usury, and as commercial banks charge interest in their operations, people feel reluctant to deposit their funds with them. It is difficult to change the attitudes of such savers, to make them deposits their savings with the commercial banks, unless these banks take special measures to attract them:

such measures as improving the services of commercial banks, encouraging the use of cheques instead of cash, and extending their operating hours.

Table 2.7 The ratios of saving and time deposits to total deposits for GCC commercial banks, 1980-86

per cent

Year	Saudi Arabia	Kuwait	Bahrain	UAE	Qatar	Oman
1980	35	82	71	76	67	74
1981	41	72	72	76	63	71
1982	45	76	72	78	64	74
1983	51	79	77	81	66	76
1984	57	85	79	86	68	79
1985	58	85	78	86	72	80
1986	61	85	81	87	72	80

Sources: Same as Table 2.3

This last measure is of particular importance to Gulf banks as, although they operate six days a week, they are only open to the public from 8.00 am to 12.30 pm (with the exception of the Omani banks which are open to the public from 7.00 am to 2.30 pm). These opening hours are inconvenient for the public in general, and for civil servants in particular, who usually work from 8.00 am to 2.00 pm, and thus it is difficult for them to cash cheques from the commercial banks which have a limited number of branches.

Furthermore, the bureaucracy and the lack of efficiency in commercial banks' operations also discourages the public to deal with them. Sometimes even a simple operation such as cashing a cheque can take up to 20-30 minutes.

It ought to be mentioned in this respect that major efforts have been made in all Gulf countries to encourage the banking habit through the increased number of branches throughout the region. In Saudi Arabia, for instance, the number of branches increased from only 140 branches in 1979 to 524 in 1984, and to 649 branches in 1988 (see Appendix A). The major aim of this policy was to maximise the amount of deposits from the public at low (usually 2-3 per cent) or no interest. This policy proved to be very successful as the volume of deposits grew from US $12.6 billion in 1979 to US $31.3 billion in 1984.

The other factor that is responsible for discouraging the banking habit is that in some Gulf states, such as Saudi Arabia, women find it very difficult to deal with banks as it will involve contact with men which is forbidden by the Saudi King. It is worth mentioning that these restrictions on Saudi women only came to the fore in 1978, when King Faisal came to the throne.

In effect, the restrictions on women, whether to deposit their savings or to be employed in a bank, have eliminated the number of potential customers to commercial banks to only half the population. This is the main reason why a large number of Saudi women with substantial net worth have been forced to use banks abroad for their financial requirements. This was the case even after some Saudi banks opened branches in the Kingdom entirely for women.

However, it is worth mentioning that this problem is only confined to Saudi Arabia, as women are able to use the same banks as men in all other Gulf states.

Finally, the tight supervision and prudential controls imposed by some central banks and monetary authorities of the region, are also responsible for limiting the activities of the commercial banks, which in turn affects the abilities of these banks to expand or diversify their activities. A prime example of these regulations is the interest rates ceiling on deposits imposed by the Central Bank of Kuwait; this results in the existence of administered lower interest rates than those prevailing in international financial markets. Inevitably this leads to the outflow of capital and thus a loss of deposits to domestic banks.

The inefficiency of the region's commercial banks is most apparent when considering the loans provided by these banks to the private sector. While these banks attract deposits from all sectors of the economy, their lending activities are confined to a limited section of the population, mainly the wealthy traders. The Kuwaiti banks, for instance, are heavily exposed to a small number of people whereby during 1985, over half of the banks risks assets went to only 200 customers (Middle East Economic Survey, June 1986).

The picture is the same in other Gulf states, where the competition between banks is very intense, and the number of customers who are considered by banks as creditworthy is minimal. The major reason for this trend is the lack of business information; even the available data lacks depth and accuracy. Thus, for commercial banks to analyse the creditworthiness of a potential borrower, they usually rely on traditional measures such as reputation and family wealth and connections. Therefore, only the rich and influential would qualify as creditworthy borrowers. The competition between banks in the Arab Gulf region has been further enhanced by the rise of Islamic banks since the mid-1970s. Because of the special role that these banks play in the region, the next section in this chapter will be devoted to analysing the growth and some operational aspects of Islamic banks.

Due to the recent origin of these banks and the complicated religious issues involved in the implementation of their financial instruments which are beyond the scope of this study, the next section will by no means be exhaustive and will concentrate primarily on the main services offered by Islamic banks.

2.4 THE RISE OF THE GULF ISLAMIC BANKS

Although the principle of Islamic banking is as old as the 'Quran', the holy book of Islam, Islamic banking only started to take shape in the 1960s, with the first experiment starting in Egypt. The first Islamic bank, however, only came into being in 1971, when the Nasser Social Bank as an interest-free financial institution, was founded with 100 per cent Egyptian state ownership.

In the Gulf region, the first private commercial Islamic bank was created in 1975, namely the Dubai Islamic Bank. This bank is a joint stock company with 10 per cent Dubai government share and 10 per cent Kuwaiti government share; the rest is private ownership. The Dubai Islamic Bank was followed by many other Islamic banks, not only inside the Gulf region but throughout the Islamic world. The most significant of these institutions was the Saudi-based Islamic Development Bank (IDB), which was created in 1975, with a capital of two billion SDRs. The mandate of the IDB was to foster economic development in the 42 Muslim countries that comprise and finance the Bank. The IDB's main functions are to provide equity capital and interest free loans for development projects, finance international trade, and to provide technical assistance. However, not all of these objectives have been fulfilled, for two major reasons; firstly, the volume of trade between Muslim countries is minimal compared to that of the Muslim countries and western countries; secondly, the IDB lacks the skilled manpower required to fulfil its original objectives, particularly that of providing technical assistance to member countries.

However, the IDB played a leading role in creating the International Association of Islamic Banks (IAIB), in 1977. The major objectives of the IAIB were to promote greater co-operation among national institutions to assist in personnel training and to represent the joint interest of Islamic banks.

It ought to be mentioned that the IDB is not a commercial bank, and it cannot accept deposits from the public. It is essentially a development assistance agency which differs from other development agencies in the Gulf region by the fact that its operations are carried out in accordance to Islamic law.

Many other Islamic banks were established in the Gulf region during the late 1970s and early 1980s, as Table 2.8 shows. By 1985, the number of Islamic financial institutions based in the Arabian Gulf had risen to nine, three of which are based in the Bahraini offshore banking centre. Islamic banks are, in effect, similar to conventional banks in the fact that they pursue the same objectives, namely to attract funds from the public at large, render chargeable services and deploy the acquired funds in profitable activities.

Table 2.8 Profile of the major Arab Gulf Islamic banks

Institution	Head office	Year of establishment	Ownership	Capital (US $ million), 1985
Islamic Development Bank	Jeddah	1975	Saudi Arabia 26%, Libya 16%, UAE 14%, Kuwait 13% and others 31%	14.3
Dubai Islamic Bank	Dubai	1975	Dubai 10%, Kuwait 10%, Private 80%	13.6
Kuwait Finance House	Kuwait	1977	Private 51%, Kuwait government 49%	64.7
Bahrain Islamic Bank	Manama	1979	Bahrain government and private sector 48.1%, Islamic Development Bank 13%, Kuwait Finance House 8.7%, Dubai Islamic Bank 4.4%, Kuwait Government 17.4% and otehrs 8.4%	15.3
Musraf Al-Islami of Bahrain	Manama	1982	Dar Al-Mal Al-Islami Trust Group 99%, Prince Faisal Al Abdulla Al Saudi 1%	20.0
Qatar Islamic Bank	Doha	1983	Qatar government and private sector 100%	13.7

Source: Annual reports

Note: Other Islamic financial institutions have been excluded from the table for lack of data

But the major difference between the two is that Islamic banks should, in principle, operate strictly in accordance with the Islamic laws derived from the Shari'a (the legal system fundamentally based on the Quran), and the Sunna (the tradition of the prophet Mohammed). Instead of the lender-borrower relationship that exists in conventional banks, Islamic finance is based on the notion of distributing justice by spreading and sharing risks and profits between the sources of capital (banks) and the users of capital (entrepreneurs).

One of the main principles of Islamic banking is the prohibition of interest, which is referred to in Islam as 'usury'. The prohibition is due to the fact that interest represents a pre-determined positive return to the provider of capital in a purely financial transaction. A number of verses of the Quran clearly state this fact; the most obvious is 'trading is permitted and usury is forbidden' (Quran 2: 275-76). Many interrelated explanations have been used to explain the reasons behind the prohibition of interest in Islam. The original ban on interest charges stems from the fact that money lenders were often exploiting the poor by charging usurious rates. Furthermore, Islam argues that lenders whose funds are used for capital investment should receive an appropriate share of the profits rather than the pre-determined fraction of income represented by interest.

Rosa (1986) views interest as violating Islamic injunctions against gains from financial dealings, unless lenders are subject to similar risks of loss as borrowers.

In general, what is forbidden in Islam is the pre-determined return on financial transactions, and not an uncertain rate of return. Islam also prohibits speculation and hoarding. Speculation is prohibited because it stimulates gambling and creates an idle class of people who engage in investment activities which do not attempt to increase society's wealth. As far as hoarding is concerned, the logic behind banning it is that it would result in the society having less resources in use than it has available.

2.4.1 Operational Aspects of Islamic Banks

Islamic banks have developed many financial instruments as alternatives to the instruments provided by conventional banks and prohibited under Islamic law. It ought to be noted in this respect that not all conventional banks' instruments are prohibited under Islamic law; many of them are either permissible or subject to controversy under Islamic law. For instance, the treatment of letters of guarantee is one such instrument that has been a subject of controversy among Muslim jurists and economists. The argument stems from the legality of Islamic banks issuing these letters of guarantee and charging fees on such a service. Some Muslim jurists argue that these guarantees are classified as 'non-lucrative contracts' and, thus, assumed as human services which should be free of charge. On the other hand, some argue that the classification of the guarantee contracts as non-lucrative is not based on any religious principle. According to this view, two types of guarantee are permissible; first, is the human activity which is free of charge, and secondly, a lucrative activity allowing fees and commissions to be charged in accordance with the risks involved (Nienhaus, 1986).

Other areas which are subject to controversy under Islamic law include financial future dealings, because the exchange rate may include interest for the deferred payment. Leasing is another instrument which is under debate among Islamic banks. Leasing itself is permitted under Islamic law, but the controversy arises when some leasing contracts treat the leasing as a pure financial loan on which they are charging interest. Discounting commercial paper is another example. Accepting or collecting commercial paper is permissible under Islamic law, but selling them at discount rates is prohibited. The reason for this being that commercial papers are treated as debts, thus, a transfer of debts is only permitted at par value.

There are many other examples of financial instruments, however, which are forbidden by Islamic banks, but they are beyond the scope of this study.

Due to the limited number of financial instruments available to Islamic banks, which do not jeopardise Islamic principles, Islamic banks have developed alternative instruments in accordance with these principles. These alternatives, which are often referred to as profit-loss sharing (PLS), include three main financial instruments, namely Modaraba, Musharak and Murabaha. The Modaraba contract is a partnership in which a bank joins an entrepreneur whereby the bank provides the capital and the entrepreneur provides his skills and labour. The bank reserves an agreed percentage of profits and bears all the financial losses, while the entrepreneur shares in profits, and he only foregoes his wages in case of losses incurred.

The Musharaka contract is basically the same as Modaraba except that the partners in Musharaka contracts contribute jointly to the capital and management of the business venture. Both parties receive an agreed percentage of profits and shares in losses, in proportion of their share of capital. Unlike Mudaraba operation where only the entrepreneur has the right to manage the venture, in Musharaka both parties have the right to manage the project. The partnership may continue until the time, usually determined in advance, when the entrepreneur will buy out the bank's share of the project. Projects for Modaraba and Musharaka are usually selected on the basis of their anticipated profitability rather than the creditworthiness of the borrower.

Under Murabaha contracts, the bank purchases goods (usually capital goods) at the request of a client, and sells them to the client at cost plus an agreed profit, on a deferred payment basis.

These three financial instruments represent the major portion of Islamic banks' total assets, usually between 75-80 per cent of total assets, as will be seen later.

The liabilities side of Islamic banks' balance sheets is dominated by deposits. These banks, as already indicated, attract deposits from the public at large, and have proved to be successful in attracting deposits from devout Muslims, particularly those who have had no previous dealing with banks.

Islamic banks offer a variety of fixed-term instruments such as current, saving and deposit accounts. Depositors receive no interest but, rather, qualify for interest free loans.

When opening a current account, the depositors are guaranteed payment of their deposits on demand. This is the same as opening a current account with conventional banks, where depositors give their explicit approval to the bank to use their funds without any interest. In return, depositors are guaranteed the payment of their funds on demand, with the security of maintaining their funds in a bank without jeopardising their religious beliefs.

A major difference between Islamic and conventional banks is reflected in investment accounts. Depositors in Islamic banks are encouraged to place their funds in these accounts on the basis of predetermined profit-sharing ratios for a specified minimum period (Bashir, 1984). To share in the bank's profits, investment account holders have to maintain their funds for at least a year (the minimum period varies from one bank to another). Notices must be given in advance of any withdrawals. On short-term investment accounts, however, depositors can withdraw their funds on demand, but to be eligible for a share in profits, they must maintain their funds in the bank for the contracted period.

However, despite their recent origin, Islamic banks in the Gulf have been, in many ways, complementary to the larger and more experienced conventional banks. Their success has been partly due to their ability to attract small investors, particularly in rural areas, who had previously had very little or no dealing with banks at all. Furthermore, these banks have a few high net worth individuals in the Gulf who prefer to deposit their funds in Islamic banks primarily for religious reasons and with very little consideration being paid to the profitability of these banks. This does not mean that Islamic banks are less profitable than other conventional banks. In many cases the reverse is true, as will be seen later.

These factors have enabled Islamic banks to attract a considerable proportion of total deposits in the economy, as can be seen from Table 2.9. The Kuwait Finance House, for example, attracted about 15 per cent of total deposits in Kuwait in 1985. By 1988, Kuwait Finance House became the largest Islamic financial institution of its kind, with paid-up capital of US $62 million and total assets of US $2.8 billion.

As can be seen from the table, the most important aspect in the operations of the listed Islamic banks represent those of Musharaka, Murabaha and Modaraba. They represented around 85 per cent of total assets in 1985. Unfortunately, the published balance sheets of these banks do not include a breakdown of the figures as to indicate the share of each of the above mentioned operations. However, Mudaraba appears to be the leading instrument in Islamic banks' operations. It has been estimated that Mudaraba operations alone represent approximately 75 per cent of total assets of most Islamic banks (Nienhaus, 1986). It must be mentioned, however, that such estimates may be misleading when applied to Gulf Islamic banks. This is due to the fact that these estimates refer to Islamic banks in general, which includes the Pakistani and Iranian banks which operate in a fully Islamised financial system.

The major portion of Islamic banks' profits is generated from the real investment activities of these banks. In addition to the operations mentioned above, other investment activities include the investmenmt on commodities and stocks not subject to monopoly speculation or any of the forbidden kinds of investments.

Table 2.9 Consolidated balance sheet of selected Gulf Islamic banks, July-1985

US $ million

	Faisal Islamic Bank (Bahrain)	Dubai Islamic Bank	Qatar Islamic Bank	Bahrain Islamic Bank	Kuwait Finance House
Total assets					
Cash and deposits with Islamic banks	3.2	48.1	3.5	21.3	270.4
Loans and discounts*	34.1	320.2	-	130.1	2,236.4
Investments	4.0	48.8	158.2**	12.9	20.4
Letters of credit and guarantees	13.4	21.9	34.6	5.0	92.2
Fixed and other assets	4.0	10.4	3.8	1.8	149.9
Total assets = Total liabilities	58.7	449.4	200.8	171.1	2,769.3
Total liabilities					
Deposits***	9.6	385.8	142.1	140.2	2,444.6
Share capital	20.0	16.1	13.7	15.2	62.3
Reserves	4.2	2.5	3.0	1.5	51.0
Other liabilities	9.5	22.4	2.1	1.8	60.2
Liability under letters of credit and guarantees	13.4	21.9	34.6	5.0	92.2
Profit and loss	2.0	0.7		1.9	6.2
Depositors and investors share in profits	-	-	5.3	5.5	52.8

Source: Arab Banking & Finance, July 1985

Notes: * Loans and discounts refer to Mudaraba, Musharaka and Murabaha operations

** Includes loans and discounts

*** Refer to current and deposit accounts

Furthermore, Islamic banks often engage in long-term investments. These investments represent the banks' own projects jointly with other individuals or other Islamic financial institutions. The fact that Islamic banks insist on real investments with projects usually selected on the basis of their anticipated profitability, rather than the creditworthiness of the borrower, means that the banks are often more profitable than conventional banks, and hence, pay greater returns to the customer.

In their short period of existence, some Islamic banks have proved to be very profitable. In a study carried out by the Faisal Islamic Bank of Sudan (FIBS) for the period 1980-82, it was found that return to depositors for that period averaged between 14.5-16.5 per cent compared to maximum reported interest rates offered by the conventional banks of about 10 per cent (FIBS Annual Report, August 1984). However, a similar study on Islamic banks in the Arab Gulf region provided different results. It was found that return on deposits and equity of most Gulf Islamic banks for the period 1980-82 varied between 9 per cent for Kuwait Finance House to only 6 per cent for Bahrain and Dubai Islamic banks, compared with some conventional banks in the region with returns of 47 per cent for the Arab National Bank and 27 per cent for the National Commercial Bank of Saudi Arabia for the same period (Abdeen and Shook, 1984).

The sharing of profits in Islamic banks is not uniform. Muslim scholars and economists have developed many models of a banking system, all of which are in compliance with the principles of Islam. The most common model, which is widely used among Gulf Islamic banks, is based on a principle called 'Two-tier' Mudaraba which was developed by Siddiqi in 1982. This model integrates the assets and liabilities side of the balance sheet (Zubair and Mirakhar, 1987). According to this model, Islamic banks' earnings from all other activities are pooled and shared with the depositors and shareholders according to the terms of their contracts.

2.4.2 Growth and Achievements of Islamic Banks

Despite the major criticism directed towards Islamic banking by westerners, and despite their recent origin and the lack of financial instruments at their disposal, Islamic banks have proved to be effective among devout Muslims and are gaining in popularity both inside and outside the Islamic world. One indicator for the increasing demand on the services offered by Islamic financial institutions, is the growing number from only one bank in the early 1970s, to over 30 in 1985. The increased number was accompanied by a rapid growth in the size of these banks, as Table 2.10 indicates.

However, it is obvious from the table that these banks, despite the rapid growth in their total deposits, are still relatively small in size. The largest Islamic bank is the Kuwait Finance House with total assets of US $3.9 billion in 1986; this represents less than one tenth of the size of the Rafidain Bank of Iraq and one quarter of that of the National Bank of Kuwait.

Furthermore, among the top fifty Arab banks in 1987, there were only two Islamic banks, namely the Kuwait Finance House, ranked 28th, and Faisal Islamic Bank of Egypt ranked 48th (Arab Banker, December 1988). It ought to be mentioned, however, that the comparison between the Arab Islamic and conventional banks may not be in the Gulf were only established in the mid-1970s, compared to the Rafidain Bank of Iraq, for example, which has been in existence for more than half a century and which has no competition in the domestic market.

Table 2.10 Total assets of selected Gulf Islamic banks, selected years 1980-86

US $ million

Bank	1980	1982	1983	1985	1986
Kuwait Finance House	621	1,971	2,734	2,769	3,916
Dubai Islamic Bank	278	139	219	449	491
Dar Al-Mal Al-Islami (Geneva)*	-	310	286	318**	na
Bahrain Islamic Bank	na	77	na	171	175
Total	899	2,497	3,239	3,707	4,582

Sources: The 1980 figures are from Wohers-Scharf, Arab and Islamic Banks, OECD, 1983. Annual Reports by banks shown. Middle East Economic Survey (various issues)

Notes: * Established in 1982
** As at 30.6.85
na Denotes not available

The initial success of the Gulf Islamic banks was primarily related to religious beliefs. Prior to the establishment of the Islamic banks, strict Muslims had very little choice but to deposit their savings in the form of current accounts with conventional banks, where no interest is paid. Once Islamic banks came into being, the majority of these customers are believed to have switched their accounts to Islamic banks. This factor, coupled with the fact that Islamic banks might have attracted new customers who had no previous dealings with banks, explains the sizeable growth in their deposits and total assets.

However, due to the recent origin of Islamic banks and the lack of detailed data concerning their operations, it is not yet possible to examine whether these banks will perform as well as, and successfully compete with, the large and more experienced traditional banks in the Arab Gulf region.

CHAPTER 3

THE INTERNATIONAL EXPANSION OF ARAB GULF BANKS

3.1 INTRODUCTION

The aim of this chapter is to analyse the reasons behind the expansion of Arab banks beyond the boundaries of the countries in which they operate. The similarities and differences between the internationalisation of Arab and other banks will also be discussed. Special attention will also be given to the major regions that have attracted Arab banks. Before considering the internationalisation of Arab banks, a few definitions are necessary to understand international banking in general and the eurocurrency market in particular, as the major Arab banks have been integrated within this global market.

Many different theories have been offered to explain the growth of international banking since the late 19th century. Even the definition of international banks has been a major area of controversy. One theory defines international banks in accordance with their geographical location. This theory was adopted by the Bank of England whereby it defines international banking as 'the activities of a bank outside its traditional domestic market sphere'. According to this definition, Bahraini banks, for example, engage in domestic banking when they sell deposits or make loans within Bahrain, and they engage in international banking when they do business through their branches in other countries whether inside or outside the Arab region. An alternative view is based on the use of currency in banks' operations. This view was put forward by Dufey and Giddy (1978); they define international banks as 'financial intermediaries that simultaneously bid for time deposits and make loans in currencies other than that of a country in which they are located'. According to this view, Kuwaiti banks, for example, are engaged in domestic banking when they sell deposits and buy loans denominated in Kuwaiti dinars regardless of where these operations are taking place. In contrast, they will be regarded as international banks when they buy loans and sell deposits in other currencies whether inside or outside Kuwait. A third view distinguishes between domestic and international banks according to the nationality of their customers (Aliber, 1984). According to this view, Saudi banks are regarded as domestic when they deal with Saudi nationals anywhere in the world, and regarded as international when they deal with non-Saudis, whether in or outside Saudi Arabia.

For the purpose of this research the first definition will be applied (i.e. Arab banks will be regarded as international banks when they deal in activities outside the traditional domestic market in which they are based). Attention will also be focused on the individuality of Arab banks. This is significant because these banks have often been regarded as one unit despite the fact that they originate in more than a dozen Arab countries.

Because the majority of the Arab banks that are active in international financial markets originate in the Arab Gulf region, the terms (Arab banks, Arab Gulf banks and Gulf banks) will be used in this research interchangeably. They primarily refer to GCC banks or banks with at least 50 per cent GCC capital.

One of the major problems that arise when determining the international operations of banks, is that of inadequate data. This is particularly so for Arab banks, as many of them report their total deposits and loans of their foreign branches with very little attention paid as to the use of currencies involved.

3.2 THE ORIGIN AND GROWTH OF INTERNATIONAL BANKING

International banking may date back to as early as the late 19th century and early 20th century. Prior to the First World War, Western European countries were the most active international financiers, notably Britain, France and Germany. The dominant role of these countries was greatly assisted by their colonial position, as the majority of their overseas lending was of a colonial nature. This helped them not only to finance their thriving industries worldwide, following the industrial revolution, but also to achieve some degree of political and economic influence over the borrowing countries in Asia, Africa and Latin America. This pattern of lending was the dominant feature in international lending until the First World War.

One of the most fundamental changes after the war was the emergence of the United States as a financial and industrial power, coupled with a notable decline in Europe following the economic depression of the 1930s. This, in effect, meant that Europe was no longer the most important international financial centre, as the United States poised to take over that role and become the major capital supplier to the world. Furthermore, in order to protect the economic system and to avoid the numerous problems that occurred prior to the war, many important international agreements and institutions were initiated to promote international monetary co-operation through exchange rate stability, to provide long-term loans to finance balance of payments, and to assist in the process of the reconstruction that was created by the war. To achieve these targets, and as a result of the Bretton Woods agreement, the International Monetary Fund (IMF) and the World Bank were established immediately after the war. Furthermore, the General Agreement on Tariffs and Trade (GATT) also became effective during that period, and as a result, free international trading systems were established.

These transformations created favourable economic conditions that played a very important role in the initiation and the development of international banking. Due to the GATT, for example, foreign trade and direct investments grew rapidly after the Second World War. As these activities require constant financial services, the internationalisation of banks became inevitable.

However, the biggest move towards the expansion of international banking occurred in the 1950s, with the creation of the so-called eurodollar market. A combination of many factors led to the initiation and the rapid growth of the eurodollar market. Revell (1973) noted that one of these factors was the restrictions imposed by the British authorities on the use of the pound sterling for foreign trade. This was a direct result of the sterling crisis in 1957. This action greatly enhanced the demand for US dollars outside the United States, as the British banks substituted US dollars for pound sterling when financing foreign trade.

Differences in regulations have also played an important role in the development of the eurodollar market (Freidman, 1969). The most important regulation that stimulated the growth of the market in the early 1960s was regulation Q, under which the Federal Reserve fixed the maximum interest rates that member banks could pay on time deposits. The influence of regulation Q on the growth of the eurodollar market acted in two basic ways (BIS, 1970). Firstly, by strengthening the international eurodollar bank's ability to offer higher rates than the banks in the United States. Secondly, by giving rise to demand for eurodollar funds by US banks, and thus increasing the eurodollar deposit rate.

Another major force behind the growth of the eurodollar market has been the direct and indirect exchange controls imposed by the US authorities for balance of payments purposes. The Interest Equalisation Tax in 1963 and the Voluntary Foreign Credit Restraints Programme (VFCR) in 1965, are examples of such controls.

These regulations coupled with the decline, in real terms, of the current surplus of the United States, resulted in eroding the dominant position of the United States in the late 1950s. Consequently, Europe began to rise again in the early 1960s, with London being the major financial centre.

International banking was also encouraged by the technological advance in transport and communication, such as jet aircrafts, telex and the use of satellites. Communication facilities played an important role in facilitating the spread of information and reducing costs. This encouraged the internationalisation of banks, in which this information played an important role in reducing the cost of engaging in international borrowing and lending; international banking had long been handicapped by the slowness and uncertainty of communication. The most important development, during the 1970s, to enhance the growth of international banking, was the removal of the series of capital controls in the United States in 1974. With the removal of restrictions on capital movements, US banks began to arbitrate between the domestic and eurodollar market whenever interest rate differentials made this profitable. Furthermore, the removal of restrictions on capital flows into Germany in 1974, and the exchange controls in the United Kingdom in 1979, had a similar influence, as the Deutschemark and the sterling became integrated in the eurodollar market, which became known as the eurocurrency market.

The second important development in the 1970s, was the oil price increases, with large amounts of oil money being invested in the United States and Western Europe, thus providing the major banks in those regions with relatively cheap deposits which enabled them to bid aggressively in their lending operations. The direct impact of the oil revenues on the eurocurrency market is difficult to quantify, but the indirect benefits are numerous. For instance, the expectation that flows of oil funds to the United States would lead to the dramatic strengthening of the US dollar, was an important consideration behind the removal of barriers against capital outflows in the United States in 1974, as mentioned earlier. However, the impact of oil revenues on the eurocurrency market and on Arab banks will be analysed in Chapter 4.

There is no doubt that the lack of regulations concerning the operations of international banks, has been the most important reason behind their growth. No reserve requirements are applied for international banks, which gives them a great competitive advantage over their domestic counterparts. The competitive advantage of international banks stems from the fact that they incur lower costs and, therefore, are able to offer higher returns to investors and lower rates to borrowers. The cost advantage to international banking is explained in Table 3.1, where the obvious cost of reserve requirements to banks is the interest foregone on their cash reserves.

Table 3.1 Cost advantage of international banking due to differential reserve requirements

Borrowing rate (%)	Differential reserve requirements (basis points)				
	1	5	10	15	20
5	5	26	56	88	125
10	10	53	111	176	250
15	15	79	167	264	375
20	20	105	222	353	500

These figures are based on the formula

$$\text{Cost advantage} = \frac{ri}{1-i}$$

on the assumption that no interest is paid on reserve requirements, where:

r = market interest rate on domestic borrowing, and

i = reserve ratios

Source: R.M. Pecchioli (1983), The Internationalisation of Banking, The Policy Issues (Paris: OECD)

3.3 GROWTH OF THE EUROCURRENCY MARKET

The eurocurrency market consists of international financial markets and international or 'euro' banks that accept deposits and make loans in foreign currencies other than that of the country in which the banks are operating. The term 'euro' derives from the original location of the market. It reflects the geographical location of its beginning in the European financial centres (mainly London, as mentioned earlier). But with the broadening of the market in the late 1960s and early 1970s, many banks from other regions, notably Asia, the Middle East and South America, became involved. Therefore, the title 'euro' (or more broadly, international) banks could be applied to any bank operating outside its national boundaries. A Saudi bank in London or a Kuwaiti bank in Bahrain, are considered to be international banks.

The eurocurrency market can generally be divided into two major markets; namely, the syndicated lending market and the eurobond market. Because of the importance of the syndicated lending market to Arab banks, this market will be discussed in detail.

A syndicated credit is a loan in which a highly structured group of banks formed by a manager (or a group of managers), makes funds available on common conditions to a borrower. This type of lending commonly occurs in the eurocurrency market and some domestic financial markets, but there exists a sharp distinction between the two. In the domestic markets, if a corporate borrower requires more funds than any single bank is able or willing to provide, the borrower often draws down its credit lines at other banks, sometimes at less favourable terms. In the eurocurrency market, however, if a given borrower needs a large loan, a syndicate will usually be formed and all banks involved in that syndicate will participate in the loan on the same terms.

Generally there are three levels of banks in the syndicate; the lead bank, the managing bank and the participating banks. Most syndicated loans are led by one or two major banks who negotiate to obtain a mandate to raise funds for the borrower. There may be another party involved in the syndicate, particularly for large loans; that is the agent bank. This bank acts on behalf of the banks that participate in providing the funds, in supervising and handling the payment of interest, and in the amortisation of the loan.

The syndicated lending market was initiated in the 1960s. Since then, it has provided many sovereign borrowers throughout the world with the opportunity to borrow large sums on relatively favourable terms. Table 3.2 shows that the growth of this market has been remarkable. It grew from US $29 billion in 1974, to reach US $133 billion in 1981.

The rapid growth of the market was partly due to the increased deposits among the lending banks following the rise in oil revenues, and partly due to its competitive nature and the many advantages it offers to lenders and borrowers. From the lenders' viewpoint, the syndication procedure is a means of risk diversification through lending in different regions and sharing the risks with other banks. Furthermore, the free nature of a market where there are no restrictions on banks' entry, allows different size banks to participate in the syndicate. This was of particular importance to Arab banks that lacked the international experience and the financial resources to act as lead-managers for large loans during the early years of their internationalisation. Therefore, the involvement of Arab banks in the syndicated lending market is

Table 3.2 The syndicated medium-term eurocredit market, 1970-83

US$ billion

	Industrial countries[1]	Developing countries Non-OPEC[2]	OPEC[3]	Centrally planned countries[4]	International organisations[5]	Total
1970	4.2	0.3	0.1	-	-	4.6
1971	2.6	0.9	0.4	0.1	-	4.0
1972	4.1	1.5	0.9	0.3	-	6.8
1973	13.8	4.5	2.8	0.8	-	21.9
1974	20.7	6.3	1.1	1.2	-	29.3
1975	7.3	8.2	2.9	2.6	0.2	21.2
1976	11.3	11.0	4.0	2.5	0.1	28.9
1977	16.8	13.5	7.5	3.4	0.2	41.4
1978	29.1	26.9	10.4	3.8	0.2	70.4
1979	27.5	35.4	12.6	7.3	0.3	83.1
1980	39.1	24.0	11.0	2.8	0.4	77.3
1981	86.0	33.4	11.9	1.8	0.3	133.4
1982	42.7	28.7	12.8	0.8	0.2	85.2
1983	35.2	25.1	7.6	1.0	1.3	70.2

Source: Morgan Guaranty Trust Co., World Financial Markets (various issues)

Notes:
1 Includes Austria, Denmark, France, Greece, Ireland, Italy, Norway, Portugal, Spain, Sweden, United Kingdom and United States
2 Includes Argentina, Brazil, Chile, Colombia, Korea, Malaysia, Mexico, Peru, Philippines and Taiwan
3 Includes Ecuador, Indonesia, Nigeria, UAE, Venezuela
4 Includes China, East Germany, Hungary, Poland and others
5 Includes regional development organisations

considered to be the first real experience for these banks in international banking operations.

3.4 THE INTERNATIONAL EXPANSION OF ARAB BANKS

The internationalisation of banks has taken many forms, the most popular of which is a branch. This is a banking office which can provide full banking services including large loans based on the size of the parent bank's capital. Branches (which are not regarded as separate legal entities from the parent bank) can also take deposits, extend credits, participate in money markets and compete with home banks and other foreign branches.

Another popular form of establishing banks abroad is through opening representative offices. Unlike branches, these offices can not take or lend funds. They are much smaller than branches; a typical representative office has only one or two individuals representing the parent bank. The main attraction of these offices is that they are utilised for entry where the presence of foreign commercial banks is either limited or prohibited. They also provide the parent bank's clients with credit analysis and economic information about the business opportunities in the countries in which they operate. The obvious disadvantage of the representative offices, which makes them less attractive to many banks, is their inability to conduct banking business in the host country.

Other popular forms of establishing foreign banks include agencies, subsidiaries and affiliates. Agencies represent a form which is less attractive than branches, but more effective than representative offices. Unlike branches, agencies can not accept deposits from local residents of the host country but they are permitted to make commercial and industrial loans. The term subsidiary refers to a foreign bank that is partly or entirely owned by the parent bank (i.e. ownership of more than 50 per cent of equity). If the parent bank owns less than 50 per cent, the foreign bank is then referred to as an affiliate.

Another important form of establishing foreign banks is through forming consortia banks. These banks are narrowly defined by the Bank of England as 'banks which are owned by other banks but in which no one bank has a direct shareholding of more than 50 per cent and in which at least one shareholder is an overseas bank'. This form of establishing banks abroad proved to be very popular amongst Arab banks during the 1970s, as will be seen later in this chapter.

It ought to be mentioned in this respect that this definition may not necessarily apply to all Arab consortium banks discussed in this chapter. A broader definition will be applied according to which Arab banks with foreign banks amongst its shareholders will be considered as a consortium bank.

3.4.1 The Early Expansion of Arab Banks

The expansion of Arab banks outside their national boundaries can be traced back to as early as the 1940s (well before the global expansion of the euromarkets in the 1960s).

The first Arab bank to venture outside its country of origin was the Arab bank of Palestine. By the mid-1940s, this bank had three branches in neighbouring Arab countries, namely Jordan, Egypt and Syria. The political instability in Palestine during the 1940s, prior to the establishment of the state of Israel, was a major reason behind the regional expansion of the Arab bank. The political instability in Palestine was also responsible for the declining role of Jaffa as the main financial and trading centre for the Arab region. During the 1950s, Beirut took over Jaffa's role and developed to become the unrivalled financial centre in the region. Beirut's role as a financial centre will be further discussed in Chapter 5.

Throughout the 1950s, Lebanese bankers were the most experienced in the Middle East, and were the main beneficiaries from the oil price increases in the 1960s and the early 1970s. To expand their role further, most of the Lebanese banks established a presence in the Middle East and Europe. A typical example was the Banque Libanese pour le Commerce, established in 1950; this bank opened up a subsidiary in Damascus in 1953, and in Paris in 1956.

In the early 1970s, Arab investors relied on the financial market in Beirut to manage their investments in the Western financial markets. But since 1973, with the increased oil revenues, a direct Arab presence in the international financial markets became necessary. It is not surprising, therefore, that this period witnessed the initiation and growth of a large number of Arab consortia banks to combine Western expertise and Arab wealth.

Today, Arab banks have footholds in all international financial centres whether in the developed or the developing countries. Since the late 1960s, the process of the internationalisation of Arab banks has followed the same pattern of the early overseas expansion of Western European and American banks, with an obvious time lag between the internationalisation of the two groups of banks. However, Arab banks compensated for their late arrival on the international scene, by the speed of their expansion. Their efforts to become international financiers was greatly enhanced by the world's economic conditions that prevailed in the mid-1970s, which were characterised by high oil prices and the greater needs of many developing countries, looking for balance of payments adjustment finance.

For the purpose of this research, a survey was conducted during the period 1985-87. The survey was based on a series of personal interviews with fifteen Arab banks based in London. This methodology was pursued following unsuccessful attempts with an unsolicited mailed questionnaire.

However, the questions asked were targeted to the areas that are considered to be responsible for the overseas expansion of Arab banks; such areas as trade finance, political instability, increased competition from other banks, regulations and the low absorptive capacity of their home countries.

Not surprisingly, all fifteen banks included in the survey stressed the importance of financing trade between their home countries and the rest of the world, as the most important reason behind their international expansion. This, in effect, is very similar to the internationalisation of banks from other regions, particularly Japanese banks. Changes in the Gulf countries' domestic economy and the emergence of stronger trade and investment links between the Gulf and the world economy have undoubtedly created substantial pressures for Arab Gulf banks and other financial institutions to expand overseas. Because of a strong correlation between the oil revenues and the volume of trade, Arab banks' foreign expansion to finance trade will be further discussed in Chapter 4.

Another similarity between the internationalisation of Arab and other banks in Western Europe and Japan, was the ethnical effect of the many Arab citizens that reside in the West and the United States. This is very similar to the overseas expansion of Japanese, South Korean and Pakistani banks to London and the United States, whereby a major portion of their business has been to service their nationals and their descendants in those countries.

According to the survey, 53 per cent of Arab banks were driven to expand overseas to serve their customers who reside abroad, particularly in London, which is still the Western centre that attracts most Arab visitors.

The strong competition from other banks, whether foreign or domestic, is also considered to be a major reason behind the internationalisation of Arab banks. Nine banks, or 60 per cent in the above survey, regard this factor as an important reason behind their foreign expansion. This is particularly so for the Bahraini, the Emirates banks and some Saudi banks; the international expansion of these banks was in the hope of pursuing a greater share of the international market.

Another common reason stressed by all fifteen Arab banks included in the survey, was the perception of the profit opportunities arising in international lending through different regulations. International financial operations can be very profitable if conducted successfully and with long-term strategy and commitment. This factor partly explains the international expansion of Arab banks in the late 1970s and early 1980s, which coincided with the growing profitability of the major international banks. The ten largest US banks, for example, experienced earnings from foreign operations of US $1.37 billion in 1980, and the compound annual growth rate of these earnings between 1976-80 was 17 per cent (Solomon Brothers, 1981). It is generally agreed, however, that returns from international operations are generally lower than those of domestic operations. This is due to the intense competition between banks, which results, amongst other things, in lowering spreads, and in the heavy reliance of international banks on the interbank market, compared to domestic banks (Terrell and Key, 1977). In the absence of profitable domestic business outlets in the Arab region, international operations appeared attractive to Arab banks, especially after the oil price increases.

Other similarities between the international expansion of Arab banks and that of the US banks, were the restrictions imposed on banks and the existence of interest rate ceilings. In most Gulf states, where no exchange controls exist and with monetary authorities that are reluctant to let interest rates rise to acceptable levels to match those offered in the major international financial markets, funds inevitably flowed out of the region to the European countries, United States and recently Japan, where wide interest rate differentials sometimes exceed 10 per cent. Banks' customers in the Arab region often find it cheap to borrow local currencies, particularly in countries where interest rate ceilings exist such as in Kuwait, and by placing them in higher yielding international instruments, have forced the major Arab banks to protect their customers and keep in close step with international financial markets. Therefore, banks in Kuwait, Saudi Arabia and the UAE have followed the same pattern that caused many Western European and US banks to operate internationally; that is to have a presence where their customers are, in order to reduce the likelihood of losing a major portion of their business to their competitors who are already placed in international financial markets.

Another important factor that is considered to be of prominent importance behind the internationalisation of banks in general, and of Arab banks in particular, was the growing requirements of developing countries for external finance. Eighty per cent of Arab banks interviewed stressed the importance of this factor for their international expansion during the 1970s and early 1980s. Development programs in many Arab and other developing countries have become increasingly geared towards developing and broadening their industrial basis as a means of achieving self-sufficiency and economic development. As the financing needs of these industrial projects were generally medium to long-term, and in view of the incapability of most commercial banks in the developing countries to provide finance on such terms, most developing countries were forced to tap the euromarkets for the borrowing requirements. The majority of these requirements were met by the syndicated lending credits, as opposed to bond financing. This was largely due to the fact that almost all developing countries were, and to some extent still are, unfamiliar with the techniques of bond financing; furthermore, the scarcity of well-developed secondary markets in such countries is also to blame. Throughout the 1970s, there was an unprecedented demand for medium and long-term financing by the developing countries. This process continued until the late 1970s, when most of these countries, particularly those of Latin America, had reached their maximum exposure limits with Western banks. The newly established Arab banks with relatively high capitalisation were attracted to these lending opportunities both within and outside the Arab region. Driven by their depressed domestic economies and the anticipated high profitability on international lending operations, Arab banks became increasingly involved in foreign lending. By early 1982, most Arab banks were, relative to their sizes, heavily exposed to developing countries' borrowing, as will be seen in Chapter 6.

This heavy involvement of Arab banks in lending to developing countries was greatly enhanced by the many techniques evolving in international lending. Techniques such as roll-over credits, syndicated loans, subparticipation and many others, encouraged Arab and banks from other regions to participate on a large scale in project financing. The growing importance of the syndicated lending market during the 1970s, contributed largely to the international expansion of Arab banks. The effect of this lending technique was to offer Arab banks the opportunity to participate in loans to foreign borrowers with whom they had little customer relationship. Another assisting factor for Arab banks in international financial markets, was the development and the growing importance of the eurocurrency interbank market. This market has provided all international banks with a suitable vehicle for the management of their liquidity; this is of particular importance to Arab banks as most Arab countries lack broad and well-developed money markets.

One of the major differences between the internationalisation of Arab banks and that of other banks (particularly those based in developed countries) is that, while the latter were driven to operate internationally as a logical extension of their thriving domestic business, and to stimulate home country market and attract business to it, and most importantly, to follow their industrial companies abroad, the case for Arab banks is different. Unlike the Japanese, European or US banks, Arab banks have no industrial firms to follow overseas. Apart from trade finance and the involvement in the eurolending market and to a lesser extent in the eurobonds market, their only other motives to venture overseas were; firstly, to attract a portion of the large investments made by Arab governments and the private sector in the developed world following the major oil price increases in the 1970s, as will be discussed in Chapter 4; and secondly, to overcome the problems associated with their home countries such as the low absorptive capacity and the political instability.

One of the most important factors responsible for the internationalisation of Arab banks has been the political instability in the Middle East. The region is dominated by different political, ideological and ethnical views which have played a major role in increasing the hazards of greater instability. However, there is no doubt that the major source of instability in the region has been the Arab-Israeli conflict. Since 1948, when Israel was created in Palestine, there have been four major wars between the Arabs and Israel, and with no concrete peace in sight, the risk remains that the war may erupt again. The political instability in the region does not provide Arab banks, financial markets and investors with the ideal atmosphere in which to thrive. Inevitably investors have been forced to transfer some of their funds out of the region. Arab banks have taken the example of their customers and have moved beyond their national boundaries into the more politically stable regions of Western Europe, the United States and the Far East.

A typical example of an Arab country that has been torn by internal and external wars is the Lebanon. The civil war in Lebanon which started in early 1975, had two major devastating effects on the financial sector. Firstly it eliminated the role of Beirut as the main financial centre in the Arab region, as will be seen in Chapter 5; and secondly, the Lebanese commercial banks and investors were forced to transfer a major portion of their funds abroad. Foreign investment by the Lebanese banks increased rapidly, from US $1.5 billion in 1976, for example, to around US $5 billion in 1981. Many foreign branches of Lebanese banks were set up abroad, mainly in Paris, to cater for the large and growing expatriate community there.

Two other main events have further heightened the political instability in the Middle East since 1979. The first of these was the Gulf war between Iraq and Iran for the period 1979-88, and the second was the Israeli invasion of Lebanon in 1982. The main effect of the Gulf war was in destabilising the Gulf region and placing a major burden on its financial resources. These factors, combined with lower oil prices since 1982, accelerated the depression in the economies of most Gulf countries and, hence, forced most Gulf banks to venture abroad. Although there are no precise figures on the cost of the Gulf war, it is estimated to have cost the Gulf region in excess of US $100 billion.

Many other factors are believed to be responsible for the overseas expansion of Arab banks; such factors as technological advances in the field of information; ease of entry into the euromarkets, whereby even the small and inexperienced Arab banks were encouraged to participate in syndicated lending; nationalism is also believed to have influenced Arab banks (particularly Arab national banks) to operate internationally; establishing banks abroad represented a major attempt by Arab countries to have more control of their oil wealth, as will be seen in Chapter 4.

Finally in the early 1980s, establishing branches abroad (mainly for reasons of prestige and connections) amongst Arab banks became a fashionable exercise, with little regard for economic and commercial realities.

3.5 THE INTERNATIONAL EXPANSION OF ARAB ISLAMIC BANKS

The importance of establishing Islamic banks outside the Arab and other Muslim countries, stems from the fact that there are millions of Muslims from various countries who reside in Western Europe and the United States. It was the need to cater for those Muslims who would prefer to see their funds being invested in accordance with Islamic principles, that led to the establishment of many financial institutions in Western Europe.

The first Islamic bank to be established in a non-Muslim country was the Islamic Bank International of Denmark. This bank was granted a commercial banking licence in 1982, and was in operation in early 1983. Prior to that, Islamic banks had had some presence in other international financial markets, but not as deposit takers. A typical example is the Dar al-Mal-al-Islami which was established in Geneva in 1981.

Because of the nature of their operations, Islamic banks could not follow the example of other Arab conventional banks in venturing abroad or participating in euromarket operations. The refusal of Islamic banks as deposit-taking institutions in many Western countries arises because a central feature of these countries banking systems is that of capital certainty for depositors. Some aspects of Islamic banks, such as Musharaka, imply that depositors should share fully in the fortune of the Islamic institution receiving their funds. Thus, there appears to be no capital certainty for the depositors whether to the original deposits or the return on it. This was the main reason behind the refusal of the Bank of England to grant licences to Islamic banks as deposit takers. The argument put by the Bank of England was as follows: 'The Bank of England is not legally able to authorise under the Banking Act an institution which carries on business in this way because it does not take deposits as defined under the Act' (R.L. Pemberton, 1984).

Another problem for the foreign supervisory authorities when deciding whether to issue banking licences for Islamic institutions is the problem of capital adequacy. Supervisory problems might arise when assessing the capital adequacy of an institution involved in operations which might sometimes lead to capital uncertainty.

The use of interest in most operations in international financial markets has also prevented Islamic banks from participating in such operations. Syndicated lending, for example, involves heavy reliance on the interbank market; as mentioned earlier, the inevitable use of interest in such operations has made it increasingly difficult for Islamic banks to participate.

The same argument applies for other operations such as swaps and clearing arrangements.

Another difficulty associated with the expansion of Islamic banks in Western Europe is the absence of the lender-of-last-resort. Islamic banks, in principal, can not take resources to the facilities of the conventional central banks of Western Europe, because they are interest-based. Wilson (1986) notes, 'As far as their dealings in Western markets are concerned, they are not even recognised as secondary banks, and their clients receive no central bank protection'. The recent origin of most Islamic banks provides another problem for their overseas expansion. They have not yet developed sufficient financial instruments to supply firms with unconditional liquidity and working capital. Therefore these banks are often seen by Western central banks as having little additional services to offer.

However, Islamic banks in reality do not comply exclusively with Islamic principles. The Annual Reports of the Islamic Bank International reveal that during its first year of operation in 1983, only 50 per cent of its assets were invested in accordance with Islamic law. The absolute compliance with Islamic principles for any Islamic bank operating in non-Muslim countries is almost impossible. This is due to the fact that only a few instruments are at present available at the disposal of these banks, which makes the matching of assets and liabilities very difficult to achieve or maintain.

In light of these difficulties it is not surprising that the overseas expansion of Islamic banks has been concentrated in Arab and other Muslim countries. By 1987, there were over 40 Islamic financial institutions, situated in more than 20 Muslim and non-Muslim countries. The leading Islamic banks in the process of international expansion have been the Faisal Islamic Bank with branches in Egypt, Sudan and Bahrain; Dar-al-Mal-al-Islami with branches in Geneva, Niger and Senegal; and Al-Baraka Bank with branches in Turkey, Sudan, London and Bahrain.

In the long-term Islamic banks will benefit greatly from the formation of the European Community in 1992. Banks operating in any European country, such as Denmark in the case of Islamic banks, will no longer be required to seek authorisation from countries such as the United Kingdom, Germany or Greece when they wish to open a branch or a subsidiary there. This in effect means that most of the problems facing Islamic banks' international expansion in Western Europe will be eliminated in 1992, provided that these countries do not exercise their rights of reciprocity requirements, an issue whic has not yet been decided.

3.6 THE GROWTH OF ARAB-WESTERN JOINT VENTURES

The worldwide expansion of Arab banks has taken several forms. Many have chosen to establish joint ventures with Western banks, while others have set up branches and subsidiaries in the main international financial centres.

One of the main objectives for creating the Arab consortia banks was that they represented the only alternative to the small and medium sized Arab banks to participate in the thriving eurocurrency markets during the 1970s (i.e. recycling the oil revenues of their countries). Therefore, Arab banks (like other international banks) were hoping that by pooling their capital resources with the management and expertise of their western partners, they would be able to exploit international lending opportunities for their clients.

Arab consortia can be divided into two major groups. First, those established prior to the first oil price increases in 1973. The main purpose behind their establishment was to promote and finance trade between the Middle East and Western Europe. This group includes the French-Arab Bank International (FRAB) which was created in 1969, with many different shareholders from Western Europe, Japan and the Middle East (see Appendix C); the Union de Banques Arabes et Francaises (UBAF) which was established in 1970; and finally the Compagnie Arab et International d'Investissment (CAII) established in 1973 in Luxembourg. It is noticeable that these consortia are promoted by the major French banks, Credit Lyonnais in the case of the UBAF, with 31.95 per cent ownership, and Societe Generale in the case of FRAB, with 25 per cent ownership. The concentration of these Arab consortia banks in France was related to the unlimited support of Charles de Gaulle's government to the Arab countries in their conflict with the then newly established Israel, whereby during the late 1960s and early 1970s, France was considered to be the most pro-Arab Western power. Furthermore, France enjoys strong economic ties with many Arab countries, in particular the Arab African countries (Algeria, Morocco and Tunisia) and Lebanon.

In addition to the priority business of trade finance, the activities of these consortia banks also included loan syndication. The UBAF, for example, was ranked fourth among the top Arab international banks in terms of total syndicated loans in 1983, as will be seen in Chapter 7. They are also involved in fund management, real estate, bonds and equities, advisory services for corporate customers, swaps and other services.

The most important of the Arab consortia banks established during this period has undoubtedly been the UBAF. In addition to its prominent position in eurolending, its geographical expansion has been very impressive. By 1985, with 17 branches and subsidiaries, the UBAF was the Arab bank with the largest foreign network throughout the world.

The second group of Arab consortia companies were those established in the aftermath of the oil price increase. During 1974-80, Arab monetary authorities promoted the creation of Arab consortia banks to satisfy the growing needs for finance of many Arab and other developing countries, and to train a new breed of Arab bankers in order to assist the Arab national banks in recycling their oil surpluses.

This period, not surprisingly, witnessed the creation of a large number of Arab consortia and a major expansion in the already existing ones. During 1974 alone, 14 Arab consortia were established both within and outside the Middle East. Examples of such consortia were Banco Arabe Espanol (1975) based in Madrid, Saudi International Bank (1975) based in London, Arab Hellenic Bank (1979) based in Athens, the Banco Saudi Estanbol and the Arab Turkish Bank (1977) based in Istanbul. The most significant Arab consortia bank established during that period was the Arab Latin American Bank, which is better known as 'Arlabank'. Based in Bahrain, this bank was created in 1977, at a time when the Latin American region was attracting a large portion of the oil revenues placed in Western Europe and the United States. Therefore, the creation of Arlabank may be seen as a sign of the Arab banks taking full advantage of the then thriving business in Latin America. By the end of 1986, almost two-thirds of total Arlabank's assets were in various countries in Latin America, namely Argentina, Mexico and Brazil. The profitability and the effects of the 1982 Latin American debt crisis on Arlabank will be discussed in Chapter 7.

Apart from the oil price increase, another important factor which led to the growth of the Arab consortia banks, came in 1977 when Saudi Arabia decided to nationalise its banking industry. As a result of this policy, all foreign branches in Saudi Arabia were transformed to consortia banks with a minimum Saudi ownership of 60 per cent. Thus, the British Bank of the Middle East, for example, became known as the Al-Bank Al-Saudi Al-Hollandi and Bank du Cairo became Saudi Cairo Bank. A list of the major Arab consortia banks, their date of establishment, ownership, paid in capital and other relevant information, is provided in Appendix C.

3.6.1 Assessment of the Arab-western joint ventures

Prior to the emergence of the first generation of Arab consortia banks in the late 1960s and early 1970s, Arab banks had very little (if any) experience in the field of international banking. By pursuing the joint venture approach with experienced and respected international banks such as Credit Lyonnais, Societe Generale, British Bank of the Middle East, Chase Manhattan and Barclays International Bank, Arab banks were hoping to achieve many objectives. The most important of these were the training of Arab bankers, recycling oil surpluses and thus finding international outlays for their resources. There is no doubt that these Arab consortia have assisted Arab banks in gaining a foothold in the major international financial markets. The figures in Table 3.3 illustrate the rapid growth of assets and profits of a selected Arab consortia.

Table 3.3 Total assets and profitability of the major Arab-Western consortia banks, 1974-79

US$ million

	1974	1975	1976	1977	1978	1979
FRAB						
assets	362	459	486	757	782	720
profits	0.41	0.06	na	2.03	0.94	0.73
UBAF						
assets	1157	1573	2100	2574	2868	3181
profits	2.45	3.66	4.19	4.90	5.15	5.92
BCCI						
assets	-	1206	1656	2206	2801	3919
profits	-	6.69	13.74	17.14	22.75	25.17
BAII						
assets	279	503	848	1081	1370	1781
profits	0.47	0.91	0.99	1.19	1.49	3.18
Banco Arabe Espanol						
assets	-	157	565	589	763	960
profits	-	0.43	1.66	1.97	2.71	4.86

Source: Wohers-Scharf, Arab and Islamic Banks, OECD, Paris, 1983, pp. 136-37

Note: na denotes not available

The UBAF is undoubtedly the most successful of these consortia, whereby by 1987, its total assets of US $14 billion were higher than those of any other Arab consortia. Even when compared to the large Arab national banks, the UBAF was ranked sixth in 1986, and fifth in 1987 amongst the top ten Arab banks in terms of total assets. Apart from the variety of services offered by the UBAF and its wide geographical presence, the appointment of Arab directors also enhanced its growth, by giving it more appeal and acceptability in the Arab world.

The other Arab-French consortium which has also proved to be successful is the BAII. The fundamental difference between this bank and the UBAF lies in its involvement in the eurobond market. Unlike the UBAF which has very little eurobond activity, BAII's management specialises in stock market activities, mainly to avoid competition with its shareholders, and with other Arab banks in other euromarket operations such as syndicated lending. To strengthen its stock market activities in London, the BAII bought the London stockbrokers Sheppards & Chase (MEED, 19 March 1986). This proved to be a very expensive acquisition, as Sheppards suffered heavy losses in 1987 following the October stock market crash, and thus, it was sold in 1988. During the same year BAII opened up its own branch in London. A unique feature about this branch was that it represented the first Arab bank in London to be granted a licence by the Bank of England to be eligible to discount bills, on behalf of its parent bank, in the London stock exchange. Despite the heavy losses suffered by Sheppards, the BAII incurred profits of US $8 million in 1987. This strong performance was related mainly to BAII's wide geographical spread and its large involvement in financing trade between the Middle East and Asia. The inclusion of the Bank of China among BAII's shareholders in 1987 (which represented the first involvement of any Chinese bank with an Arab-Western consortium) has helped the bank greatly in penetrating the Asian market.

The performance of the Saudi joint-ventures (the nationalised branches of foreign banks in Saudi Arabia) have been varied. These banks differ from other Arab consortia in the sense that they are treated more as domestic Saudi banks. They also lack the geographical expansion of the UBAF and the BAII. Al-Bank al-Saudi Al-Fransi, which is considered to be the largest of all the nationalised foreign banks in Saudi Arabia, for example, prides itself on being purely domestic and has no international operations whatsoever. This bank was established in 1977, with 60 per cent Saudi ownership, and the other 40 per cent is owned by the original parent bank, namely France's Banque Indosuez. To concentrate on its domestic operations, it increased its branch network in the kingdom from only four branches in 1978 to 55 branches in 1988.

Unlike other Arab consortia which rely heavily on the interbank market for their funding, the Saudi consortia attract their deposits from their Saudi customers, where there is no shortage of private wealth. The deposits attracted by the six Saudi consortia amounted to over US $2 billion in 1987. What makes these deposits of particular importance, is that almost 60 per cent of the total are placed by investors who do not seek interest revenues in line with Islamic religion, as mentioned earlier.

However, not all Saudi consortia performed profitably, particularly in the early and mid-1980s due to the general recession in the kingdom and the low oil prices. The Saudi Cairo Bank, for instance, incurred losses of US $16 million in 1986 and US $8.8 million in 1987, and has not recorded profits since 1984 (SAMA, 1988).

In general, the majority of Arab consortia banks appear to have reached the end of their services. The success of Arab consortia banks was confined to the large ones such as UBAF, FRAB, BAII and Saudi International Bank, which in many ways managed to build their own independent business, and are a match for many of the old and well-established Arab national banks. The smaller Arab consortia banks, however, proved less effective and did not achieve many of the original objectives that were responsible for their establishment. Very few of the Arab consortia followed the exact pattern of progress that was expected by their shareholders. The first objective, as mentioned earlier, from the Arab banks' viewpoint, was for these consortia to play an active role in the recycling of the oil revenues. In reality this objective was not fully achieved. In this respect, Wilson (1983) notes 'At no time have they accounted for more than 10 per cent of the recycled funds'.

The ineffectiveness of most of the Arab joint ventures was reflected by the rapid slowdown of their establishment since the early 1980s. Furthermore, a major trend that started gaining momentum since 1980, was the taking over of some of these consortia by their Arab shareholders. A typical example of this trend was the transformation of FRAB from an Arab-French consortium to a wholly-owned Arab bank after the purchase of all the foreign shareholding by the National Bank of Kuwait. Nationalism is one of the reasons that could be used to explain this change. There has been a general feeling among Arab banks and Arab monetary authorities, that the reliance on Western banks has been too great for many Arabs to be recognised as an established institution in their own right. As the top management was, generally, provided by the Western partners in the consortia, these managements were mainly concerned about realising large profits, with very little attention being paid to the poorer Arab countries' financial needs.

From the viewpoint of the Western banks, however, their main motive in joining the Arab banks, was to gain a foothold in the Arab region, particularly after the first oil price increase. But with the creation of the offshore financial centre in Bahrain, the major Western European and US banks were invited to set up branches there, as will be discussed in Chapter 5. Therefore, there was little need for the joint ventures with Arab banks. The same argument applied to Arab banks, which since the mid-1970s had established many wholly-owned Arab joint ventures, namely Gulf International Bank and Arab Banking Corporation. These new Arab banks were created primarily to penetrate international financial markets. Thus, by the early 1980s, many Arab banks felt that they had acquired the necessary expertise to handle their international business. Furthermore, with the establishment of the wholly-owned Arab banks, which by 1983 had a large foreign expansion, there was very little co-operation between them and the Arab consortia. In fact, the major Arab-Western joint ventures were often viewed as competitors.

Another major problem associated with a large number of Arab consortia banks was their low capitalisation, the reason for this being that the majority of Arab shareholders were from Arab poorer countries, in addition to those from the rich oil producing countries. The inability of the former group to contribute to increasing the capital of these consortia has often led to the reluctance of the latter group to participate fully, whether in increasing the capital or placing their deposits with these institutions.

However, there is no doubt that the major reason for the downfall of most Arab consortia was the diversity of interests among their shareholders. Eventually, it became difficult to tell the real motivation behind the existence of these banks. It was for this reason that a major Saudi-French consortium collapsed in 1988, namely Al-Saudi Banque. This bank, like the majority of the Arab consortia, was originally established primarily to provide private banking services to Arab clients, and to assist in channelling the Arab wealth abroad. Its main problem lay with its management, whereby no precise functions were set, and the imprudence of its lending policies. These policies coupled with the low capitalisation eventually led to the collapse of the Al-Saudi Banque in October 1988 (Monro-Davies, 1988).

It is these limitations of Arab consortia, and the growing experience of some Arab banks in international financial operations, that inevitably led to Arab banks establishing their own offices abroad.

3.7 THE GEOGRAPHICAL DISTRIBUTION OF ARAB INTERNATIONAL BANKS

Arab banks today are located all over the world, particularly in Western Europe and the United States. They have recently begun to set up branches in Asia, especially in financial centres like Singapore, Hong Kong and Tokyo.

The first expansion wave of Arab banks was in Western Europe, particularly in London, Paris and Luxembourg. This move was seen as a natural development because Arab countries for many decades have had the closest economic and trade relations with these countries. The most important financial centre to attract Arab banks was, and still is, London.

3.7.1 Arab Banks in London

The growth of Arab banks represented in London has been very rapid. Prior to 1970, for instance, there were only three Arab banks in London, By 1973, four more Arab banks had been established in the City of London. The massive acceleration of the flow of Arab banks into London occurred in the period between 1977-81, whereby in 1981 some 44 offices and branches were set up in London. The rapid growth of Arab banks in London was predictable and, perhaps inevitable. Since most Arab countries were colonies of the British empire in the 19th and 20th centuries, it is only natural that these countries should have very strong historical ties with London. In addition, until recently, London was the most important financial centre in the world. It offers many advantages and facilities as a financial centre; for example, its good communication system, its prime position in the euromarkets and its advanced financial markets. It is the prominent position of London in the euromarkets that attracted Arab banks to it, because the majority of their operations are in these markets. Between 1975-80, for example, London's share from the global eurocurrency market averaged 32.7, which represents the highest share of any financial centre in the world.

Another important reason for Arab banks to be present in London is to finance the growing trade between the United Kingdom and the Arab region. The trade volume between the GCC members and the United Kingdom is represented in Table 3.4.

Table 3.4 Total GCC imports from the United Kingdom, 1974-85

	Total imports (US$ million)	Imports from the UK as a % of total	% growth
1974	712.8	8.9	-
1975	1273.5	11.0	78.7
1976	1812.3	9.7	42.4
1977	2956.7	10.3	63.1
1978	3540.7	10.3	19.8
1979	3999.6	9.6	13.0
1980	4511.5	8.7	12.8
1981	4662.5	7.8	3.3
1982	5320.8	7.9	14.1
1983	4800.7	7.7	-9.8
1984	3969.8	7.2	-17.3
1985	4070.8	10.0	2.5

Source: External Trade for GCC Members 1974-85, Arab Monetary Fund Publication, October 1987, Arabic, pp. 58-59

As can be seen from the table, the trade between the Arab Gulf states and the United Kingdom has shown positive growth, particularly during the mid to late-1970s. (The negative trade volume during 1983-84 reflects the general trend in the economies of the Gulf countries where their overall imports during that period were on the decline.) Although the volume of trade financed by Arab banks is not known precisely, they are believed to have financed a major portion of the total.

Other Arab banks established a foothold in London to follow their customers. London has always been a major tourist attraction to Arab nationals. According to the Euromoney figures, Arab visitors to the city of London spent a total of £528 million during the summer of 1983 alone, which represents a 40 per cent increase compared to 1981.

London's attraction to Arab banks can also be attributed to the favourable climate created by the Bank of England during the 1960s and 1970s. A bank establishing a representative office in London is only required to notify the Bank of England within a month of doing so. This explains the large number of Arab banks with representative offices in London, whereby in 1984, for example, they represented 10 per cent of total representative offices in the city of London, as can be seen from Table 3.5.

As the table illustrates, despite their relatively late arrival in London, Arab banks represent a significant portion of all foreign banks established there.

The first Arab bank to arrive in London was the Arab Asian Bank, which established its London subsidiary in 1948, followed by the Rafidain Bank of Iraq in 1952 and the United Bank of Kuwait in

1966. In general, only 9 Arab banks were represented in London prior to the first oil price increase in 1973. Between 1973-79, 16 more Arab banks established a foothold in the city of London following the increased investment and trade between the United Kingdom and the Arab region.

Table 3.5 Arab banks in London, April 1987

Type of representation	Number of Arab banks			Total foreign banks*	Arab banks as a % of total
	Gulf	non-Gulf	Total		
Branches	12	7	19	155	12.3
Representative offices	10	7	17	229	7.4
Subsidiaries	4	1	5	42	11.9
Consortia	5	-	5	26	19.2
Total	31	15	46	452	10.2

Sources: Figures related to Arab banks are compiled from the Arab Banker, volume v, no. 1, January/February 1985, p. 17 and Euromoney, Aril 1987, pp. 127-157
Total foreign banks in London are from Euromoney, April 1987, p. 127

The most significant arrival to London in the late 1970s and early 1980s, was that of Gulf International Bank and Arab Banking Corporation. The importance of these two large Arab banks lies in their high capital and the wide range of financial services they offer. For Gulf International bank, London was the first major step towards achieving its global expansion. The London office of Gulf International Bank was set up in 1978. It is largely due to its London office that the Gulf International Bank has enjoyed a prominent position in the euromarkets, as will be seen later in Chapter 7. Arab Banking Corporation set up its branch in London in 1982, only two years after the creation of the bank's headquarters in Bahrain. With a capital of US $1 billion, Arab Banking Corporation is undoubtedly the largest Arab bank to be established in London. Since its arrival, this bank has made a significant impact on the Arab banking scene in London, with its emphasis on sovereign risk credit and its determination to play a major role in eurocurrency syndication.

Another large Arab bank to be established in London was the Saudi International Bank. This consortium Arab bank which is owned 50 per cent by the Saudi Arabian Monetary Agency and the remainder by leading international banks headed by Morgan Guaranty Trust Co., is considered to be the most successful Arab bank in London. Its balance sheet has grown rapidly since it was established in 1975, with total assets up from US $388 million in 1976 to US $2,934 million in 1980, while its loans have risen from US $26 million to US $775 million during the same period. It is worth mentioning that the figures related to 1980 might be exaggerated by the lower value of the US dollar where the £/US$ exchange rate was 2,3850, compared to a rate of 1.7024 in 1976. However, since its launch, the bank's main efforts have been concentrated on treasury business and syndicated lending, whereby in 1980, for example, it was ranked fourth amongst Arab banks in terms of syndicated lending participation as a lead or co-manager.

To further enhance the position of Arab banks in London, the Arab Bankers Association (ABA) was established in London in 1980, and by 1984 the ABA had 500 members from many Arab and non-Arab countries. Its aim was to assist in the formation of a new generation of Arab bankers (The Banker, December 1984).

The latest Arab banks to arrive in London are the Al-Ahli Bank of Kuwait and the Bank of Kuwait and the Middle East. The latter was granted a full banking licence by the Bank of England in December 1988 (MEED, March 1989). The arrival of these two relatively small banks which are, by no means the most internationally active among Arab banks, reflects the depressed economies of the Arab Gulf region and the importance of London as an international financial centre to Arab banks.

A full list of Arab Gulf banks with representation in London is provided in Appendix D.

In general, Arab banks' offices in London are often looked on as an important means of exposure diversification to international business at a time of limited domestic opportunities and intense competition. By the end of 1988, there were more Arab banks present in London than in any other financial centre in the world.

The general view in the Arab banking community is that a bank is not considered international unless it is represented in London. It ought to be mentioned in this respect that, within Europe, France used to be an important financial centre that attracted a large number of Arab banks. Unlike London, the arrival of Arab banks in Paris only effectively started in the 1970s. Prior to that there were only two Arab banks present in Paris; the Banque de Syria et des Liban (the former central bank of Syria and Lebanon), and the Bank Libanais Per Le Commerce. The arrival of Arab banks in Paris in considerably large numbers, however, occurred in the 1970s when many Arab consortia were set up there, as mentioned earlier.

Since 1981, however, the presence of Arab banks in Paris has been somewhat limited compared to their presence in other centres such as London or New York. The most important factor that contributed to the declining role of Arab banks in Paris, was the nationalisation programme adopted by the then newly elected socialist government. Under this programme, Arab banks with relatively small balance sheets were forced to bring in a French partner. This was seen as a major deterrent for the establishment of Arab banks in Paris. Furthermore, the devaluation of the French franc and the tightening of exchange controls created further constraints on foreign banks operating in Paris. These factors can be used to explain the rapid increase in the number of Arab banks in London, where more liberal banking policies exist, particularly after the abolishing of exchange controls in 1979.

This, in effect, is a reverse situation to that which existed in the late 1960s and early 1970s. During that period Arab banks in Paris were allowed to participate in all banking activities, whereas the operations of foreign banks in London were somewhat restricted.

It must be mentioned, however, that although there was a major change in policy in France in 1986, when the nationalisation programme was lifted and a more liberal policy of privatisation was adopted, no more new Arab banks were established there. Instead they opted for other financial centres in Europe, the United States and Asia.

3.7.2 Arab Banks in the United States

Since the md-1970s there has been an influx of many foreign banks into the US market. These banks saw the need to be present in the United States for a variety of reasons. Some wanted a foothold in financing the growing trade between their home countries and the United States, while others, like the Japanese banks, followed their home country customers who were expanding their business to the United States. The other attraction of the United States to foreign banks, was the growing importance of New York as a financial centre, whereby since the early 1980s it has become the most sophisticated international financial centre in the world. It is not surprising, therefore, that the number of foreign banks in the United States has been growing dramatically since the late 1970s and early 1980s. According to the Federal Reserve Bank's statistics, in 1972 there were only 52 foreign banks in the United States with 104 offices and assets of US $25 billion. In 1983, however, the number of foreign banks in the United States had risen to 230 banks with 420 offices and with assets of US $300 billion. By early 1985, there were in excess of 900 foreign banks operating in the United States and the majority of them have a presence in New York.

For Arab banks, however, their arrival in the United States is a recent development. Unlike their establishment in London, Arab banks lagged behind most other international banks in realising the importance of New York to their international operations.

The late arrival of most Arab banks to the United States can be attributed to many reasons, such as reciprocity requirements, political reasons, costs and competition. One reason for the late arrival of Arab banks into the United States was the freeze of Iranian capital held in the United States in 1979 following the hostage crisis. The effect of this action was to temporarily shake the confidence among Arab banks towards the United States.

The 1978 International Banking Act was regarded as one of the most important developments to encourage foreign banks to enter the US market, and Arab banks were no exception. The effect of this Act was to remove the reciprocity requirements for the Federal Licensing Authority. Because most Arab countries refused, through the policy of nationalisation of their banking industry, to allow US banks to enter their countries, and with the New York authority demanding reciprocity, some of the biggest Arab banks (particularly the Saudi and Kuwaiti banks) were unable to start up in New York. Therefore, it is only since 1978, that Arab banks have been allowed to register their presence either through the relevant state authority or through the Comptroller of the Currency.

The other banking act that also enhanced the flow of Arab banks into the United States, was the introduction of the International Banking Facility (IBF), in 1981. The effect of this act was to allow banks operating in the United States to deal with foreign entities as if they were in a tax haven (Arab Banking and Finance, March 1984).

The third factor that is also believed to be responsible for the late arrival of Arab banks in the United States was the high costs involved in establishing presence there. The cost of running an office is higher in New York than probably anywhere else in the world. Furthermore, because of the large number of banks (domestic and foreign) operating in the United States, for a foreign bank to have any success in finding profitable outlets for its funds, requires huge investments in information processing technology and in hiring teams of experts and specialists.

Although these factors apply to all international banks operating in the United States, they are of particular relevance to Arab banks, as these banks are entering this competitive market for the first time. Despite these limitations, however, the number of Arab banks with a presence in the United States has been increasing rapidly. In 1980, for example, there were two Arab banks operating in the United States, namely the UBAF Arab American Bank which was set up in New York in 1976, and the Arab African International Bank in 1979; but by the end of 1988, there were 38 Arab financial institutions in the United States, as can be seen from Table 3.6. This reflects the awareness of Arab banks of the growing importance of New York and its challenge to London, which was until recently the most important financial centre in the western world.

Table 3.6 Arab Banks in the United States, end-1988

Type of office	No. of Arab banks Gulf	Non-Gulf*	Total	Arab banks as a % of all foreign banks
Branch	11	2	13	8.3
Representative office	3	1	4	3.9
Agencies	1	2	3	6.0
Subsidiaries	2	-	2	10.5
Charter licence**	2	2	4	2.4
Federal licence	10	2	12	17.9
Total	29	9	38	6.8

Sources: Compiled from The Banker, June 1989, pp. 25-40
Arab Banker (various issues)

Notes: * Includes banks from Egypt, Jordan and Arab consortium banks based in Europe
** Refers to charter or licence whether granted by New York state or any other state of the United States

As the table illustrates, in a relatively short period of time, Arab banks have managed to overcome the difficulties of breaking into a market that is, traditionally, dominated by the largest international banks in the world. By the end of 1988, Arab banks represented just under 7 per cent of the total foreign banks operating in the United States. In terms of the number of branches present in the United States, the Arab Gulf states have a higher number than Britain, Germany and France. Similar to their earlier expansion in Western Europe, Arab banks were motivated to penetrate the US market by the increased volume of trade between the Middle East and the United States, and the large investments made by Arab governments and the private sector in the United States. Imports made by the GCC countries from the United States witnessed unprecedented growth during the 1970s and early 1980s. In 1974, GCC's merchandise imports from the United States were to the value of US $1.1 billion, whereas by 1982, this figure had reached US $11.6 billion, showing a tenfold increase during that period. Apart from Japan, no other industrialised country has enjoyed such high volumes of trade with the Arab countries. Between 1977-85, US goods represented 16 per cent of total imports to the Gulf countries. Amongst the GCC countries, Saudi Arabia is the major importer of US goods. The trade links between Saudi Arabia and the United States are mainly financed by the Saudi banks present in the United States, with Saudi International Bank dominating the proceedings due to its American shareholder, Morgan Guaranty. For the Kuwaiti banks that are considered to be the leaders among Arab banks in foreign exchange operations, international trade financiers and the real estate markets, the desire to be established in the United States was a natural extension of their operations at home. Commercial Bank of Kuwait, for example, which set up its New York branch in 1984, was strongly attracted by the prospect of extending its foreign exchange operation by a further eight hours (The Banker, December 1984). The different time zone and the growing importance of New York also attracted the National Bank of Kuwait, in 1984. The other factor that influenced Kuwaiti banks to be established in the United States, was the massive Kuwaiti investment there. By 1984, the Kuwaiti authorities alone invested US $50 billion in the United States, in addition to the substantial private Kuwaiti investments in North America.

Because of their recent origin, the branches and agencies of Arab banks in the United States are relatively small compared to other banks. As can be seen from Table 3.7 the average assets of these branches in 1985, was around US $210 million, ranging from US $1,228 million for the UBAF Arab American Bank to US $61 million for the United Bank of Kuwait.

As Table 3.7 shows, the US branches of Arab banks have witnessed very modest growth in total assets during 1985. It is also apparent from the table that these banks have applied a conservative attitude in their financial operations in the United States. This is reflected in the reduction in their lending by nearly 7 per cent between 1984 and 1985; consequently their deposits with other banks have increased by over 700 per cent. These figures may suggest that the role of Arab banks in the United States is very minor; they are, however, often viewed as very important sources of funds to other banks operating in the United States. This is particularly true for banks such as the Gulf International Bank.

Its loans in the US market during 1984 totalled US $11 million, US $10.4 million (or 94 per cent) of which went to foreign banks operating in the United States.

Table 3.7 **Assets and liabilities for US branches and agencies of Arab banks, 1984-85**

	1984		1985	
	US$ mn	% of total	US$ mn	% of total
Assets				
Cash from depository institutions	1,255.6	43.2	1,133.5	38.5
Securities	197.1	6.8	194.9	6.6
Federal funds sold	146.7	5.0	171.7	5.8
Loans	1,144.7	39.4	1,067.6	36.2
Due from related institutions	24.3	0.8	200.3	6.8
All other assets	139.4	4.8	179.6	6.1
Total assets*	2,907.8		2,947.6	
Liabilities				
Total deposits and credit balances	1,361.8	46.8	1,759.3	59.7
Due to related institutions	810.3	27.9	540.7	18.3
All other liabilities	735.7	25.3	647.6	22.0

Source: Arab Banking and Finance, vol. 3, no. 10, November 1984 and the Board of Governors for the Federal Reserve System

Note: * Details may not sum due to rounding

While interbank operations may be profitable, and at times of depressed business opportunities, can be inevitable, they do not always justify having a branch in the United States.

However, other Arab banks are enjoying a profitable existence in the United States and consider their US offices as a major area of asset growth. This group includes banks like the Arab Banking Corporation and Bank Audi (USA). The Arab Banking Corporation is, undoubtedly, one of the most successful banks operating in the United States. Its financial results during 1984 indicate this fact. 82 per cent of its total loans in the United States went to commercial and industrial projects and to syndicated lendings to foreign governments. Only 7.5 per cent of its total lending was in the interbank market.

While the success of Arab Banking Corporation in the United States has been due to its heavy involvement in project financing and syndicated lending, that of Bank Audi (USA) is somewhat different. This bank, which is a joint venture owned by several Lebanese and US banks, relies almost entirely on its ethnic appeal to Arab nationals, particularly Lebanese, in its operations. It provides full commercial and retail financial services to Arab nationals living in the United States, the majority of whom are high net worth individuals.

In general, however, Arab banks appear to have overcome the many difficulties that prevented them from entering the US market during the late 1970s, and are making good progress. They are aided by lower cost of capital to their parent banks, particularly the Saudi banks and, therefore, enjoy a competitive advantage over other US and foreign banks operating within the United States.

3.7.3 Arab Banks in Asia

The expansion of Arab banks in Asia may be regarded as a continuation and a natural extension of their efforts to become financial institutions with a global network.

The presence of Arab banks in Asia can only be dated back to the early 1970s, when the UBAN Arab Japanese Finance Limited was established in Hong Kong, in 1974. For the majority of Arab banks, however, there was a time lag between them and other international banks in realising the importance of being established in the main Asian financial centres.

Similar to their early expansion in London and New York, Arab banks were driven to establish themselves in the Asia-Pacific region to geographically diversify their operations and to compensate for the declining business in their domestic economies. Furthermore, the low growth rates and the increased competition among banks in the traditional financial centres of Europe and the United States, focused attention on the more dynamic economies of the Asia-Pacific region. Therefore, the expansion of Arab banks in Asia has followed the same pattern as for other international banks, namely the European and North American banks, but not necessarily for the same reasons. There are many advantages for Arab banks to operate in Asia. Perhaps the most important of these is the rapidly growing trade between Asia and the Arab Middle East. The trade volumes denoted by total imports, between the two regions, is shown in Table 3.8. As the table illustrates, there was a massive increase in the volume of trade between Asia and the Middle East from US $2.35 billion in 1975, to reach their highest level in 1982, with US $17.02 billion.

The table also indicates the importance of trade from Asian countries to the Middle East in relative terms, as their share from the total imports to Arab countries for the period 1975-85 averaged 22.3 per cent.

Although the choice of banks for trade finance is usually done by the exporters, the experience of the last decade suggests that some Asian countries prefer banks that are acceptable to the importers; hence, the importance of Arab banks in financing imports from Asia. This is particularly true in barter and countertrade operations that involve the use of oil. The sensitivity of Arab members of OPEC in pricing oil in countertrade deals, has also encouraged the reliance on Arab banks.

Table 3.8 Total GCC imports from Asia, 1975-85

(US$ million)

Year	Imports from Asian countries Japan	Other*	Total	Imports from Asia as a % from total imports
1975	1.65	0.70	2.35	20.2
1976	2.80	1.25	4.05	21.8
1977	4.26	2.33	6.59	22.9
1978	5.57	2.51	8.08	23.4
1979	6.59	3.13	9.72	23.4
1980	9.14	3.90	13.04	25.10
1981	10.87	4.13	15.00	25.05
1982	12.80	4.22	17.02	25.30
1983	12.43	4.21	16.64	26.80
1984	10.74	3.86	14.60	26.50
1985	8.36	3.37	11.73	28.70

Sources: IMF, International Financial Statistics Yearbook, 1987
AMF, Foreign Trade for GCC Countries, 1974-1985, no. 4, October 1987

Notes: * Includes China, Hong Kong, India, Indonesia, Malaysia, North Korea, Philippines, Singapore, South Korea, Sri Lanka and Thailand

The second attraction for Arab banks to establish a foothold in the financial markets of Asia, is the growing importance of that region to Arab investors and Arab tourists.

Thirdly, there is a large concentration of Muslims in South East Asia (in Indonesia alone there are at least 150 million Muslims), with great perception for Arab commercial and Islamic banks.

Lastly, the strong historical ties that the Middle East has with Asia, which is longer than with any other region in the world, also attracted Arab banks to establish a presence there.

Against this background it appears natural for Arab banks to have a presence in Asia. If anything, their arrival in Asia has been long overdue. In 1974, there was only one Arab bank in Asia, but since then, and with the deregulation and liberalisation in the Japanese financial markets, the number of Arab banks in Asia has rapidly increased, as shown in Table 3.9. By 1985, with 74 Arab banks operating in different countries in Asia, there were more Arab banks in Asia than in any other region.

The large number of Arab banks present in Hong Kong can be explained by its geographical proximity to China, which represents great investment and trade potentials to Arab banks. However, when compared to banks in other regions, the number of Arab banks operating in Hong Kong is relatively limited. The late arrival of Arab banks and their concentration on representative offices rather than branches, reflects the requirements set up by the Hong Kong monetary authorities. The Hong Kong authorities insist on the reciprocity requirements; this clearly affected banks from Kuwait and Saudi Arabia, where no foreign banks are allowed.

Table 3.9 Arab banks present in Asia (Australasia) - June 1985

Type of office	Hong Kong	Pakistan/ India	Singapore	Japan	Australia	China	Other*
Branches	3	14	8	1	-	2	9
Representative offices	6	1	3	6	3	1	2
Merchant banks	-	-	-	-	3	-	-
Deposit takers	12	-	-	-	-	-	-
Total	21	15	11	7	6	3	11

Sources: Compiled from MEED (various issues); Asiabanking, November 1981, pp. 46-65; Asiabanking, December 1985, pp. 86-91

Notes: * Includes Bangladesh, Indonesia, Maccau, Malaysia, Philippines, Republic of Korea, Sri Lanka, South Korea and Thailand

Furthermore, only one branch of large and well-known banks is permitted. The Hong Kong monetary authorities also require a minimum of three year moratorium before allowing foreign banks to establish branches on the island. These requirements clearly make it difficult for some Arab banks, particularly the smaller ones, to set up branches there.

The first Arab bank to establish a presence in Hong Kong was as mentioned earlier, the UBAN Arab Japanese Finance Limited in 1974. The UBAN is a joint venture of nine Arab and five Japanese banks; its main business in Hong Kong is syndicated lending and trade finance.

Many other Arab banks followed the example of UBAN, whereby in 1985, there were twenty one Arab banks represented in Hong Kong. The most significant involvement by Arab banks in Hong Kong came in 1985, when Arab Banking Corporation bought the Sun Hung Kai Bank (SHKB). Immediately after the acquisition, Arab Banking Corporation injected US $47 million into the bank. Realising the importance of Hong Kong, Arab Banking Corporation further extended its presence there when it opened a branch in its own name, in 1985.

The long-term objectives of Arab Banking Corporation's commitment in Hong Kong was to break into the Chinese market. This was achieved by the end of 1985, when the newly acquired SHKB opened two branches in China.

Furthermore, there are signs that Hong Kong may attract larger Arab investments than has been the case so far. The establishment in 1984 of the Arabian Gulf Investment Far East International (AGIFEI) in Hong Kong, was a clear indication of the island's attraction to Arab investors. The ownership of AGIFEI is shared between Saudi Arabia with 51 per cent, Kuwait with 29 per cent and the Hong Kong & Shanghai Banking Corporation which has a 20 per cent share and which also holds the management contracts (Asia Banking, December 1985). The lack of data concerning AGIFEI operations does not permit the assessment of its success and the nature of its operation.

The entry of Arab banks into Singapore was primarily for its important position in South East Asia. Therefore, the offices of Arab banks in Singapore were centres for attracting business from other countries in the region, in particular from Indonesia, Malaysia, Philippines and Thailand.

Recent events, however, have contributed to eliminating the importance of that region to most international banks, including Arab banks; first was the liberalisation of the financial market in Tokyo; many Arab banks, particularly the smaller ones, found it more cost effective to have one branch in the South-East Asia region, therefore, their offices were transferred from Singapore to Tokyo. Second, the cost of establishing offices in Singapore is generally too high in accordance with the benefits that such offices might acquire. Third, with 200 foreign banks in 1985, Singapore is considered to be one of the most overbanked countries in the world. The increased competition between banks and the declining business opportunities have forced many banks to withdraw their presence in Singapore. Fourth, the political instability in the region has also eliminated the importance of South East Asia to international banks. The most recent example to highlight the political instability was the overthrow of the Marcos government in the Philippines. The effects of that event and the general strike that followed have reduced the economy of the Philippines to a standstill.

Finally, because Arab banks in Singapore play a regional role, the depressed economies of Singapore's neighbouring countries which resulted from lower oil prices, have greatly affected Arab banks. Although the depressed economies in the South East Asia region affected all foreign banks operating there, Arab banks, due to their small balance sheets and their inability to sustain losses, were the most affected. According to Peat Marwick Management Consultants, during 1985 there were 20 foreign banks operating in Singapore with losses of S$ 1 million (US $474,000) or more; three of these were Arab banks. Not surprisingly, therefore, no Arab banks have been established in Singapore since 1985; instead they are opting for Tokyo.

Although the presence of Arab banks in Japan dates back to 1976, when the UBAF established a branch in Tokyo, the small capital of that branch did not allow it to have any significant success. The big push towards establishing an Arab presence in Japan, however, came in the mid-1980s. In 1985, the National Commercial Bank of Saudi Arabia set up a representative office in Tokyo. Two other major Arab banks have followed since then, namely Arab Banking Corporation and Gulf International Bank. This means that the largest Arab banks have realised the importance of Japan as a major trading partner with the Arab region, and also the importance of Tokyo as one of the most important financial centres in the world. Japan enjoys stronger economic ties with the Arab Middle Eastern countries than any other industrialised country. The special economic ties between Japan and GCC members, stems from the fact that these countries provide Japan with more than 75 per cent of its oil needs. In addition, about 20 per cent of the GCC members' total imports are from Japan. In 1982, for example, the level of imports by the GCC members from Japan of US $12.8 billion, was higher than the imports by the GCC from any other industrialised country. The high level of trade between the Middle East and Japan is likely to remain steady, or many even accelerate in the near future despite the major recession in the Middle East. This is due to the fact that all Middle Eastern countries are developing countries, and are trying to diversity their economies with particular attention being paid to industrial projects. This implies that there will always be a need for the transfer of technology from Japan and the western world.

In addition to the large volume of trade between the Middle East and Japan, the diversification of Arab investments away from the United Kingdom and United States to Japan in recent years, has also provided Arab banks with another attraction; to be established in Tokyo. These two factors, trade and investment, imply that there is a massive cash flow between the Arab region and Japan. By being present in Tokyo, Arab banks stand a good chance of managing a slice of the rapidly growing business between the two regions. Furthermore, due to the fact that the liberalisation of the Japanese financial market is relatively recent, the impact of foreign banks is still very low compared to other financial centres such as London or New York. In 1985, for example, the share of foreign banks of the total financial transactions carried out in Japan was barely 3 per cent (Asiabanking, December 1985). Therefore, unlike the financial market of New York, for instance, where the late arrival of Arab banks contributed largely to their ineffectiveness, the market of Tokyo is recent and the potential for Arab banks, particularly in the field of trade finance, is excellent.

In conclusion, many factors have been responsible for the international expansion of Arab banks. Although this expansion can be traced back to the 1940s, it was very modest and such banks like the Arab bank of Palestine was driven to operate in other Arab countries primarily for political reasons.

The internationalisation of Arab banks on a large scale, however, only started in the early 1970s, when the Arab Gulf region emerged as a financial power in the Middle East. The expansion of Arab banks is in many ways strikingly similar to that of the early overseas expansion of Western European and American banks.

Trade finance has been one of the most important reasons behind the international expansion of Arab banks. Furthermore, political instability in some Arab countries, such as the Lebanon for example, and the increased wealth of other countries (GCC), led many Arab nationals with high net worth to reside abroad, mainly in the west. Arab banks expanded abroad to accommodate for this growing market. Monetary policies of the Gulf states are also responsible for the large sums of foreign investments by Arab governments and the private sector in the international financial markets. The monitored interest rates of the region made it very profitable for the Gulf banks to rely on the international interbank market and benefit from the favourable interest rates that exist in these markets. The large investments by the Arab Gulf governments and private sector, have forced Arab banks to expand into international financial centres where the majority of their countries wealth is invested.

London, followed by New York and Tokyo, due to their prime positions internationally have attracted Arab banks in large numbers.

CHAPTER 4

OIL REVENUES AND THE INTERNATIONALIZATION OF ARAB BANKS

4.1 INTRODUCTION

Arab Gulf countries, like other oil producing countries, experienced a rise in oil revenues as a result of the two oil price increases that occurred in the 1970s. These rises led to prices soaring to a level far above the costs for production and distribution. As a result, large financial resources were accumulated in several Arab Gulf countries.

Most of the evidence, so far, suggests that the lion's share of these surpluses were invested in the form of shares, bonds and bank deposits in the west.

The main emphasis of this chapter will be to analyse the relationship between the oil surpluses and Arab banks, particularly Arab banks in international markets. The management of the Arab countries' investments in the West will also be analysed.

4.2 THE OIL PRICE INCREASES

Since 1973, three major changes in oil prices have occurred. They can be summarised as follows:

1 The first increase in oil prices occurred in 1974, as a direct result of the Arab-Israeli war, and the determination of the Arab governments to use oil as a political weapon against western governments for their support of Israel. Due to this policy, which became known as the 'Arab boycott program', an increase of 238 per cent in oil prices followed.

2 A 44 per cent increase in oil prices in 1979, was mainly due to a reduction in the Iranian output, following the revolution and the overthrow of the Shah of Iran.

3 There was also a 65 per cent increase in oil prices due to the eruption of the Gulf war in 1980, between Iraq and Iran, two of the major oil producing countries in the Middle East.

The latter increase in oil prices was aggravated by a deliberate attempt by other Middle Eastern countries to reduce oil production as can be seen in Table 4.1. Table 4.1 indicates that the production of OPEC countries, in which GCC countries account for almost 44 per cent of total production, was dominant.

Because Arab Gulf members of OPEC had the major share of OPEC production, they substantially affected the rate of oil and gas extraction, and, in turn, the capital markets worldwide due to the surplus in their current accounts in the period between 1974 and 1981, as can be seen from Table 4.2.

This table reflects the fluctation in the current account balances of OPEC members. The effects of the two oil shocks resulted in the accumulation of huge surpluses. But the turning point came in 1982, when the combined current account of OPEC members had a deficit of US $12 billion. This decline reflected both the rapid growth in imports and also a decline in oil revenues due to lower oil prices than those experienced in the 1970s, and a rapid decline in world demand for OPEC oil. As a result oil prices dropped by US $5 per barrel in 1983. The most significant point about Table 4.2, however, is the dominance of the six GCC countries in the oil surpluses.

Table 4.1 World oil production, 1973-81

(million barrels per day)

	1973	1974	1975	1976	1977	1978	1979	1980	1981
GCC	13.081	13.581	11.664	13.580	14.010	13.119	14.718	14.069	13.218
	(44.5)	(156.2)	(131.8)	(156.3)	(180.4)	(169.6)	(274.8)	(434.3)	(456.0)
OPEC	30.989	30.729	27.155	30.738	31.253	29.805	30.929	26.878	22.667
	(105.4)	(352.4)	(306.9)	(753.8)	(402.5)	(385.4)	(577.4)	(829.7)	(782.0)
World	55.8	56.1	53.4	57.9	59.9	60.1	62.7	59.7	55.711
OPEC/World (%)	55.5	54.8	50.9	53.1	52.2	49.6	49.3	45.0	40.7
GCC/OPEC (%)	42.2	44.2	43.0	44.2	44.8	44.0	47.6	52.3	58.3
GCC/World (%)	23.4	24.2	21.8	23.5	23.4	21.8	23.5	23.5	23.7
Price per barrel (US$)	3.40	11.50	11.30	11.51	12.88	12.93	18.67	30.87	34.50

Source: Central Intelligence Agency: Economic and Energy Indicators, 1984

Note: Figures in brackets represent US$ million per day

Despite OPEC's overall deficit in 1982, these countries experienced a total current account surplus of over US $6.5 billion.

Table 4.2 Current account balances of OPEC and its GCC members, 1974-82

(US$ billion)

	OPEC	GCC	GCC as % of OPEC
1973	7	5.70	81.4
1974	69	37.80	54.8
1975	35	24.17	69.1
1976	39	22.28	57.1
1977	29	19.00	65.5
1978	6	10.34	172.3*
1979	63	32.03	50.8
1980	111	72.10	65.0
1981	53	68.82	129.8
1982	-12	6.58	542.0*

Sources: IMF Occasional Paper, June 1984
OAPEC Statistical Bulletin, January 1984

Notes: * In 1978, 1981 and 1982, non-GCC members of OPEC incurred deficit in their combined current accounts

It must be mentioned in this respect that the data concerning oil revenues varies from one source of information to another. For instance, according to data published by Bank of England, OPEC members experienced a combined current account deficit of US $3 billion in 1978, while according to OPEC and the IMF, these countries experienced a current account surplus of US $6 billion, as can be seen from Table 4.3.

Table 4.3 OPEC's current account surplus, 1973-81

US$ billion

	1973	1974	1975	1976	1977	1978	1979	1980	1981
BIS	6	67	31	36	26	0	114	63	-3
Chase Manhattan	-	72	37	39	32	-1	118	61	1
IMF	7	69	35	39	29	6	111	53	-12
Bank of England	6	67	32	36	25	-3	110	49	-15
OECD	-	66	32	28	28	-1	111	50	-15
OPEC	7	69	36	38	29	6	113	61	-3
Morgan Guaranty	7	68	35	40	33	11	-	68	6

Sources: Financial Times, 20 September 1979
Financial Market Trends, various issues
World Economic Outlook, International Monetary Fund, 1983 and 1984
Bank of England Quarterly Bulletin, March 1985

Therefore, for uniformity throughout the course of this research the IMF figures will be adopted, wherever possible, concerning the oil revenues and the current account of OPEC members.

4.3 RECYCLING OIL SURPLUSES

The increase in oil prices from US $3.40 per barrel in 1973 to US $11.50, in 1974, and further to US $34.50 in 1981, is considered to be one of the most important developments increasing the growth of international capital flows. The effect of these increases in oil prices was to create a huge deficit in the balance of payments of the oil importing countries, and large surplus in the balance of payments of oil exporting countries. For example, these surpluses rose from US $7 billion in 1973 to US $69 billion in 1974, and to US $111 in 1980 (see Table 4.2).

However, what was needed at the time was to channel the capital flows from the oil surplus OPEC countries to the oil consuming deficit countries. Therefore, the oil exporters became capital exporters as well. A large part of this process, which became known as the recycling process, was taken up by the international banking system, as shown in Table 4.4. This table shows that of the OPEC estimated cash surplus of US $52 billion in 1974, US $28.6 billion was held in bank deposits, mainly in the United Kingdom and United States. Between 1975-78, this proportion tended to decline due to the increased imports that were necessary to impelement the very optimistic development plans of OPEC members. However, when the surpluses emerged again in 1979, for reasons mentioned in the beginning of this chapter, the largest burden again fell on the international banking system. Therefore, most recycling, in

Table 4.4 Foreign assets of oil exporting countries*, 1974-83

US$ billion

	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983
Bank deposits	28.6	9.9	12.0	17.9	7.3	40.6	44.3	2.5	-12.3	-11.3
- sterling deposits	1.7	0.2	-1.6	0.3	0.1	1.5	1.4	0.5	1.2	0.1
- US dollar deposits	4.2	0.6	1.9	0.4	0.8	5.1	-1.3	-2.0	4.6	0.9
- eurocurrency deposits	13.8	4.1	5.6	3.1	-6.7	15.5	14.5	7.8	-9.2	-7.0
- other**	8.9	5.0	6.1	14.1	13.1	18.5	29.7	-3.8	-8.9	-5.3
Government paper	9.1	2.5	2.7	3.7	-3.2	2.3	18.4	17.6	8.8	-6.8
- treasury bills and government stock	3.6	-0.5	-0.9	0.0	0.5	0.2	2.0	0.8	0.1	0.2
- US treasury bonds and notes	5.5	2.4	3.2	3.4	-2.4	2.1	9.6	10.5	7.3	-6.7
- other	0.1	0.6	0.4	0.3	-0.4	-	6.8	6.3	1.4	-0.3
Placements with developing countries	4.9	6.5	6.4	7.0	6.2	8.7	6.3	7.2	3.9	1.2
Equities, property and other investments***	7.0	13.7	14.4	11.0	7.8	3.7	20.1	25.0	5.6	-2.7
Non-foreign exchange reserves****	2.4	5.0	1.7	0.4	-0.3	-0.8	1.7	2.1	2.1	4.3
Total	52.1	37.6	37.2	40.0	17.8	54.5	90.8	54.4	8.1	-15.3

Source: Compiled from Bank of England Quarterly Bulletin, March 1985, p. 71

Notes:
* Figures may not add up due to rounding
** Includes, Austria, Belgium, Canada, Denmark, Finland, France, Ireland, Italy, Japan, Luxembourg, Netherlands, Norway, Spain, Sweden and Switzerland
*** Includes OPEC's bank credit to non-banks worldwide
**** Includes gold, SDRs, reserve position in IMF and World Bank bonds

practice, has been dominated by western banks, particularly the major US and UK banks. Considering their high capitalisation and effective management, the dominance of these banks in the oil revenues recycling process was a natural development.

4.4 THE PATTERN OF OPEC INVESTMENTS

The pattern of OPEC investment throughout the period between 1974-80 took several forms, in terms of both period and geographical placement of assets. In terms of period, the first surplus period witnessed short-term investment on a large scale. For example, of the surplus of around US $53 billion in 1974, about US $36 billion (69 per cent) was made on a year to year basis, compared to only US $16 billion in long-term investment. Liquidity, short-term accessibility and safety, were the main reasons for the short-term investment by oil producing countries, particularly GCC countries. Saudi Arabia is a typical example of an Arab Gulf country with massive foreign assets, which prefers to invest in short-term instruments. The investment policies of Saudi Arabia were (and to some extent still are) based on ensuring the security and liquidity of these assets, rather than their potential yield.

However, in the following years the pattern of investment started to change, as more long-term investments were made by these countries and the volume of short-term investments began to decline. For example, short-term investments were down from 69 per cent of total investments made by OPEC in 1974, to 27 per cent in 1975 and to only 18 per cent in 1981, compared with 31 per cent, 73 per cent and 82 per cent, long-term investments for the same period, as can be seen from Table 4.5.

Table 4.5 Deployment of OPEC surpluses according to maturity, 1974-81

Year	Short-term investment* US$ billion	% of total	Long-term investment** US$ billion	% of total
1974	36.3	69	16.6	31
1975	9.5	27	25.7	73
1976	13.3	36	24.1	64
1977	11.6	35	21.7	65
1978	4.0	30	9.3	70
1979	43.2	71	17.4	29
1980	42.5	49	44.5	51
1981	8.3	18	37.7	82

Sources: Balance of Payments Statistics, International Monetary Fund, Washington DC, 1983
Bank of England Quarterly Bulletin (various issues)

Notes: * Includes bank deposits, government stocks, treasury bills, bonds and notes
** Includes portfolio investments, other placements, assets and liabilities with international institutions (IMF and IBRD) and loans to developing countries

The most important reason for this trend, was that during the second oil price increase period in 1979-80, more surpluses were accumulated by the low absorbing GCC countries with already high liquidity. Thus, there was a tendency to switch from short-term to long-term investment. The growth of long-term investments by OPEC members in general, and the GCC countries in particular, was partly due to the investment policies adapted by Kuwait. In contrast to Saudi Arabia, Kuwait targeted its foreign investments to ensure the highest yield possible. Instead of concentrating on bank deposits and short-term lending, Kuwaiti investments were made on a long-term basis particularly the holdings of long-term bonds and shares. The success of Kuwait's foreign investments was partly due to its active financial and capital markets which were thriving during the 1970s. The geographical placement of these surpluses, however, was concentrated mainly in the West, particularly in the early 1970s. For example, of the total investments made by OPEC in 1974, almost 80 per cent was placed in the industrially advanced countries, with the United States and the United Kingdom taking 20 and 38 per cent respectively. However, the pattern of investment changed with the emergence of the second surplus period starting in 1979. The share of GCC surpluses invested in the United States and United Kingdom dropped from 20 and 37 per cent in 1974, to 11 and 27 per cent in 1979, respectively. The most important reason for this was the action taken by President Carter of the US government, to freeze the Iranian assets held in the United States in 1979, in the aftermath of the hostages crisis. Another reason was the action taken by the British government to freeze the Argentine assets held in the United Kingdom in 1982, following the Falklands crisis. The difference in the investments went to other European countries, such as Germany, France, Belgium and Japan, as OPEC members in general, and Arab members in particular, saw the need to geographically diversify their assets, as can be seen from Table 4.6.

This table clearly indicates the growing importance of other European countries in the recycling process, as their share has increased rapidly over time, from US $12 billion in 1974 to US $32.4 billion in 1980. Within this group, Germany was the European country that benefited most from OPEC's diversification policy, as OPEC's investments in Germany rose from US $1.5 billion in 1974 to

Table 4.6 Estimated distribution of annual GCC surplus by recipients*, 1974-84

US$ billion

	Industrial countries					
	United States	United Kingdom	Other	Developing countries**	International institutions***	Total
1974	8.7	15.8	12.0	4.1	2.6	43.2
1975	7.2	3.2	8.2	5.6	3.0	27.2
1976	9.0	3.4	9.2	5.8	1.5	28.9
1977	6.8	2.9	9.7	6.8	0.2	26.4
1978	1.0	-1.4	5.6	9.4	0.1	14.7
1979	5.1	12.9	20.6	9.2	-0.3	47.5
1980	10.6	13.2	32.4	11.3	3.7	71.2
1981	12.2	7.0	10.7	13.4	2.0	45.3
1982	9.8	-6.9	14.6	12.0	1.5	31.0
1983	-7.1	-10.4	1.9	9.1	1.1	-5.4
1984	-2.5	-3.5	2.8	8.1	-2.9	2.0

Sources: Placements with industrial countries are from the Oxford Institute of Energy Studies, F2, 1984 and Bank of England Quarterly Bulletin (various issues)
Placements with developing countries are from N. Sherbing, Arab Financial Institutions and Developing Countries, World Bank Staff Working Paper no. 794, 1985

Notes: * Based on the assumption that the GCC placements are equal to approximately 75 per cent of total OPEC investments
** Includes net assistance and loans
*** Represents placements within the IMF and World Bank

US $9.5 billion in 1980 (Bank of England, March 1985). At the same time the amounts invested in the United Kingdom and the United States diminished, as mentioned earlier. In addition to the Carter move, the low investment in the US and the UK also reflected the lower level of interest rates on domestic dollar deposits compared with those in the euromarkets. It also reflects the Arab investors' determination to diversify some of their assets from the dollar. The dollar's erratic performance in the early 1980s, forced Arab governments to invest in the Japanese yen, the Deutschemark and several other currencies.

It was within the context of diversification, that the Arab initiative to set up new financial institutions and to encourage the already existing ones, was created. Another reason for the Arab Gulf members of OPEC to implement the diversification policy in their investments was profitability, because some of the investments that were made in foreign assets did not earn sufficient return and were not protected from risks, such as currency exchange default. However, it was, undboutedly the risk factor rather than profitability, which led OPEC countries to still invest a large share of their surpluses in the form of short-term investments in the developed countries.

Table 4.6 also indicates that the developing countries' share from these surpluses expanded rapidly, from US $4.1 billion in 1974 to US $13.4 billion in 1981. Even when OPEC countries started drawing on their investments in the west in 1983 and 1984, they continued to place funds in the developing countries. The significant point about the investments made by OPEC in the developing countries, is that since 1982 the share held by these countries has been higher than the share of all industrial countries put together. A high proportion of the placements of funds in the developing countries was in the form of net assistance.

This was part of the policy implemented by Arab members of OPEC to protect the less fortunate third world countries, particularly Muslim, from the full impact of the increased oil prices. According to OPEC statistics, the net assistance to the developing countries was estimated to be 59 per cent of the total funds placed in these countries. Table 4.7 shows the aid granted by Arab/OPEC countries over the 1975-83 period. As far as development aid to less developed countries is concerned, the Arab countries have probably contributed more than any other nation in the world. Official development assistance from Arab countries exceeded 4 per cent of their GNP during the period 1975-80, as shown in Table 4.7. The US contribution, averaged about 3.2 per cent of the GNP during the same period. After the decline in their oil revenues, however, Arab development aid declined to about US $6 billion in 1982 and US $5 billion in 1983, from in excess of US $9 billion in 1980.

4.5 OIL REVENUES AND THE INTERNATIONAL ACTIVITIES OF ARAB BANKS

The previous discussion in this chapter now leads us to question as to what extent have Arab banks actually benefited from the rising oil revenues following the two oil price increases in the 1970s?

The effect of the massive oil revenues on Arab economies has been phenomenal. While the oil revenues of the Arab nations multiplied more than twenty times between 1971-81, the gross national product of GCC countries soared during the same period from

Table 4.7 Official development assistance from the Arab members of OPEC to the LDCs, 1975-83

(US $ million)

	1975	1976	1977	1978	1979	1980	1981	1982	1983
Iraq	215	231	61	173	847	829	140	9	-3
Algeria	41	54	47	44	272	65	97	128	44
Libya	259	94	113	146	105	282	293	43	85
Saudi Arabia	2,756	3,033	3,138	5,506	4,674	5,944	5,664	4,028	5,038
Kuwait	946	532	1,309	996	447	645	1,154	1,168	996
UAE	1,046	1,021	1,060	891	967	906	811	402	100
Qatar	338	195	194	109	280	284	850	50	22
Total	5,601	5,160	5,922	7,861	7,622	8,955	8,409	5,828	5,162
OPEC*	6,231	6,104	6,263	8,292	7,786	9,129	8,252	5,891	5,476
As % of GNP									
Arab	5.68	4.20	4.0	4.78	3.56	3.08	3.45	2.65	2.98
OPEC	2.92	2.32	2.03	2.46	1.88	1.74	1.51	1.06	1.05
As % of oil revenues	9.2	7.1	7.4	10.0	5.6	4.3	4.7	4.6	5.2

Sources: World Bank, World Development Report, 1983
Middle East Economic Survey, December 1984

Note: * Non-Middle Eastern members of OPEC granted small amounts of aid, this group includes Algeria, Nigeria and Venezuela

US $54 billion to over US $435 billion. Gross domestic product in the GCC countries rose from US $11 billion in 1971 to over US $231 billion in 1981. Furthermore, agricultural, industrial and trade sectors in these countries witnessed massive growth rates as a direct result of the increased oil revenues, as mentioned in Chapter 1.

Against this background, it is natural to assume that Arab banks have benefited largely from the oil revenues and that the growth of Arab banks and the eurocurrency markets has been closely connected with the OPEC surpluses. It can be argued, however, that neither are directly dependent on the OPEC surpluses. The growth of the eurodollar market was more a result of the US monetary policy in the 1960s; in particular, the 'Interest Equalisation Tax' and Regulation Q in 1969, rather than the OPEC surpluses (Saudi, 1985). Figures represented in Table 4.8 support this view.

Table 4.8 shows that the growth rate in the eurodollar market was much higher between 1965 and 1973, than after the first oil price increase in 1973-74. It reached its peak level in 1969 with a growth rate of 70 per cent compared to only 25 per cent in 1974.

For Arab banks, however, as mentioned in Chapters 2 and 3, the old generation of these banks were created in the 1920s and 1930s, well before the discovery of oil in most Middle Eastern countries, (with the exception of Bahrain, where oil was discovered in the 1920s). It is clear that oil played no part at all in the establishment of these banks. The same argument applies for national banks, as many of these banks were established in the 1950s, mainly for political reasons and to achieve economic and financial self-sufficiency.

Table 4.8 Growth of gross and net eurocurrency markets, 1964-84

(US $ billion)

	Gross amount	% increase	Net amount	% increase
1964	20	-	14	-
1965	24	20	17	21
1966	29	21	21	24
1967	36	24	25	19
1968	50	39	34	36
1969	85	70	50	47
1970	115	35	65	30
1971	210	30	85	31
1972	315	40	110	29
1973	395	50	160	45
1974	495	25	220	38
1975	485	23	255	16
1976	595	23	320	25
1977	740	24	390	22
1978	950	28	495	27
1979	1,233	30	615	24
1980	1,524	24	755	13
1981	1,861	22	890	18
1982	2,060	11	960	8

Source: Morgan Guaranty Trust Co, World Financial Markets (various issues)

Up until the 1960s, all Arab banking was domestically orientated. The first serious involvement in international markets occurred in the late 1960s, with the formation of European-Arab consortia banks in western Europe. As mentioned earlier, the most important reason for the establishment of these consortia banks, was the realisation of the Arab nations for the need to protect their growing economic interests by being present in the international financial community. After the emergence of the first wave of oil surpluses in 1973, the already existing Arab consortium banks in Europe did not manage to attract more than a marginal proportion of deposits from the Arab

Gulf states. These banks could have attracted more Arab capital had they been able to develop a broad investment banking capability for the European and US markets at the time. Instead, most of them had built up a commercial banking business with the deficit Arab countries. However, there is a little doubt that these consortia banks were given a boost by the oil surpluses. During 1973-78, for example, the number of these consortia banks increased rapidly from two to about fifty, and almost all of them were formed by Arab surplus countries.

In 1979, however, the renewed availability of the oil revenues and the huge current account surpluses that followed, coincided with the realisation by Arab countries of the importance of having a permanent and effective presence in the international financial markets. Therefore, a proportion of these surpluses were directed towards increasing the capital of the existing Arab banks. As a result the combined capital of the top 25 Arab banks rose from US $2 billion in 1979 to over US $6 billion in 1982.

Furthermore, this period also witnessed the establishment of new Arab banks. A prime example of these new banks was the Arab Banking Corporation. As mentioned in Chapter 3, this bank is considered to be the leading Arab bank in international financial markets.

The relationship between oil surpluses and the internationalisation of Arab banks is difficult to quantify in absolute terms. During the years leading to the first oil price rise, Arab banks' participation in international financial markets was insignificant. But the build-up started in the late 1970s (this coincided with the declining of oil revenues in real terms).

However, even before the first oil price increase in 1973, there were slight oil price movements in 1971 and 1972, and these resulted in an increase of oil revenues into the low absorbers. Until then, and because the oil revenues were relatively small, local banks were able to handle these financial flows. But when the massive surpluses arrived, following the two oil price increases, local financial institutions could no longer handle these resources. Thus, there was a need for a more sophisticated financial system; this was found in the established and flourishing euromarkets, particularly in the syndicated credit market. Because these markets were not as heavily supervised as national markets, they attracted Arab capital and eventually forced Arab financial institutions to establish themselves within these markets, although only initially on a small scale. However, as mentioned earlier, the major breakthrough into the international financial markets came with the second oil price increase in 1979-80.

Table 4.9 shows the relationship between oil surpluses of the Arab Gulf countries and their commercial banks' capital, total assets and total deposits. As can be seen from the table, Arab banks' capital, deposits and assets have been growing steadily despite the rise and fall of the oil revenues. For example, even during the years 1982-84 where the oil surpluses declined sharply (from US $57.7 billion in 1981 to US $8 billion in 1984), Arab banks' capital, deposits and assets continued to grow, though at a relatively slower rate. The data in Table 4.9, however, does support the view that the oil price increases, did provide Arab banks with the opportunity of enjoying relatively high

Table 4.9 Current account surpluses of GCC countries and their impact on the region's commercial banks*, 1975-85

	GCC current account		Total assets		Capital and reserves		Total deposits**	
	US$ million	% change	US$ million	% change	US$ million	% change	US$ million	% change
1975	24.17	-36.1	14.0	55.6	na	-	na	-
1976	22.28	-7.8	23.5	67.5	0.83	-	16.0	-
1977	19.00	-14.7	32.2	37.1	1.66	100.0	20.3	26.9
1978	10.34	-45.6	40.1	24.6	2.42	45.8	25.7	26.6
1979	32.03	209.8	50.2	25.3	3.16	30.6	28.8	12.1
1980	72.10	125.1	65.3	30.1	4.32	36.7	37.8	31.3
1981	68.82	-4.5	85.7	31.2	5.86	35.6	50.1	32.5
1982	6.58	-90.4	98.7	15.1	7.94	35.5	57.7	15.2
1983	-4.63	-170.4	103.4	9.8	9.03	13.7	60.5	4.9
1984	-4.19		109.7	6.0	10.19	12.8	67.6	11.7
1985	0.57	86.4	110.7	0.9	11.38	11.7	68.1	0.7

Sources: OAPEC Statistical Bulletin, January 1986
International Financial Statistics Yearbook 1987, IMF, Washington DC
Money and Banking in the Arab Middle East, 1987, Arab Montary Fund publication (Arabic)
Gulf Co-operation Council in Figures 1988/1989, National Bank of Kuwait publication

Notes: * Represents commercial banks from the six GCC members
** Represents private and public sector deposits with commercial banks

capitalisation, as their capital grew from less than US $1 billion in 1976 to about US $6 billion in 1981.

This is supported by the correlation test which was based on data represented in Table 4.9. The highest correlation between the three variables and that of oil revenues was that of the increase in Arab banks capital. It was shown that 42.3 per cent of the increase in Arab banks capital for the period 1975-1985, can be attributed to the oil revenues, compared to 33.5 per cent for total deposits and 27.9 per cent for total assets, for the same period.

Of the three measures adopted in Table 4.9, that is total assets, capital and deposits, the volume of deposits with commercial banks is, perhaps, the best indicator of the relationship between the rapid growth of the current account surplus of the GCC countries and the commercial banks. This is of particular importance because the success of any commercial banks depends largely on its ability to attract deposits from the public at large.

When studying the change in total deposits of the GCC commercial banks, it is clear that these deposits (although witnessing an average annual growth rate of 32 per cent over the period 1976-1985), did not increase to the same proportion as oil revenues.

The picture becomes clearer if we are to consider the deposits made by the public sector, which covers the governments of the region and their agencies, with the region's commercial banks. Considering that the bulk of the oil revenues is controlled by the government of the region, the volume of deposits made by the GCC governments with domestic commercial banks would give a clear indication as to what degree Arab banks directly benefited from the oil revenues.

In 1980, for example, following the second oil price increase, only US $3.7 billion was deposited with the region's commercial banks. This represents as little as 2 per cent of the total oil revenues incurred by the GCC countries during the same year. Foreign assets of the region's governments during the same year were in excess of US $130 billion, the majority of which were deposited with European and American international banks.

The reasons for this disparity between domestic and commercial banks are numerous. The GCC governments, like other governments, have a responsibility not only for the present generation but also for future generations. Therefore, it was natural for them to search for the safest and most profitable investment opportunities whether in domestic of international markets.

During the first oil price increase in 1973/1974, there were very few Arab banks with international experience. Even those existing at that time, and which were making good progress in the international financial markets, were largely overlooked by the region's authorities.

This was due to many reasons; firstly, such banks like the UBAF and Saudi International Bank, for example, were of recent origin and lacked the variety of financial instruments offered by the large US banks like Citibank or Chase Manhattan Bank. This fact, coupled with the conservative attitude of most governments in the Arab Gulf region, worked in favour of the western and US banks which accommodated a large portion of the oil revenues, as previously mentioned.

Secondly, GCC domestic banks lacked the effective management to attract these deposits and invest them successfully.

Thirdly, the region lacked the existence of effective capital and financial markets. Such markets play an important role in attracting funds and creating investment opportunities in a region as wealthy as the Arab Gulf region.

Finally, the political instability in the region gave the authorities another incentive to direct their investments outside the region.

The above mentioned factors and other constraints affecting the Arab banks, will be discussed in greater detail in Chapter 9.

It was the desire of Arab banks to manage a slice of the Arab funds invested in international financial markets, that initially attracted them to move beyond the boundaries of their domestic market. The international expansion of Arab banks during the 1970s and early 1980s was given a boost by the establishment of large Arab banks that are primarily international banks. Such institutions like Gulf International Bank, Saudi International Bank and Arab Banking Corporation, were created by the GCC members, Libya and Iraq, mainly to assist in the recycling process.

These banks were forced to operate internationally by the following factors; they lacked the domestic business that local banks enjoy, and with their high capitalisation there was no alternative but to move to international markets. This is particularly true for Arab Banking Corporation and Gulf International Bank. Furthermore, to stand any chance of attracting a proportion of the region's oil revenues, they had to operate in markets where the oil revenues are deployed, that is, the international financial markets.

However, even those banks which were highly capitalised and generally possessed the necessary expertise to succeed in international markets, did not manage to attract a significant portion of the oil revenues.

Ironically, the GCC authorities opted for establishing these new banks following the two oil price rises of the 1970s, rather than acquiring larger shares of ownership in the already existing and operating banks.

In this respect, a direct causality can be established between the oil revenues of the region and the increased number of Arab banks with international operations. As has been established in Chapter 3, in 1970, the number of Arab banks operating internationally numbered only 4 whereas by the early to mid-1980s, the number of these banks had risen to 90. There is very little doubt that the increased number of Arab banks operating internationally was largely due to the rapid growth of oil revenues and the thriving economies of the region.

As far as the internationalisation of Arab banks is concerned, as mentioned earlier, the major involvement in the international financial markets came with the second oil price increase in 1979-80. Table 4.10 indicates this point clearly.

As can be seen from this table that there was a one year lag between the surplus year (US $72 billion in 1980) and the fastest growth rate of Arab banks' international activity. This may indicate that Arab banks reached their peak level in 1981, with a growth rate of 139.5 per cent, as a result of the rapidly growing syndicated lending market throughout the world, and not necessarily because of the increased oil revenues (Nakajavani, 1986). Furthermore, one can argue that even the downturn in Arab banks' activity in the euromarket after 1982, is a development which may have happened regardless of the declining oil revenues. Rather, it may have been related to the generally depressed eurocurrency market following the Latin American debt crisis in 1982. Indeed, the empirical evidence supports the view that there were very few direct linkages between the current account surpluses which resulted from the massive oil revenues and the international activities of Arab banks. The empirical test is based on a regression analysis which estimates the degree of dependence of Arab banks on the oil surpluses. The data used for the test is shown in Table 4.10. This test is based on an assumption that a linear relationship exists between the international expansion of Arab banks and the oil revenues. Furthermore, for the purpose of this test the current account surplus was used as the proxy for the oil revenues, and the volume of Arab-led syndicated loans as a proxy for the internationalisation of Arab banks.

Unfortunately, the lack of data concerning the involvement of Arab banks in international financial markets prior to 1974, limited the sample data to only 13 observations. The regression analysis using this data set revealed very little relationship between the two variables, as the R^2 was less than 10 per cent, see Appendix E.

Even when running the regression analysis for the period 1974-1981 (a period which witnessed the highest growth in oil revenues), the analysis revealed that only about 48 per cent of the growth in

Arab banks' international activity can be attributed to the rising oil revenues.

The regression equation is:

$$Y = -0.91 + 0.108X + U$$

where Y refers to the international activities of Arab Gulf banks, X is the current account surpluses of the GCC countries, and U is an error term. For more details see Appendix F.

Table 4.10 Current account surpluses of GCC countries and the international activity of Arab banks, 1974-85

(US $ billion)

	The surplus six countries	Arab banks total eurocredits/bonds	Number of Arab eurobanks
1974	37.8	0.07	4
1975	24.2	0.16	8
1976	22.3	0.32	14
1977	19.0	1.48	22
1978	10.3	3.09	34
1979	32.0	3.23	29
1980	72.0	4.45	31
1981	68.8	10.78	30
1982	6.6	12.42	28
1983	-4.6	8.00	26
1984	-4.2	7.00	25
1985	0.7	6.10	30

Source: Middle Eastern Economic Survey (various issues)
Bank of England Quarterly Bulletin, March 1985
IMF Balance of Payments Statistics, 1985
Mehran Nakhjaavani, Arab Banks and the International Financial Markets, 1983
Sherbiny, Oil and the Internationalisation of Arab Banks, Oxford Institute for Energy Studies, F6, 1985

Clearly as far as the recycling process was concerned, Arab banks played a very minor role. Indeed, data published by the Bank of England and the OAPEC Bulletins support this analysis. It has been established that out of the US $198 billion accumulated surpluses, only 3.5 per cent (US $6.9 billion) was deposited with Arab banks, particularly in the Bahraini financial centre. Furthermore, until 1979 total assets of all Arab banks operating in the international financial markets amounted to around US $30 billion, which represents only 10 per cent of the total Arab money identified as the accumulated gross foreign assets of the GCC countries.

The argument so far, has produced very little significant direct linkages between the oil surpluses and the international activities of Arab banks. As already mentioned, Arab governments, while agreeing to invest a very small proportion of the surplus funds in new bank capital, preferred to place their funds with the more experienced Western banks. This, however, did not prevent the rapid growth of international Arab banks at a time in the mid-1970s when funding proved no problem, as the interbank market flourished due to the rapidly rising international liquidity.

Another way to establish the causality between OPEC surpluses and the development of Arab banks, particularly in international financial markets, would be to distinguish between the aims and achievements of these banks' shareholders (Sherbiny, 1985). The most important of these aims can be summarised as follows: to initiate Arab penetration of the international capital markets; to provide training for young Arab bankers; and most importantly, to help cater for financial needs in the Arab region. While some of these objectives were achieved, as the volume of financial institutions expanded along with oil revenues, the improved quality and width of these institutions has also provided a more comprehensive range of financal services, both in and outside the region. Furthermore, the domestic banks have flourished, and Arab-European consortium banks have been formed, as mentioned earlier. There is very little doubt that these objectives could not have been achieved without the huge oil resources.

However, two of the most important of these aims remained unfulfilled.

Firstly, Arab banks were not generally active in catering for the financial needs of the Arab region; apart from the inefficiency of the region's financial markets, one of the main reasons for this was the establishment of the 'Arab Aid Agencies' which took a great deal of business away from commercial banks, particuarly that of lending to the third world countries. For example, in just over seven years between 1974 and 1980, the number of OPEC aid institutions expanded rapidly, from only four in 1973 to 15 in 1980. In addition, these aid institutions experienced a 2,267 per cent increase in their capital, from US $1.2 billion to US $28.4 billion during the same period. Although the increase in capital helped these Aid institutions to broaden the scope of their activities, both in terms of geographical placements and services offered, these funds diminished largely from commercial lending.

Secondly, and more importantly, Arab banks were not managing a significant proportion of their surplus funds, mainly because Arab banks had lower capital base than their competitors, in particular the American banks.

It follows from the previous discussion that Arab Gulf banks did not take full advantage of the oil revenues of the 1970s. This is reflected in the fact that the direct benefits reflected in the form of government deposits to Arab banks were minimal, compared to their foreign deposits.

However, the indirect benefits of the oil revenues to the Gulf banks are numerous. As a direct result of increased oil revenues, the GCC economies experienced unprecedented growth. This is particularly true for the trade and construction sectors of the economy as mentioned in Chapter 1. The growth in these sectors resulted in a rise of demand for finance and for banking services. Since the most economic sector to benefit from the oil revenues was the trade sector, the next section will concentrate on the role of the trade sector in the development of Arab Gulf banks.

4.6 TRADE FINANCE AND ARAB BANKS

The very rapid expansion in oil revenues in the 1970s and early 1980s, was accompanied by a rapid increase in the volume of imports by the GCC countries. As can be seen from Table 4.11, the rise in imports has been phenomenal. The volume of imports of about US $8 billion in 1974 increased to US $67.4 billion in 1982. The rapidly growing trade was largely due to the ambitious development plans in the Arab Gulf economies. These plans necessitated a massive growth in the imports of capital goods and consumer goods. Imports from Western Europe alone soared by 419 per cent between 1974-80.

Many observations can be drawn from Table 4.11. The most noteable one is the concentration of trade in the Middle East by the GCC members.

Table 4.11 Total imports of GCC and other Arab countries, 1974-82

US$ billion

	GCC countries Volume	GCC countries % change	K&SA** %	All Arab countries* Volume	All Arab countries* % change	GCC as % of all Arab countries
1974	7.991	-	55.2	28.071	-	28.5
1975	11.633	45.6	56.7	39.516	40.8	29.4
1976	18.602	59.9	64.6	44.989	13.9	41.3
1977	28.814	54.9	67.7	62.629	39.2	46.0
1978	34.513	19.8	72.3	72.687	16.1	47.5
1979	41.583	20.5	70.8	86.799	19.4	47.9
1980	51.952	24.9	70.6	110.873	27.7	46.9
1981	59.887	15.3	70.6	133.790	20.7	44.8
1982	67.358	12.5	72.6	138.437	3.5	48.7

Sources: Foreign Trade for GCC Members, Arab Monetary Fund, October 1987
Internatioanl Financial Statistics, Supplement on Trade Statistics, Supplement Series, no. 4, IMF, 1982

Notes: * Includes all members of the Arab league
** Refers to Kuwait and Saudi Arabia

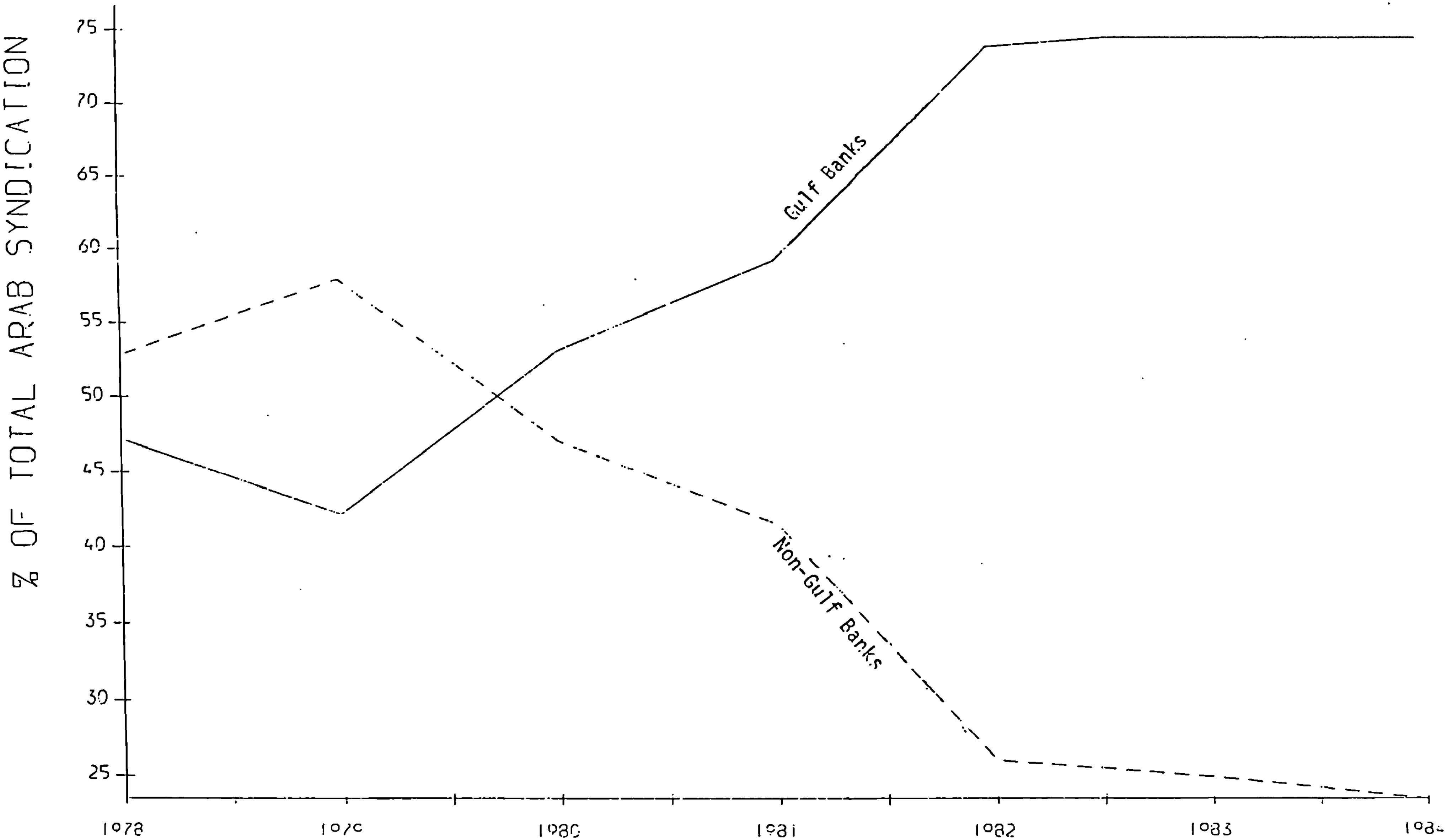
Between 1974-1982, 42 per cent of total Arab imports went to the Arab Gulf region. Furthermore, the share of the GCC members increased over time, from 28 per cent in 1974 to 48 per cent in 1982. This indicates that although the volume of imports by all Arab countries has increased over time, that of the GCC countries has been growing at a faster rate.

It has already been mentioned in Chapters 2 and 3 that Arab banks are trading banks by tradition, and trade finance has been one of the major reasons behind their international expansion. The greater share of GCC imports, therefore, explains why Arab Gulf banks have been the leaders in the process of the internationalisation of Arab banks. Between 1981-1982, the Saudi commercial banks financed private sector imports alone, to the value of US $32.9 billion (SAMA, 1985). If we apply the volume of syndicated lending managed by Arab banks as an indicator to the degree of their international expansion, the dominant role of the Gulf banks becomes apparent, as Figure 4.1 illustrates. On average, Arab Gulf banks represented around 65 per cent of total syndicated loans managed by all Arab banks during the period 1978-1984. As can be seen from Figure 4.1 the share of Arab Gulf banks has increased from 47 per cent in 1978 to 72 per cent in 1984. This indicates the increased sophistication and competitive power of the Gulf banks, as they started to dominate international financial operations in the Middle East.

The second important observation about Table 4.11, however, is that within the GCC countries, the volume of imports was dominated by the two large oil-producing countries - Saudi Arabia and Kuwait.

Figure 4.1

Location Of Arab Banks Active In International Financial Markets, 1978 – 84



Between them they accounted for around 67 per cent of total imports made by the Gulf region. This, in turn, can be used to partly explain the dominant role that the Saudi and Kuwaiti banks played in setting up new international banks and joint ventures in the major international financial markets.

In conclusion, for reasons which will be discussed in the following chapters, Arab banks only managed to attract a minor portion of the oil surpluses that existed in the Gulf region. Due to the lack of data concerning Arab Gulf countries' investments in their own region and with their own banks, the portion of oil surpluses managed by Arab banks is difficult to measure in absolute terms. However, two measurse can be used to indicate the direct benefits that occurred to Arab Gulf banks from the oil revenues; they are the number of Arab banks operating internationally and the increased capitalisation of these banks. These two measures do indicate that there was a direct causality between the internationalisation of Arab banks and the oil revenues. It was not a coincidence that the number of Arab Gulf and other banks operating internationally had increased from only 4 before the first oil price to about 90 following the second major oil price increase.

The indirect benefits to Arab banks from the increased oil revenues, are invaluable and numerous. As a direct result of the oil surpluses that occurred in the Arab Gulf countries, the region started on a massive development plan which necessitated a very rapid increase in imports for capital goods necessary to implement these plans. Arab Gulf banks took advantage of the rising imports, and are believed to have financed the major share of them. It was the trade finance, as already mentioned in Chapter 3, that played an important role in attracting Arab banks abroad.

The second indirect factor that may have led to the international expansion of Arab banks, can be seen in the rapid capital outflow from the region to the international financial centres. To stand any chance of attracting a portion of these funds, the major Arab banks were forced to move to such international financial markets like London and New York that accommodate for the bulk of the Arab foreign deposits.

Finally, oil revenues played an important role in the creation of the offshore banking centre of Bahrain. Arab banks benefited greatly from their offices in Bahrain, as will be discussed in the next chapter.

CHAPTER 5

OFFSHORE AND OTHER FINANCIAL CENTRES IN THE MIDDLE EAST

5.1 INTRODUCTION

The aim of this chapter is to explain the reasons behind the establishment of the offshore banking centre in Bahrain and to analyse the advantages of this centre to the Gulf region in general, and to Arab banks in particular. A comparison will also be made between Bahrain and some other rival Gulf states and the Lebanon, all of which have the potential to become major financial centres in the area.

An international financial centre is usually also an important domestic financial centre. Such centres (for example, London, New York, Singapore and, more recently, Bahrain) have developed to attract international financial business. These centres were able to develop and move beyond their boundaries because of the advantages they enjoy, such as their viability, geographical location, tax regulations and the freedom of entry for foreign banks. But perhaps the most important factor of all for any domestic financial centre to develop into an international financial centre is the political stability in its home country. Without political stability, no financial centre can succeed, particularly in Third World countries. Furthermore, some cities have become important financial centres mainly because of restrictions imposed in other neighbouring countries and rival centres. London, for instance, has benefited greatly from the regulatory policies in France and Germany. Bahrain has also benefited from such policies in other Gulf states, namely Saudi Arabia and Kuwait.

Until the 1960s, most international financial centres grew at ports or island centres of international trade. Those countries which possessed a colonial empire had a considerable advantage, but the dominant factor in the position of any financial centre was the relative weight of the country in international trade and its ability to export capital (Revell, 1973 and 1983). Since the early 1970s, however, other regions which were not well known for their existing banking facilities, have grown to become important centres for international banking. The most important reason for this development was that the governments of some countries in these regions deliberately implemented regulatory and taxation policies favourable to the development of the banking business. Centres such as Singapore and Hong Kong emerged in the Far East, and Bahrain, the Lebanon and, to a lesser extent, the UAE in the Middle East. Some of these centres have reached the stage at which they rival those of Western Europe and the United States. The share of the eurocurrency market held by these emerging centres is shown in Table 5.1.

In general terms, there are four types of offshore financial centres classified according to the sources and uses of funds; they can be summarised as follows:

1 <u>Primary Centres</u>

London and New York are perfect examples of primary financial centres. They are very well established, their main characteristic being that they operate on a worldwide basis.

Table 5.1 Eurocurrency liabilities of major offshore banking centres, selected years, 1970-85

Percentages of gross market size

Centre	1970	1975	1980	1983	1985
London	43.5	36.7	31.8	30.9	29.2
Bahamas	6.1	11.3	8.3	6.7	5.5
Singapore	0.3	2.7	3.6	5.1	5.0
Bahrain	-	0.4	2.5	2.8	2.0
Hong Kong	0.3	0.8	2.1	2.6	3.9
Cayman Islands	-	-	2.2	2.2	3.3
Panama	0.3	1.9	2.3	2.1	1.3
Netherlands Antilles	-	-	0.5	0.5	0.3
Gross market size (US$ billion)	115	485	1524	2056	2615

Sources: 1 Morgan Guaranty Trust, *World Financial Markets*, January 1984

2 Bank for International Settlements, *International Banking Developments*, July 1986

2 Booking Centres

As the name implies, these centres are used mainly for booking business to take advantage of the tax regulations. They collect funds from outside the area in which they operate, and use them in the outside world. Nassau and the Cayman Islands are examples of this group.

3 Funding Centres

The outside world is the source of funds for these centres. Unlike booking centres, they use the funds in the regions in which they operate. Singapore and Panama are both funding centres.

4 Collecting Centres

These centres are usually situated in a wealthy region, most of their funds being obtained from within that region. Their main task is to make these funds available to the outside world. Bahrain provides a perfect example of this group.

The aim of this chapter is to concentrate on the last two of these types of centre. Almost all financial centres in the Middle East fall into these two categories.

5.2 FINANCIAL CENTRES IN THE MIDDLE EAST

Although Bahrain is the largest and most dominant financial centre not only in the Gulf region, but also in the whole of the Arab Middle East, other centres also exist in the region. The following section will concentrate on the roles played by the financial markets of the Lebanon, United Arab Emirates and Jordan.

From the early 1950s, until the outbreak of the Lebanese civil war in 1975, the Lebanon was the most important financial centre in the Middle East. During 1970-1975, Beirut became an attractive financial centre for foreign businessmen and bankers eager to do business with the Arabian Gulf. After the first oil price increase in 1973/1974, the Lebanon had the potential to grow from a regional centre to an international financial centre. Its role was limited, however, mainly because of the lack of supporting industries and of a well-developed local money and capital market. Nevertheless, Beirut's status as the leading banking centre remained unchallenged until the emergence of the offshore market in Bahrain in 1975, and the political unrest that the Lebanon has witnessed ever since.

Until 1974, a combination of several factors had contributed to the growth of the financial centre in Beirut. Such factors were; foreign investments, the banking secrecy law and, most importantly, political stability.

In the mid-to-late 1860s, when the Lebanon was part of the Ottoman Empire, a large amount of French capital was invested in the Middle East, mainly in Beirut and Palestine. After the First World War, major changes occurred in the Lebanese financial system. The defeat of Turkey in that war resulted in the collapse of the Ottoman Empire. As a result, the Lebanon was brought under French control in 1920, and during the French mandate, the Lebanese pound emerged to replace the Turkish lira. Furthermore, a variety of foreign and local banks opened branches in Beirut. By the late 1930s, there were about fifteen banks in the Lebanon, most of which had their head offices in Beirut.

Beirut's image as the main financial centre in the Middle East was greatly enhanced in 1956 by the introduction of the Banking Secrecy Law. According to this law, it was illegal to provide any information to any third party about the financial position of any customer, without his prior permission. The introduction of this law was of vital importance to Beirut as a financing centre, since it became the refuge of Arab capital from the enforced seizures imposed in some Arab countries. The Banking Secrecy Law encouraged the opening of more banks in Beirut; for example, in the period between 1955 and 1965, the number of foreign and domestic banks operating in the Lebanon increased from 31 in 1955, to 93 in 1965.

Even after independence in 1948, the Lebanon was still strongly connected with France, as French rule had left a strong impact on the country. France helped the country a great deal by establishing new educational institutions, as a result of which the French language became commonly spoken. Perhaps the most important impact of French rule was the institution of western democracy in Lebanon. After independence, the Lebanon became one of the very few democratic Arab states.

However, although the 1975 civil war in Lebanon is considered to be the most important factor behind the elimination of Beirut's financial system, other factors were also responsible for the decline of Beirut as a financial centre. The turning point in its development occurred in the mid-1960s, a period that witnessed the failure of two banks, owing to the lack of proper supervision and control. The many factors contributing to the decline of Beirut as a financial centre can be summarised as follows:

1 The banking system in Lebanon operated without a governing body until the establishment of the central bank in 1964. Furthermore, the creation of very small and risky banks led to the inevitable result of the collapse of some banks. A prime example is the collapse in 1966 of Intra Bank, which was considered to be the largest bank in Lebanon.

2 As a result of the 1967 war between the Arabs and Israel, it was feared that Israel might occupy Lebanon. The effect of this was to discourage any new investment in Lebanon, and at the same time it accelerated the outflow of capital from the country.

3 The outbreak of civil war in early 1975, led to the division of Beirut into two parts, each under the control of two hostile parties. The effect of this war was devastating: the human losses have been estimated at about 2 per cent of the population. A large number of skilled workers left the country, mainly for the Gulf area, and many others emigrated to the United States and Europe. This inevitably led to the closure of many banks owing to the flight of capital out of the country. Even the banks that stayed open, such as the British Bank of the Middle East, have been badly damaged. In order to ensure the continuation of services to their clients who have taken refuge in Europe, many banks have left Lebanon altogether to establish themselves in Europe.

4 Until 1977, when the 'free banking zone' was established, non-residents' deposits in all currencies were subject to reserve requirements, a deposit insurance fee, and a 10 per cent withholding tax on interest paid on all deposits, except savings deposits. Furthermore, to contain the growing problem of the appreciation of the Lebanese pound, the Bank of Lebanon prohibited banks from paying interest on non-residents' deposits denominated in Lebanese pounds.

All these factors gave other emerging centres in the region a great competitive advantage over Beirut. Centres such as Bahrain, where there are no reserve requirements and no withholding tax, benefited greatly in attracting business away from Beirut. It can be argued that Beirut's competitiveness in attracting foreign deposits was further constrained by the increased sophistication of banking operations in the Gulf, particularly in Kuwait and Bahrain. Another factor was the low capitalisation of major Lebanese banks.

Destroying the last hope of bringing peace to Lebanon, the Israeli invasion of Lebanon, in 1982, made it impossible for banks and other institutions to carry out their duties. The banking secrecy law was severely threatened as the Israeli troops forced some banks to expose the accounts of wealthy Palestinians. This period, not surprisingly, witnessed a huge transfer of capital from Beirut to much safer places in the west, particularly in France. Some of that capital also went to the newly emerged and promising financial centre in Bahrain.

The United Arab Emirates (UAE) had hopes of attracting banking business away from Bahrain. The political leadership in the UAE found it difficult to accept the fact that the less wealthy Bahrain had become the main financial centre in the Middle East region. The Currency Board, which acts as a central bank, came under pressure from the government and started granting licences to foreign and local Arab banks almost on demand (Abu-Koash, 1978). With a tiny population of 1,040,250 in 1988, the UAE may be regarded as the most overbanked country in the world; in 1977, for example, it had 55 licensed banks with 429 branches, that is, one bank branch for every 1,750 inhabitants.

The sharp increase of banks in the UAE was encouraged by the economy boom during 1975 and 1976, particularly in the construction and property sectors. Several banks found it profitable in the short-term to become heavily involved in real estate lending. They were borrowing short at above market rate and lending long to individuals who proved to be in the high risk group. The year 1977 witnessed a collapse of the boom. This led to a sharp drop in the return on real estate investments. Many customers could not meet their obligations when they fell due. Inevitably, many banks were faced with the rescheduling of such debts and moreover, they suffered big losses due to the bankruptcy of some of their customers. Not surprisingly, there was a financial crisis in the UAE in 1977 which led, among other things, to the suspension of two banks, namely the Janata and Ajman banks. This crisis led to the introduction of a new moratorium on the establishment of new bank branches, and the imposition of new restrictions on the operations of commercial banks.

The UAE did not develop into a financial centre which could challenge that of Bahrain for many reasons, some of which are:

1 The interference of the authorities in the Currency Board's decisions. This was clear in 1975, when the Currency Board imposed a moratorium on the establishment of new banks. This moratorium only lasted until April 1976, mainly because some of the rulers in the UAE often pressurised the Currency Board to grant special authorisations.

2 The general lack of business and the intense competition among many banks for the declining business since 1982, following the fall in oil prices. Furthermore, the dominance of National Bank of Abu Dhabi, which absorbed 27 per cent of the market in 1982, has left over 50 banks (local and foreign) chasing the remainder.

3 Certain measures have been taken in recent years to eliminate the number of foreign banks in the UAE. The most important of these measures was the decision taken by the central bank to limit the number of foreign bank branches in the Emirates to eight. This decision particularly affected the older foreign banks in the Emirates. Such banks as The British Bank of the Middle East and Grindleys closed most of their branches following that decision. Altogether over 70 branches were closed.

4 The lack of a consistent approach by the smaller Emirates towards foreign banks. While Dubai holds the view that the competition can only enhance the quality and widen the services offered by local banks, Abu Dhabi recently applied a 20 per cent tax on the profits of foreign banks.

5 The lack of proper regulation over commercial banks' operations until 1980 when the UAE central bank was established.

Amman, the capital of Jordan has been on the verge of emerging as an important financial centre in the Middle East. The Amman stock market was established in 1976, and was encouraged by the rapid growth of the Jordanian public liability companies, as Table 5.2 shows.

Among the many factors that have contributed to the success of Amman as a financial centre and a capital market are:

1 The availability of funds in the region following the oil price increase in 1973-74. This coincided with the massive increase in the number of Jordanians working in the Gulf region, which led to an increase in revenues in Jordan.

Table 5.2 The growth of the Amman financial market, 1978-83

Year	Number of companies	Number of shares	% growth
1978	67	2,429,152	-
1979	70	6,534,900	169.0
1980	71	17,898,885	173.9
1981	72	29,231,085	63.3
1982	99	45,839,068	57.0
1983	109	61,079,192	33.2

Source: Collected from data published by the Central Bank of Jordan

2 Jordan heads the list of countries receiving aid from the oil producing states in the Gulf. The increase in oil revenues in 1974, brought about an increase in the Arab aid programme, as mentioned earlier in Chapter 4.

3 The increased number of public liability companies in the mid to late-1970s with their share traded in the Amman financial centre, as shown in Table 5.2, gave the centre a boost in its early years of establishment. The Gulf war between Iraq and Iran (1980-88) was one of the main reasons behind the increased number of Jordanian companies, or the continuation of many others that were in difficulties before the war started. Jordan, being one of Iraq's main allies in the Middle East, was a major supplier of goods and services to Iraq during the course of the Gulf war.

4 The relative political stability of Jordan and its acceptability by many Gulf countries, coupled with the

existence of many supporting industries, has made it a natural place to develop into one of the major financial centres in the region.

5 Finally, unlike many Gulf countries, Jordan enjoys the availability of skilled personnel. This makes the operation of foreign banks in Amman relatively cheaper than banks operated in the Gulf region, because they do not have to incur high expenses that are usually associated with recruiting staff from abroad.

However, recent events have prevented the Amman financial centre from developing into a major financial centre to challenge or, indeed, replace that of Bahrain. Such events like a decline in oil prices in recent years which has slowed down projects and services in the whole of the Middle East. Fewer Jordanians were needed in the Gulf region and, therefore, a decline in revenues into Jordan followed. Amman was also affected by the decline in Arab aid. Furthermore, the role of the many companies that encouraged the shares dealings in the Amman financial centre, was in decline. The majority of these companies were concentrated on the services sector and ignored the industrial and agricultural sectors. The reduced demand for these companies in recent years, led to a dramatic fall in their share prices.

Perhaps the most important factor responsible for the decline of Amman as a financial centre, was the nationalisation of the banking industry. The effect of this was to discourage any new investment in Jordan. For the Jordanian authorities, like the Saudies, insisted that any company or bank which wanted to be established in Jordan should be, at least, 51 per cent Jordanian owned.

5.3 BAHRAIN

5.3.1 Introduction

Historically, Bahrain has prospered through the availability of water on the island and its development as a trading point in the Gulf. Bahrain was the first Gulf country to produce oil in 1932, but it has smaller oil revenues than any other Gulf country; many of the countries where the oil wealth dates back only to the 1960s, have sufficient oil resources to be relied upon as a source of national wealth for many decades to come (as already mentioned in Chapter 1). But although in 1968-69, oil revenues contributed to 80 per cent of Bahrain's GNP, by 1982, this contribution had diminished to only 25 per cent, and it is expected to decline further in the 1990s. This is one of the most important reasons why Bahrain has sought a role for itself other than as an oil producer; as a small country (only 230 square miles), the government determined in the mid-1960s, when Bahraini oil output had maximised, that the future of its economy should be as a service industry.

Bahrain has been familiar with commercial banks for many years. The first bank to be established on the island was the Eastern Bank in 1921, which later became known as the Chartered Bank. Many banks have followed since then, for example, the British Bank for the Middle East in 1944, Bahrain Bank in 1957, and the Arab Bank Limited in 1960.

Until 1971, Bahrain, like most other Gulf states, had a special treaty relationship with Great Britain, whereby Bahrain was the centre of British administration for its Gulf responsibilities. This treaty helped Bahrain greatly in becoming a major telecommunications centre in the Gulf.

5.3.2 Offshore banking units (OBUs)

Although foreign banks were allowed to operate in Bahrain in 1969, and by 1971, ten were operating there, Bahrain first became recognised as an offshore financial centre in the Gulf in 1975, after the decision by the BMA to announce that it was prepared to grant licences to banks wishing to establish offshore banking units on the island. As mentioned earlier, the decision by the BMA, coincided with the decline of Beirut, which was no longer a safe place after the eruption of the civil war in Lebanon. However, it is debatable whether the emergence of the financial centre in Bahrain was a replacement for Beirut, or rather a natural development which would have occurred regardless. The main reason for the Bahraini authorities to establish an offshore banking centre was to compensate for the declining oil revenues. The implementation of this diversification policy gave financial services a prominent role in preparing Bahrain for the post-oil era. Bahrain was considered by many Arab countries to be the most unlikely spot to become a financial centre in the region. As a trading centre, it is less important than most of its neighbouring states such as Dubai and Abu Dhabi; with a population of less than half a million, and with only three indigenous banks, there was a very small financial base to work on.

Despite that, Bahrain, unlike Dubai, seized its opportunity to become the banking centre of the Gulf region. It took full advantage of the tragic circumstances in Lebanon, and also the political isolation of Egypt after the Camp David accord with Israel, at a time when Cairo was emerging as a financial centre. Furthermore, Bahrain was also aided in the successful creation of an offshore banking centre by the many advantages it offered. Some of these advantages make Bahrain almost unique and unchallenged in the region. These advantages are:

5.3.2.1 Location

To have any success in international banking, a financial centre should be located in or near the countries whose economies are dynamic and industrialising rapidly. The Middle Eastern countries are with only few exceptions probably neither, but Bahrain is located in the centre of the world's wealthiest region. A central location in the Gulf has meant that Bahrain is ideally situated to serve the whole of the Middle East region. Although modern communications have helped to reduce the importance of the geographical location of a financial centre, by making it possible to execute financial operations without the parties concerned having to be physically present in the same place, Bahrain was the financial centre least affected by this factor, because of the importance of physical presence in an area where tradition plays an important part, such as the Middle East.

5.3.2.2 Time zone

Generally, the world's most important financial centres fall into four distinct time zones: North America; Western Europe; the Middle East; and the Far East. New York and London are the two unchallenged financial centres occupying the first two time zones. Until 1975, however, Beirut was the only financial centre in the third time zone, but because of the decline of Beirut for reasons mentioned earlier in this chapter, Bahrain has taken over as the most successful financial centre in the area. In the fourth time zone, Tokyo is the main centre followed by Hong Kong and Singapore.

Table 5.3 shows the different time zones and the major financial centres in the world that occupy them. As the table indicates, Bahrain's time zone gives it a distinct advantage for operating in currency dealing and foreign exchange business after Singapore closes, but before the European centres open. Furthermore, Bahrain is probably the only centre in the world to open on Saturdays, which gives it the opportunity to trade for seven days a week.

5.3.2.3 Freedom from tax

There are no corporate, withholding or personal taxes in Bahrain, and the authorities have declared that they have no intention of introducing them in the near future. This makes Bahrain a natural place to develop as a financial centre. The success of Bahrain can also be attributed to the restrictions imposed on the banks in neighbouring countries. For example, while Bahraini OBUs have no liquidity requirements to meet, the Kuwaiti banks, in contrast, are obliged to observe a liquidity ratio of 25 per cent and a lending ceiling of 10 per cent. Therefore, Bahraini OBUs are in a position to offer cheaper loans to Kuwaiti customers than Kuwaiti banks can. Bahrain as a financial centre has also benefited largely from the Kuwaiti policy of not admitting foreign banks, and the Saudi move towards the nationalisation of its banking system. These leave the offshore banking centre of Bahrain unchallenged, because almost all international banks in the world want to do business with those two countries. Such banks have opted to establish themselves in Bahrain as it provides the nearest option.

Table 5.3 Time differences from London of selected offshore centres

Centre	Time differences (hours)
Bahamas, Cayman Islands, Panama and New York	-5
Bermuda, Barbados and Anguilla	-4
Bahrain	+3.5
Seychelle Islands	+4
Singapore	+6.5
Hong Kong	+7
Manila	+8

Source: Time Zones of the World, The Daily Telegraph Map Series, (London: Geographia Ltd)

5.3.2.4 Political stability

Bahrain's political acceptability in the Arab region has made it a natural place for development as a financial centre. As mentioned earlier, such political stability is vital for banking centres. Without political stability there is no security for depositors, investors and institutions. This is particularly so in areas as volatile as the Middle East. Bahrain, unlike Lebanon, has a long history of political stability; the Al Khalifa family has been ruling the island for more than two centuries. In a region as politically volatile as the Middle East, Bahrain (along with other GCC countries) are probably the most politically stable countries.

5.3.2.5 Good telecommunications system

Bahrain developed as a regional communications centre after the Second World War. As air travel from Europe to the Far East became more common, Bahrain proved to be a useful stopping point. Furthermore, the special treaty which Bahrain had with Great Britain helped in the development of its excellent transport and telecommunications facilities.

5.3.2.6 The oil price increase

The rise of oil prices in 1973, led to greatly increased financial activity in the Middle East. The launching of the Bahraini offshore market was mostly in response to a need to improve the banking services at a time when the surpluses from oil prices proved too much for the existing local banks to handle. It can be argued that the creation of the offshore centre in Bahrain was not only necessary to assist in the recycling process, but vital to the Middle East region, to fill the gap left by the Lebanon in 1975.

5.3.2.7 Other factors

There were some other factors that helped with the establishment of Bahrain as a banking centre in the Gulf. They can be summarised as follows:

1 Stable currency
2 Ease of use of international currencies
3 Reasonable living environment
4 Well-educated labour force
5 Tradition of trading and an open society
6 There is less bureaucracy in Bahrain than in other Gulf states

5.3.3 Growth of OBUs in Bahrain

As a financial centre, Bahrain engages primarily in outward financial intermediation. This is due to the fact that the Gulf region in general, and Bahrain's neighbouring countries such as Saudi Arabia and Kuwait in particular, generate excessive savings owing to their high income the low absorbing capacities of their economies. The role of Bahrain, and the main reason behind the creation of its offshore centre, was to attract these surplus savings whereby international banking institutions could invest the funds in a more sophisticated manner than could the local institutions. Therefore, the economic rationale for a centre such as Bahrain, is efficiency in the management of investing funds on an international scale. This efficiency is made possible by the economies of scale and the service of support industries on the island.

Since the recognition of Bahrain as a financial centre in 1975, foreign banks have rushed to open offshore branches there; virtually all major world banks have established a presence in Bahrain. Recently, Japanese banks, for the first time since 1975, have started to show interest in the financial centre of Bahrain. This partly explains why Bahrain's growth as a financial centre has been extremely rapid. This point is well illustrated in Table 5.4, which shows the position of Bahrain compared with that of other centres, in terms of foreign banks. The financial needs of the area, after very optimistic development plans in most Gulf countries, proved so significant, particularly in the period between 1975 and 1981, that Bahrain's share of the total eurocurrency market increased from US $2 billion in 1975, to US $51 billion in 1981.

One indicator which can be used to show the pace at which this financial centre has been growing, is total offshore banking assets. These grew from US $1.7 billion in 1975, to US $23.4 billion in 1978 and to US $63 billion in 1987. Table 5.5 shows the rapid growth of OBUs in Bahrain between 1975 and 1986. As can be seen from this table, the growth rate of OBU assets have been uneven. The period between 1975 and 1982 witnessed rapid growth, with the exception of 1979 (when the rate of growth was somewhat slower owing to uncertainty in the region after the overthrow of the Shah of Iran and the fear that the Iranian revolution might expand to other Gulf countries). However, the volume of assets dropped significantly during 1983-1986. This was due to many factors. The first and most important was the decline of oil revenues in the oil-exporting Gulf states, which resulted in the slowing down of most industrial and infrastructure projects in neighbouring countries.

Table 5.4 World financial centres ranked in terms of banks represented, end-1981

Ranking	Centre	Branches	Representative offices	Subsidiaries	Multinational consortia	Other offices	Total
1	London	209	121	39	66	28	463
2	New York	97	58	36	9	41	241
3	Hong Kong	69	61	66	24	14	234
4	Singapore	44	52	12	22	53	183
5	Frankfurt	44	106	14	6	2	172
6	Paris	50	56	32	26	7	171
7	Luxembourg	14	-	72	35	34	155
8	Bahrain	24	40	3	8	63	138
9	Sao Paulo	9	89	16	16	7	137
10	Tokyo	55	65	2	2	9	133
11	Sydney	5	69	18	16	21	129
12	Grand Cayman	68	1	37	2	1	109
13	Nassau	65	-	33	4	3	105
14	Jakarta	14	58	1	28	4	105
15	Los Angeles	25	14	13	3	33	88
16	Beirut	24	41	17	3	2	87
17	Toronto	3	51	30	1	2	87
18	Rio de Janeiro	9	49	17	9	-	84
19	Caracas	5	70	2	2	3	82
20	Zurich	16	21	31	7	6	81

Source: The Banker Research Unit, 1982

Table 5.5 Total assets of offshore banking units in Bahrain, 1975-87

Per cent

Year	Total assets (US$ million)	Growth rate of assets
1975	1,687	-
1976	6,214	268.3
1977	15,701	152.7
1978	23,441	49.3
1979	27,764	18.4
1980	37,466	34.9
1981	50,734	35.4
1982	59,007	16.3
1983	62,741	6.3
1984	62,692	-0.1
1985	56,805	-9.4
1986	55,680	-2.0
1987	63,482	14.0

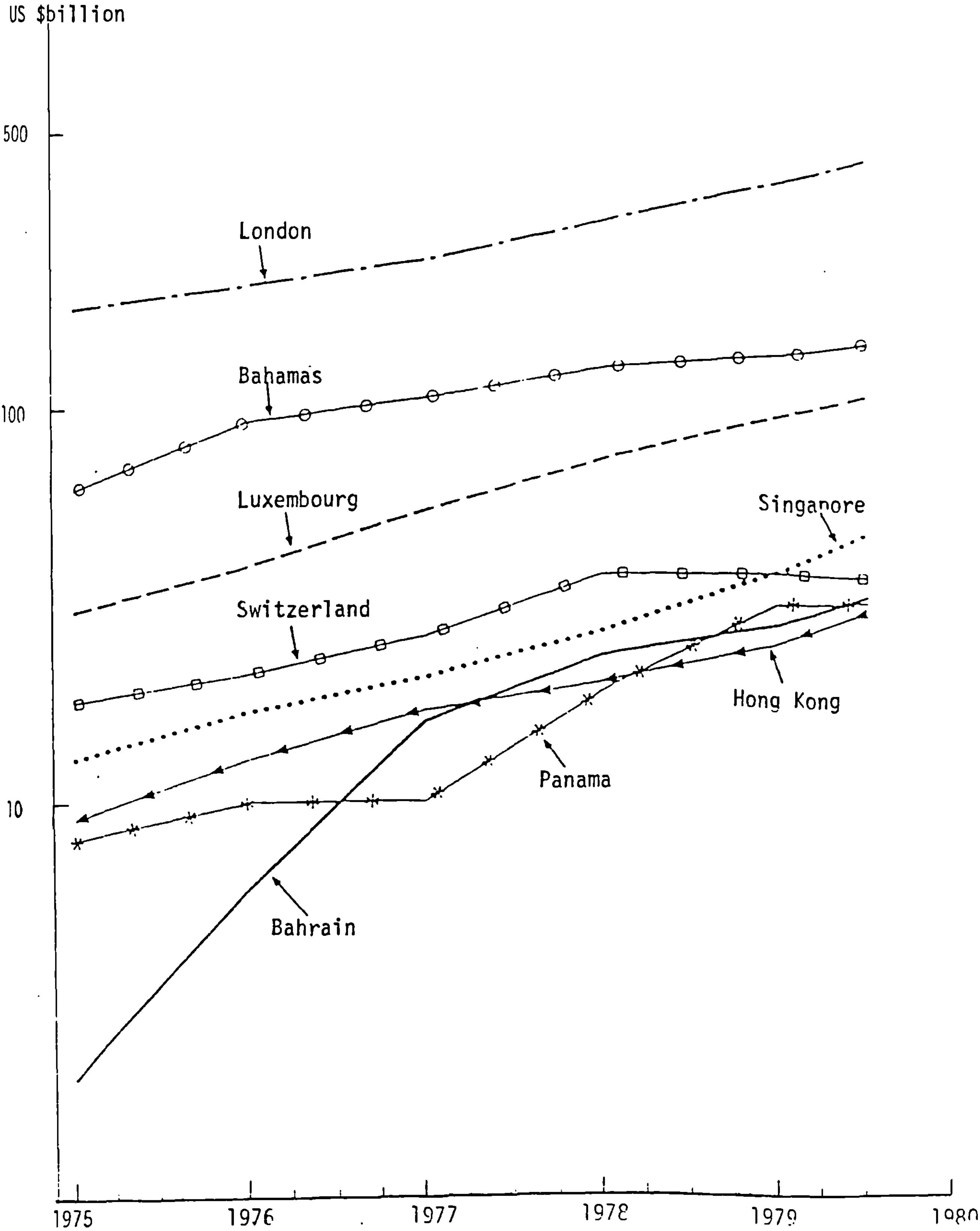
Source: Bahrain Monetary Authority, *Annual Report* (various issues)

The second was the continuing war between Iraq and Iran, countries which both used to be major sources of funds for OBUs; this war greatly depressed business in the region. The third factor was the accumulation of bad debts by most Arab banks as a result of their involvement in South America. Finally, as a result of the previous three factors, some banks either departed completely from Bahrain, or reduced their representation to the minimum level.

The growth of the offshore centre in Bahrain is also shown in Figure 5.1. This shows the rapid growth of the centre compared with other well-known offshore banking centres in terms of their share of the eurocurrency market. Between 1975 and 1978 Bahrain was undoubtedly the fastest growing offshore centre in the world. Since

Figure 5.1

The Development of Bahrain Compaired to Other Financial Centres (1975-1980)



Source: Based on data in the Bankers Magazine,Feb 1981

1979, however, the rate of growth started to slow down. In addition to the reasons mentioned above, the generally depressed eurocurrency market was to blame, particularly syndicated lending.

At the beginning of its establishment, the Bahraini offshore banking centre was dominated by major Western banks, but in the late 1970s and early 1980s, Arab financial institutions realised the importance of the Bahraini offshore banking centre and started opening branches there. The number of Arab banks operating in Bahrain quadrupled between 1976 and 1986, as shown in Table 5.6.

5.3.4 The money market

Although the development of Bahrain's financial centre is relatively recent, the BMA is actively encouraging the growth of the money market, and has initiated the introduction of certificates of deposit (CDs) and promissory notes in order to assist its development.

All banks in Bahrain (local and offshore) accept all types of deposits either in Bahraini dinars or in any other major international currency. The best markets are those available for US dollars, Swiss francs, Deutschemarks, sterling and yen. Domestic and offshore banks are competitive for non-Bahraini residents' deposits, with their interest quotations. Bahraini dinar deposits and loan rates are determined by the forces of supply and demand in the market, and are generally parallel to those prevailing in the eurocurrency markets. This is one of the advantagse that attracts depositors from other Gulf countries to Bahrain. Where interest rates ceilings exist in neighbouring countries, such as Kuwait, the BMA does not influence domestic interest rates either through the

Table 5.6 Number and origin of OBUs operating in Bahrain, 1975-86

	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
Arab countries	-	4	6	9	11	12	16	20	21	23	23	22
Western Europe	1	11	14	18	20	21	22	23	23	23	23	20
Northern America	1	8	8	10	10	10	10	11	12	11	10	8
Other countries	-	3	5	5	10	15	17	18	19	19	18	18
Total	2	26	33	42	51	58	65	72	75	76	74	68
Arab banks as a percentage of total	-	15.3	18.2	21.4	21.6	20.7	24.6	27.8	28.0	30.3	31.1	32.4

Source: Bahrain Monetary Authority, *Annual Report* (various issues) use of discount policy or open market operations. The BMA does, however, recommend an interest rate of 6-8 per cent on Bahraini dinar deposits and a rate of 8-10 per cent on dinar loans.

The efficiency of the money market in Bahrain is regarded as one of the most important advantages that gives Bahrain a competitive edge over its main rivals in the Middle East. In this connection, Wilson (1983) argues, 'Bahrain is a much better base for foreign exchange business than Beirut ever was, even in its heyday'.

Although money markets have grown rapidly in Bahrain, bond and stock markets remain very thin and lag behind other sectors of the economy. This is due to the fact that there is no active secondary market in the country. There is no formal stock exchange in Bahrain, but there are 17 registered stock brokers to facilitate the trading of Bahraini and exempt companies' shares.

To encourage the establishment of a capital market to complement the operations of the already existing financial market, the Bahrain Monetary Agency announced in 1977 a further type of licence, that is the Investment Banking Licence (IBL). By January 1984 there were 16 IBLs operating in Bahrain, and by the end of 1988, the number of these institutions had further risen to 18.

5.3.5 Sources and uses of offshore funds

Capital flows into Bahrain originate mostly in Arab countries and Western Europe. Since 1978, however, the share of Arab countries as sources of funds has grown from 50 per cent, to 66 per cent in 1983. Consequently, the share of Western European banks has declined from 30 per cent of the total to 21 per cent during the same period, as can be seen from Table 5.7.

Table 5.7 The geographical location of OBU sources and uses of funds, selected years, 1976-85

US$ million

	1976	1978	1979	1980	1981	1982	1983	1984	1985
Sources of funds									
Arab countries	2,578	11,666	24,236	34,075	39,452	41,099	29,290	26,265	24,926
North America	0,214	1,891	0,358	0,700	1,287	2,677	1,965	2,299	3,458
Western Europe	2,277	7,018	9,311	11,101	12,296	12,822	16,541	13,310	13,132
Offshore countries	0,932	1,850	2,339	2,905	4,371	4,656	5,614	6,579	6,015
Other									
Uses of funds									
Arab countries	2,487	11,688	19,770	24,823	28,993	29,370	41,147	38,398	37,268
North America	0,013	0,277	0,641	1,003	1,431	2,252	2,469	1,882	2,389
Western Europe	1,129	5,301	9,764	13,257	14,321	15,604	13,528	11,058	10,561
Offshore countries	1,241	2,971	2,538	3,857	4,654	6,010	4,214	3,952	3,698
Other	1,344	3,204	4,753	7,794	9,608	9,505	1,334	1,515	1,764

Source: Bahrain Monetary Authority, Quarterly Statistical Bulletin, 1986

The fact that the share of Arab countries as sources of funds has exceeded that of any other group represented in Table 5.7, shows that Bahrain has managed to fulfil the most important objective behind the establishment of its offshore centre; that is, to attract Arab funds from neighbouring oil-rich states and to become a major financial centre in the region.

The most significant point in Table 5.7 is that, on average, about 50 per cent of OBU assets are lent to Arab borrowers. The fact that 66 per cent of the funds originate in Arab countries and only 50 per cent are lent to Arab clients can lead to the conclusion that Bahrain is still mainly a collecting centre for recycling oil revenues to the outside world.

5.3.6 The maturity analysis of OBU transactions

The maturity analysis of OBU assets and liabilities shows that business transactions are predominantly of a short-term nature. On average, 87 per cent of OBU assets and 97 per cent of the liabilities are of maturities of a year or less. Table 5.8 shows that offshore banks tend to borrow on a shorter-term basis than their lending. The table also shows that the maturity structure itself has not changed over a period of ten years, between 1976 and 1986.

The concentration on short-term business transactions is not unique to Bahrain. As shown in Table 5.9, even the very well-established financial centres, such as London, share this feature. This study, which covers selective years between 1977 and 1984, shows that, on average, 85 per cent of operations carried out in the offshore centre in Bahrain were on a short-term basis (one year and

Table 5.8 Maturity classifications of assets & liabilities of the OBUs in Bahrain, 1976-86

US$ million

	up to 7 days	8 days to 1 month	over 1-3 months	over 3-6 months	over 6-12 months	over 12-36 months	over 3 years
Assets							
1976	1,059	909	1,517	1,164	445	662	458
1977	2,259	4,180	3,538	2,850	826	811	1,237
1978	2,793	5,846	6,598	4,230	1,125	1,112	1,701
1979	3,953	6,385	7,620	4,418	1,411	1,432	2,545
1980	6,603	7,759	9,977	6,975	1,572	1,587	2,993
1981	9,566	11,710	12,036	7,690	2,007	2,587	5,138
1982	8,575	15,608	13,155	8,512	2,939	3,285	6,933
1983	13,284	14,966	12,381	6,935	3,106	3,883	8,186
1984	11,108	14,360	13,613	8,806	3,296	3,561	7,948
1985	10,939	13,849	12,822	5,664	2,664	3,708	7,169
1986	13,199	12,499	10,474	6,060	2,515	3,429	7,504
Liabilities							
1976	1,714	2,131	1,487	681	149	43	9
1977	3,344	6,224	3,509	1,973	504	53	97
1978	5,078	7,420	6,101	3,590	881	174	197
1979	6,212	8,134	7,351	4,359	1,085	387	236
1980	7,670	9,837	11,006	6,557	1,370	196	830
1981	10,759	13,968	14,946	8,466	1,154	117	1,330
1982	11,013	17,821	16,920	9,086	1,746	239	2,182
1983	13,954	19,952	15,779	8,081	2,012	249	2,714
1984	11,346	19,164	17,051	9,161	2,709	348	2,913
1985	11,962	17,533	14,211	7,178	1,826	191	3,904
1986	15,869	16,930	10,812	5,648	1,850	527	3,994

Source: Bahrain Monetary Authority, Annual Report, end-1986

Table 5.9 Maturity classification of assets and liabilities of Bahraini OBUs compared with that of all UK-based eurobanks, selected years, 1977-84

Percentages of total

Maturity	Assets			Liabilities		
	1977	1980	1984	1977	1980	1984
less than 8 days	14.4	17.6	17.7	21.3	20.5	18.1
	(17.0)	(16.9)	(16.5)	(22.6)	(21.9)	(22.8)
8 days to 1 month	25.6	20.7	22.9	39.6	26.3	30.6
	(13.2)	(16.0)	(15.7)	(17.0)	(19.4)	(20.1)
1 to 3 months	22.5	26.6	21.7	22.3	29.4	27.2
	(22.0)	(23.0)	(23.4)	(26.9)	(28.1)	(28.1)
3 to 6 months	18.2	18.6	14.0	12.6	17.5	14.6
	(15.8)	(15.8)	(14.0)	(18.7)	(18.4)	(17.7)
6 months to 1 year	5.3	4.2	5.3	3.2	3.7	4.3
	(8.0)	(7.0)	(6.4)	(8.1)	(7.3)	(6.2)
1 to 3 years	5.2	4.2	5.7	0.3	0.5	0.6
	(9.8)	(6.7)	(7.2)	(4.8)	(3.2)	(2.6)
3 years and over	7.9	8.0	12.7	0.6	2.2	4.6
	(14.2)	(14.6)	(16.8)	(1.9)	(1.7)	(2.5)

Sources: Bahrain Monetary Authority, Annual Report, end-1986
Bank of England Quarterly Bulletin, March 1987

Note: Figures in brackets are those of UK-based eurobanks less), compared with 77 per cent in London. The noteable difference between the two centres is in the long-term transactions (more than three years), for which the London figures were almost double those of Bahrain. The concentration on short-term business transactions in Bahrain is due to the caution among OBUs resulting from the uncertainty of the political future of the Gulf region.

5.3.7 The role of regional currencies

The analysis of the currencies used in OBU transactions shows the dominance of the US dollar in the early stages of the development of the Bahraini offshore centre. In terms of market share, the share of the US dollar has accounted for about 67.9 per cent on the assets side, and about 65.4 per cent on the liabilities side. Because the majority of operations in Bahrain are carried out in the US dollar, it is natural to look at the offshore market in Bahrain as part of the global eurodollar market. According to BIS statistics (Table 5.1), the share of the Bahraini market was 2.8 per cent in 1976, and 4.6 per cent in 1981, of the net size of the eurocurrency market. The dollar is followed by regional currencies. The involvement of local currencies, mainly the Saudi riyal, amounts to about 24 per cent of total transactions carried out in Bahrain. The use of the Saudi riyal in Bahrain was encouraged by the fact that the offshore centre in Bahrain offered the Saudi banks a good base in which to deposit their funds, where they gained good returns and high liquidity.

Furthermore, due to the wide differences that existed between interest rates paid on Saudi riyals (about 8 per cent) and those paid on the US dollar (about 14 per cent), it was a common practice in the late 1970s for OBUs Saudi riyals and use the advanced money market of Bahrain, to exchange them with the US dollar, in order to take advantage of the interest rate gap.

The currency composition of assets and liabilities of OBUs in Bahrain is shown in Table 5.10. Owing to the awareness of other Gulf countries of the large involvement of their currencies in Bahrain, and the radical measures that these countries have taken to limit the exposure of their currencies there, the share of regional currencies seems to be on the decline. For example, assets denominated in regional currencies have declined from 22.1 per cent in 1980, to 14.4. per cent in 1986. Nevertheless, the Saudi riyal still plays an important role in Bahrain. Towards the end of the 1970s, nearly half of the Saudi money supply was deposited in Bahrain. This was the main concern of the Saudi government, which felt that it was losing control over its monetary policy. Both Saudi Arabia and Kuwait were apprehensive about the internationalisation of their currencies; they have taken some deliberate steps to reduce their involvements in Bahrain, as shall be seen later in this chapter.

Despite the declining role of regional currencies in the early 1980s, a close examination of the figures presented in Table 5.9 confirms the belief that Bahrain is well in the process of becoming a regional financial centre, making increasing use of the regional currencies. It is in the use of these regional currencies and other non-dollar currencies that Bahrain differs from other centres. These currencies, including the regional ones, account for almost 35 per cent of the total currencies used.

Table 5.10 Currency composition of OBUs assets and liabilities, 1976-86

US$ million

	1976	1978	1979	1980	1981	1982	1983	1984	1985	1986
Assets										
US dollar	4,387	16,031	18,216	24,846	34,318	42,641	47,003	48,316	43,045	42,343
Regional currencies*	1,196	6,075	7,440	8,283	10,568	10,799	10,799	9,933	9,128	8,037
Deutchemarks	183	501	524	795	1,579	1,136	1,129	1,105	1,048	1,678
Swiss francs	318	389	637	1,414	1,635	1,988	1,509	1,363	1,455	1,414
Others**	130	445	947	2,128	2,634	2,443	2,309	1,975	2,129	2,208
Total assets = liabilities	6,214	23,441	27,764	37,466	50,734	59,007	62,741	62,692	56,805	55,680
Liabilities										
US dollar	4,471	15,459	17,538	23,631	32,958	40,813	42,872	44,722	38,895	38,468
Regional currencies*	1,168	6,720	8,113	9,366	12,437	13,301	15,003	13,657	13,409	12,005
Deutchemarks	175	383	609	786	1,483	1,079	1,121	1,035	926	1,477
Swiss francs	258	295	546	1,101	1,416	1,543	1,411	1,347	1,670	1,456
Others**	142	584	958	3,582	2,440	2,271	2,334	1,931	1,908	2,274

Source: Bahrain Monetary Agency Quarterly Statistical Bulletin, 1987

Notes: * The regional currencies are the Saudi riyal, Kuwaiti dinar, UAE dirham and Qatar riyal
** These include Latin America, non-Arab Africa, Eastern Europe and the Far East

5.3.8 Control and regulations

To avoid the problems of liquidity crisis, similar to that of Lebanon in 1966 and Kuwait in 1982, and to ensure that the country is not overbanked like the UAE, Bahrain, like Singapore, has introduced licence fees to operate OBUs. The BMA has set several conditions for banks willing to establish branches on the island; they can be summarised as follows:

1 An OBU must be a full branch of the parent bank or it must satisfy the BMA of the commitment of the parent bank to its office
2 OBUs must be fully staffed; permission cannot be given for brass-plate operations in which the business is written elsewhere and booked in Bahrain mainly as an accounting device
3 OBUs must supply regular monthly balance sheets and must satisfy the BMA of their ability to meet their obligations when they fall due; in other words, OBUs must satisfy the BMA that they are liquid and solvent
4 An annual licence fee of $15,470 is payable to the BMA in order to obtain an OBU licence (this amount was originally $25,000 but was reduced in 1984)
5 OBUs are not allowed to deal in any way with residents of Bahrain, except for the government or its agencies; they are, however, free to offer all banking services for non-residents of Bahrain

Table 5.11 provides a comparison between Bahrain and other offshore centres in terms of regulations and financial requirements.

Table 5.11 The regulations and requirements of offshore centres, 1982

Centre	Ease of entry	Local capital requirements	Taxes and levies	Annual licence fee	Number of offshore banks*
Bahamas	Relatively easy even for unknown banks	None	None	US$ 300-45,000	314
Bahrain	Limited to branches of well-known international banks until early 1980s, when banks from developing countries were encouraged to enter	None	None	US$ 15,470	135
UAE	Limited to international banks with good reputation	None	None	None	55
Singapore	Easy access for most banks	US$ 3-6 mn**	10% profit tax on offshore operations	US $50,000	108
Hong Kong	Foreign banks allowed after a 13-year moratorium; generally, only one branch of large international banks is permitted	None	10% withholding tax on interest paid	None	
Luxembourg	Limited to large international banks	Lux.F.250 mn	40% corporate tax 40% municipal business tax	None	113
Cayman Islands	Licences only granted to branches and subsidiaries of major international banks	US$ 240,000	None	US $6,000-24,000	348

(*) This includes full commercial banks, offshore banking units, representative offices and investment banks
(**) If the head office is situated outside Singapore

Source: Based on data published in International Banking Centres, edited by Bowman Brown, published by Euromoney, 1982

5.3.9 The impact of the offshore centre on the Bahraini economy

Foreign banks play a very important role in the Bahraini economy. They have been the main source for bringing financial technology to the island, and by introducing foreign capital, they assist greatly in financing industrial, commercial and agricultural development.

Offshore banking units have had a positive effect on local employment in Bahrain, particularly in banking-related areas such as legal, accounting, printing, air transportation and other supporting industries. It seems that the BMA has fulfilled one of the objectives behind creating the offshore centre in Bahrain, that of creating employment. Table 5.12 indicates this point clearly.

Table 5.12 Staff position of OBUs, 1980-86

Numbers

Year	Bahrainis	Expatriate	Bahrainis as % of total
1980	781	647	54.7
1981	1,022	796	56.2
1982	1,280	953	57.3
1983	1,499	1,040	59.0
1984	1,533	1,080	58.7
1985	1,445	932	60.8
1986	1,298	814	61.4

Source: BMA publication, 1987

The table shows that until 1984, the number of Bahrainis employed by OBUs was increasing. Even though the total number of Bahrainis employed by OBUs has been on the decline since 1984, this is due to the decline in total employment. The intention of the BMA, however, is to train more Bahrainis to eventually replace most of the expatriates.

The establishment of the offshore centre in Bahrain has also stimulated the development of related industries. Telephone and telex facilities, office buildings, airport facilities, are good examples of such industries. OBUs have also provided Bahrain with direct financial benefits such as wages and salaries, fees, communications costs and the annual licence fees. These financial benefits, which are shown in Table 5.13, have contributed to an estimated 5-10 per cent of the Bahraini GNP. It must be mentioned here that commercial registration fees, from 1984, have considerably increased, with some OBUs required to pay BD 50,000 per annum, ranging down to BD 2,500 for OBU branches.

Table 5.13 Estimated financial benefits to Bahrain, 1980-86

US$ million

Year	Licence fees	Recurrent expenses	Total
1980	1.56	81	82.56
1981	1.80	131	132.80
1982	2.36	151	153.36
1983	2.48	168	170.48
1984	2.56	196.6	199.12
1985	2.58	205.2	207.13
1986	2.51	194.6	197.15

Source: Bahrain Monetary Agency, Bahrain, an international financial centre, 1987

Further effects of OBUs on Bahrain and the Gulf region can be summarised as follows:

1 By establishing money and interbank markets in Bahrain, OBUs have helped to reduce interest rates in the region
2 One of the most important achievements of the offshore banking centre is that, without its existence, the creation of the forward market for Gulf currencies, in particular the Saudi riyal and the Kuwaiti dinar, may not have been possible.

5.3.10 The effect of the offshore banking centre on Arab banks

The existence of the offshore centre in Bahrain is considered to be one of the important reasons behind the internationalisation of Arab banks. These banks have greatly benefited from being situated in Bahrain in many ways:

1 By locating most international banking and financial infrastructures in one place, such as Bahrain, Arab banks have been able to spread the overhead costs of servicing clients in various countries.
2 Arab banks have also benefited from the up-to-date information and the sophisticated financial expertise of the Bahraini offshore financial centre. Both of these services are, of course, vital for the international operations of Arab banks.
3 International banking operations often require a team of banks to work out loan syndications and other credit transactions. The amounts of money involved in these operations are usually too large for any one bank to prudently handle. This partly

explains why Arab banks located in Bahrain are among the leading banks in the syndicated eurocurrency market.

4 As mentioned earlier, the existence of the interbank money market has led to the efficient channelling of financial resources. Furthermore, efficient interbank marketing provides the opportunity to invest these financial resources easily and with minimum risk. An indication of the importance of the interbank market in Bahrain, is that it accounts for an average of 60-70 per cent of OBUs' total assets, as Table 5.14 indicates. Because the smallest banks operating in Bahrain are branches of some Arab banks, the existence of an active interbank market is of great help to these banks' international operations. This is due to the fact that these banks rely heavily on the interbank market to compensate for their limited client base.

In entering Bahrain, foreign banks gained access to one of the most wealthy regions in the world at a time when the economies of the Gulf region were growing rapidly. In doing so, these banks benefited largely, but, equally, they have contributed to improving the financial systems of the region.

By introducing new ideas and new products, by assisting in creating and expanding the foreign exchange market, and by pricing their products competitively and thus creating healthy competition, they have forced domestic Arab banks to respond to the challenge, with the net result of offering better financial services.

Table 5.14 Bahrain offshore banking units: interbank assets and liabilities, 1976-87

US$ million

	Assets			Total	Liabilities		
	Loans to non-banks	Interbank	Other assets	assets and liabilities	Deposits of non-banks	Interbank	Other liabilities
1976	1,734	4,426	54	6,214	598	5,536	80
1977	3,706	11,477	518	15,701	3,513	11,769	419
1978	6,166	16,405	870	23,441	4,786	17,947	708
1979	6,688	19,961	1,115	27,764	7,009	19,837	918
1980	8,493	26,797	2,167	37,466	8,530	27,044	1,892
1981	11,242	35,140	4,352	50,734	11,968	35,544	3,222
1982	14,316	39,558	5,133	59,007	13,698	40,995	4,314
1983	15,977	41,432	5,332	62,741	14,734	43,313	4,694
1984	18,392	41,634	2,666	62,692	14,872	43,018	4,802
1985	15,873	38,467	2,456	56,805	13,097	38,752	4,956
1986	13,862	39,056	2,762	55,680	13,072	37,641	4,967
1987	13,097	46,781	3,604	63,482	15,207	42,833	5,442

Source: Bahrain Monetary Agency Quarterly Statistical Bulletin, 1988
Gulf Co-operation Council in Figures, 1988/1989, National Bank of Kuwait publication, December 1988, p. 32

Table 5.15 provides a clear picture of the success of Arab banks headquartered in Bahrain. Many observations can be drawn from the table. Firstly, while the annual growth rate of assets of all OBUs operating in Bahrain during the period 1983-1986 was -3.8 per cent, the annual growth rate for Arab banks' assets was 7.3 per cent for the same period. Although the period in question was generally one of decline in the Bahraini offshore market, due to political uncertainty and low oil prices, these figures suggest that foreign OBUs were more affected by the recession than Arab banks.

Secondly, Bahraini-based Arab OBUs accounted for a major portion of the total market. Their market share denoted by their total assets, has been steadily growing from only 20 per cent in 1976 (BMA, 1979), to 36 per cent in 1983 and to almost 50 per cent in 1986. This indicates the growing importance of the Arab banks operating in Bahrain, which appears to have occurred at the expense of the foreign OBUs. Considering that between 1983-1986, the number of Bahraini-based Arab banks accounted for less than 20 per cent of total OBUs operating in Bahrain, their overall share of 43 per cent for that period is, by any standards, remarkable.

The success of Arab OBUs is mainly attributed to the growth of the largest two Gulf banks operating there, namely Arab Banking Corporation and Gulf International Bank. Assets held by these two banks accounted for almost 33 per cent of the total during the period 1983-1986. The picture becomes clearer when considering that Arab Banking Corporation, for example, witnessed a growth rate of total assets of 26 per cent in 1984, while during the same year some well-known foreign banks such as Continental Illinois had to pull out of Bahrain.

Table 5.15 The share of Bahrain-based Arab OBUs in the total offshore market in Bahrain*, 1983-86

	1983		1984		1985		1986		1983-1986
	1	2	1	2	1	2	1	2	2
Arab Banking Corporation	8.76	14.0	11.06	17.6	13.07	23.0	14.58	26.2	20.0
Gulf International Bank	7.44	11.9	7.42	11.8	7.74	13.6	8.01	14.4	12.9
Arlabank International	1.72	2.7	1.85	3.0	1.70	3.0	1.65	3.0	2.9
Gulf Riyad Bank	1.27	2.0	1.19	1.9	1.07	1.9	0.86	1.5	1.8
Bank of Bahrain & Kuwait	0.86	1.4	0.83	1.3	0.77	1.4	0.65	1.2	1.3
Bahrain Middle East Bank	0.39	0.6	0.57	0.9	0.56	0.9	0.50	0.9	0.8
Kuwait Asia Bank	0.45	0.7	0.57	0.9	0.65	1.1	0.49	0.9	0.9
Al-Ahli Commercial Bank	0.37	0.6	0.43	0.7	0.44	0.8	0.39	0.7	0.7
Bahrain International Bank	0.27	0.4	0.29	0.5	0.32	0.6	0.35	0.6	0.5
United Gulf Bank	1.29	2.1	1.13	1.8	0.50	0.9	0.31	0.6	1.4
Total**		36.4		40.4		47.2		49.9	43.0

Sources: Arab Gulf Journal Supplement, 1984
MEED (various issues)
Annual reports
Bahrain Monetary Agency Statistical Bulletin, 1987

Notes: * Some Bahraini-based Arab banks have been excluded from the table either because their share is insignificant or because of lack of data
** Figures may not add up due to rounding

Key: 1 Total assets US $ billion
2 Market share (%)

There is very little doubt that the success of Arab banks operating in Bahrain, is largely attributed to the experience they gained by working with and competing against other well-known western banks. Foreign OBUs operating in Bahrain have been the main source of transmitting financial technology into the region. As mentioned earlier, Arab banks have benefited greatly from the financial expertise and the supporting industries that exist in Bahrain. This, in turn, has enhanced their ability to operate internationally, by providing their management with the experience they previously lacked.

Because most Arab banks had their first experience in regional and international financial operations by being situated in Bahrain, the island has, in many ways, been an 'eye-opener' for such banks to operate internationally.

If we apply the volume of syndicated lending lead-managed by Arab Gulf banks as a proxy for their internationalisation, the advantages and importance of the offshore centre to these banks becomes even clearer, as Table 5.16 illustrates.

The table indicates the growing importance of Bahrain to Arab international banks that are headquartered in Manama. The share of these banks of the total syndicated loans managed by the Arab Gulf banks, grew steadily since the inception of the offshore market until 1981. This growth was, naturally, at the expense of other Arab Gulf banks, whereby in 1981, for example, the Bahraini-based Arab international banks managed more syndicated loans than all other Gulf banks put together. Since 1981, however, the share of the Bahraini banks declined marginally from 53 per cent to about 45 per cent in subsequent years. This reflects certain measures that were taken by the Saudi and Kuwaiti monetary authorities, as will be explained later in this chapter.

Table 5.16 The share of Bahraini-based Arab banks from the total syndicated lending led-managed by all Arab Gulf banks, 1978-84

	GCC			Bahraini-based Arab banks as a % of total GCC banks
	Bahrain	Other	Total	
		US$ billion		
1978	0.20	0.89	1.09	18
1979	0.23	0.82	1.05	22
1980	1.14	0.75	1.89	60
1981	2.85	2.53	5.38	53
1982	3.56	3.70	7.26	49
1983	2.23	2.98	5.21	43
1984	1.87	2.22	4.09	46
Total	12.08	13.89	25.97	47

Source: Calculated from Nakhjavani, 'Arab banks at the cross-roads', Middle East Economic Survey, 1985

It can be argued that the existence of the offshore banking centre and the international operations of Arab banks are interdependent. As mentioned earlier, Arab banks have benefited greatly by being present in Bahrain. Equally, Bahrain as an offshore centre would not have reached its status without the existence of Arab banks. Indeed, the rapid growth that the OBU market witnessed in the early 1980s, is mainly due to the increasing number of Arab banks on the island. The arrival of the giant banks such as Arab Banking Corporation and Gulf International Bank with their huge capital bases, has moved Bahrain a step closer to becoming an unchallenged financial centre in the Middle East. Although these banks have branches in most financial centres, particularly London and New York, the establishment of their head offices in Bahrain is a clear indication of the growing importance of Bahrain as a financial market for the Arab World. This point is clearly illustrated in Table 5.17.

Table 5.17 Banks with offshore licences in Bahrain, selected years, 1978-86

Numbers

Year	Developed countries	Banks with Middle East capital*	Others	Total
1978	25	13	4	42
1980	31	22	11	64
1986	27	27	14	68

Source: Bahrain Monetary Authority, *Annual Reports* (various issues)

Note: * Including Arab consortium banks

As can be seen from this table, the decline in the number of banks from developed countries is associated with an increase in the number of banks with Middle Eastern capitals. This can lead to the conclusion that Arab banks operating in Bahrain are gaining in confidence and gradually replacing Western banks on the island. Between 1984-1986, for instance, 6 foreign OBUs, 10 representative offices and an investment bank left the island altogether. One of the most influential banks to leave Bahrain, was Lloyds Bank. According to the bank's management, the withdrawal from Bahrain was primarily due to the banks' inability to engage in any retail banking from Bahrain, and to the rapid decline in the syndicated loan market (MEED, 20 December 1986).

5.3.11 The weaknesses of Bahrain as a financial centre

The discussion in this paper so far has concentrated on the growth of Bahrain, the success of OBUs and the importance of the offshore centre to the Arab banks. This section will deal with the major weaknesses and disadvantages of Bahrain as a financial centre. They are as follows:

1 One of the major weaknesses of Bahrain as a financial centre, is that it has not followed the international trend of securitisation, whereas this trend has been evident in every other well-known financial centre in the world. Dealing in such bonds as certificates of deposit, floating rate notes, treasury bonds and treasury notes is relatively inconsistent in Bahrain. With the increasing importance of eurobonds, as will be seen in Chapter 7, for Bahrain to develop into a full service financial centre, efforts must be made to develop a capital market, particularly as the main capital market in the region (Kuwait) is effectively closed to foreigners.

2 Bahrain is a relatively expensive base for banking operations. This is due to the fact that, in general, 45 per cent of the total employees are expatriate staff in senior positions (Table 5.12). According to the BMA statistics, the total expenditure

of OBUs in 1978, was US $53 million; this figure was more than three times higher in 1981, as it soared to $161.4 million. Naturally, the number of OBUs had risen during that period, from only 42 in 1978, to 58 in 1981. However, the rise in expenditure was far higher than that of the number of OBUs. For instance, it is estimated that staff salaries, housing and other similar expenses account for between 50 and 72 per cent of banks' annual budgets.

3 Bahraini OBUs are already unpopular in Kuwait, the UAE and Saudi Arabia. The authorities in these countries could make the future of Bahrain as a financial centre uncertain because, as mentioned earlier, the bulk of the regional currencies invested in Bahrain come from such neighbouring countries.

Saudi Arabia has already taken some measures to reduce the overexposure of their currency and to give the Saudi Arabia Monetary Agency (SAMA), which acts as a central bank, more control over domestic liquidity. These measures are:

- To prevent the internationalisation of the riyal, SAMA has made it a prerequisite that its permission be obtained for domestic Saudi banks to invite offshore banks to participate in riyal syndications for Saudi clients. In practice, however, permission for such operations is rarely granted. Therefore, this action by SAMA has effectively excluded OBUs from riyal syndications within Saudi Arabia, consequently encouraging OBUs to concentrate more on the foreign currency components of Saudi syndications.

- By withholding 15 per cent of the interest rate that Saudi clients pay on a riyal loan from an offshore bank in Bahrain, SAMA has effectively added about 0.5 per cent to the real borrowing cost of Saudi corporations. Thus, these corporations find it cheaper to borrow riyals from Saudi local banks than from an OBU in Bahrain. This action by SAMA has given Saudi banks a competitive edge over the OBUs in Bahrain.
- Furthermore, SAMA has introduced special instruments to attract excess liquidity and keep it largely under SAMA's control. Such instruments as the Bankers' Security Deposit Accounts (BSDAs) provide Saudi banks with local short-term investment opportunities as a substitute for investment in the Bahrain offshore market.

Kuwait has taken similar action to reduce its bank activities in the Bahraini market. In 1979, the Central Bank of Kuwait imposed exchange control restrictions and liquidity requirements. According to this action by the Kuwaiti central bank, deposits of more than one month, held outside Kuwait, are not regarded as liquid and are, therefore, liable to the 25 per cent mandatory liquidity ratio.

4 One of the major weaknesses of the Bahraini offshore banking centre is that it did not provide the long-term finance that some of the countries in the Middle East region need. The short-term operations in Bahrain accounted for over 60 per cent

of the total, as mentioned earlier. Therefore, it can be argued that the offshore centre in Bahrain, although it offers many advantages, is still only a temporary solution to the many problems that face local countries and financial markets.

Finally, it has been argued by many Arab bankers and wealthy customers that, the creation of the offshore banking centre in Bahrain may have discouraged the growth of Islamic banks in the area and therefore, such banks were prevented from playing a major role in the development of the Gulf region. While this may be true in the short-term, where Islamic banks found it difficult to compete with these offshore banks initially, it can be argued that the offshore market in Bahrain did not affect Islamic banks directly, due to two main reasons; firstly, Islamic banks are relatively recent in the Middle East, with the exception of Egypt, and therefore these banks will require many years of experience before they can carry out the duties and offer the services that are offered by the OBUs in Bahrain. Secondly, it is almost impossible for Islamic banks to find alternatives for some of the services that are offered by the OBUs, simply because these services include the use of interest which is strictly forbidden by Islamic law, as mentioned earlier.

5.4 THE FUTURE

In just over a decade, Bahrain has become one of the most important offshore financial centres in the world. The emergence of this centre coincided with the decline of Beirut which was, until 1975, the leading financial centre in the Middle East. Bahrain also took full advantage of the excess money available in the region following the first oil price increase in 1973-74. Furthermore, the policies of nationalisation adopted in neighbouring Saudi Arabia and Kuwait greatly helped the cause of Bahrain in establishing an offshore centre. The political isolation of Egypt was another factor, at a time when Cairo had been on the point of emerging to replace Beirut.

Since 1984, however, the Bahraini offshore centre has been on the decline. A combination of factors has been responsible for this. The depression in syndicated lending all round the world has hit almost all offshore centres, but Bahrain has been the one most affected. This is due to the fact that the centre in Bahrain is dominated by Arab banks, and syndicated lending makes up an average of about 50 per cent of total operations run by these banks, as will be seen in Chapter 7.

The decline in oil prices since 1984, has affected the whole of the Middle East region, and Bahrain is no exception. Although its economy does not rely so heavily on oil revenues as those of other states in the region, lower oil revenues have led to the slowing down of most development plans in neighbouring countries. These plans include industrial and agricultural projects that had previously brought a great deal of business to Bahraini OBUs.

The various measures that were taken by several Gulf countries such as Saudi Arabia, Kuwait and Qatar, as mentioned earlier, to eliminate the use of their currencies in Bahrain, have, no doubt, played a role in the recent decline of Bahrain as an offshore financial centre in the Gulf region.

The future of the offshore centre in Bahrain will depend largely on the political stability in the region: with the recent Gulf war between Iraq and Iran in mind, any similar hostilities could seriously damage business in the Arab Gulf region.

The last two factors combined have already led many banks to reduce their representation in Bahrain to the minimum level or even to leave the island altogether. This has been the most severe threat to Bahrain as a financial centre, so far.

If a boost similar to that experienced in the Middle East during the 1970s, is to occur again, Bahrain should concentrate more on competing with other major centres in Europe and the Far East, not only for the recycling of oil revenues, but also for international banking business, particularly that related to trade and industrial links with the Middle East.

Being a collecting offshore centre is a good starting point, but for the Bahraini offshore market to survive, it should concentrate on the still wealthy private sector and attract more Gulf surpluses than has been the case so far.

Bahrain can only succeed in the long-term if efforts are taken now to ensure that the financial market of Bahrain has the variety of financial instruments and institutions to satisfy the needs of the Arab governments and private sectors. Establishing a capital market in Bahrain to complement the operations of the financial market, is an important step that should be given priority.

Bahrain has been rightly criticised for its inability to adapt to the changes that are taking place in the international financial markets. The most important of these changes is the shift from syndicated lending to securitisation. The creation of a sophisticated capital market in Bahrain would be an assisting factor that could speed the adaption of the financial market of Bahrain to the challenge of securitisation.

The existence of the offshore centre is vital for the international operations of Arab banks. For these banks to provide financial expertise and to be analysts, they will have to concentrate on building Arab financial markets. Bahrain has proved to be a successful base for the regional and international operations of most Gulf banks. It can safely be argued that through establishing their head offices in Bahrain, the larger international banks have developed sophisticated management techniques that are necessary for their international operations. Bahrain is the unchallenged candidate to emerge as the leading financial market in the Middle East, with all the advantages it offers. The future of Bahrain rests with Arab banks; they will have to make full use of Bahrain, either as a financial market or as a banking centre, and capitalise on the experience and sophistication of the financial facilities in Bahrain.

As long as the Gulf remains a developing area and generates financial surpluses, Bahrain will have considerable potential. The distinct time zone of the Middle East means that there will always be a need for a financial centre there. It is unlikely that there will be more than one important financial centre in the Middle East because of the concentration of wealth in the underpopulated oil producing Gulf states and the limited absorptive capacity in these states; Bahrain seems to be the natural place to occupy such a role.

Bahrain has shown great determination to grow, despite the political unrest in the Middle Eastern region. This is a positive indication of the importance and the value of the Bahraini offshore market.

CHAPTER 6

CAPITAL MARKETS IN THE ARAB GULF REGION

6.1 INTRODUCTION

There was little need for capital markets in the Gulf during the 1970s, a period that generated a massive volume of wealth, whether to governments or to individuals. The existence of sophisticated international capital markets, such as London, New York and Tokyo, with relatively high yields and a variety of financial instruments, made it very difficult for Gulf capital markets to emerge. For them to have had any success, they would have had to compete with the best and the very well-established capital markets in the world in terms of yields, currencies, maturities and a variety of services offered. This, by any measure, is not an easy task; even the once successful capital markets in the Gulf region found it difficult to absorb such wealth and at the same time maintain stock prices at an acceptable level for small investors.

The depression in the region in recent years, however, has created more need for capital markets than ever before. With greater moves towards diversification of the sources of income away from oil exports, industrialisation and large private sector participation in various countries in the region have been encouraged. This necessitates an urgent need for efficient utilisation of savings; capital markets have a very important role to play in this process. Therefore, with the decline in oil revenues in the region, the efficient utilisation of savings is undoubtedly becoming a major issue for the Gulf countries and establishing capital markets is a step in the right direction. These markets would not only help to channel direct investments towards the highest yielding projects, but more importantly, they would be able to attract part of the region's savings from abroad.

Because of the lack of well-developed financial and capital markets in the Gulf region during the boom years in the 1970s, commercial banks accummulated massive amounts of foreign assets. In the six Gulf countries, commercial banks' foreign assets witnessed a growth rate of almost 500 per cent, from just over US $8 billion in 1976 to US $48.5 billion in 1986, as shown in Table 6.1. It is clear from the table that with such enormous assets held abroad, Arab commercial banks prefer the risk/return ratios that prevail in international financial markets, particularly in the West, in preference to domestic investments. The only way that these banks would transfer their foreign assets into the domestic market would be if alternatives that at least matched those offered elsewhere were available domestically.

The same argument applies to the foreign investments of the Gulf governments, with aggregate balance of payments surplus for the six Gulf countries between 1975-84, for example, of US $266 billion. These two examples suggest that investable funds are available in the region. The availability of profitable outlets that successful capital markets may provide could channel these funds to boost economic development.

The next section in this chapter will be to analyse the capital markets in the region. This includes the Kuwaiti bond market and stock exchange, the Bahraini stock exchange and the stock exchange in Saudi Arabia.

Table 6.1 Foreign assets* of the Arab Gulf commercial banks, 1976-86

US $ million

	Saudia Arabia	Bahrain	UAE	Qatar	Kuwait	Oman	GCC Total
1976	2,348	480	2,574	382	2,352	44	8,180
1977	3,218	566	2,077	457	2,936	96	9,350
1978	3,484	635	2,584	577	4,468	107	11,855
1979	5,487	628	3,557	681	5,155	196	15,704
1980	9,693	851	5,286	733	6,933	403	23,899
1981	15,625	913	7,914	1,205	7,980	467	34,104
1982	17,753	952	9,548	1,271	7,797	557	37,878
1983	17,848	1,250	9,538	1,334	7,865	827	38,662
1984	18,808	1,159	12,101	1,726	8,235	903	42,932
1985	19,385	1,561	12,070	1,919	7,715	681	43,331
1986	23,146	1,847	13,476	1,983	7,455	597	48,504

Source: Banking and Finance in the Arab Middle East, AMF publication, 1987

Note: * Includes gold reserves, foreign currencies, deposits with foreign banks and foreign investments

6.2 KUWAIT AS AN INVESTMENT CENTRE

In contrast to Bahrain, which has established itself as the most important offshore banking centre in the Middle East, Kuwait has focused upon establishing itself as an investment centre in the region. As a financial centre, Kuwait differs from other Gulf Middle Eastern countries in that its banks, though limited in number when compared to those of Bahrain and Lebanon, are entirely Kuwaiti owned and, until the 1980s, concentrated primarily on domestic business which has grown rapidly and profitably.

Kuwait also differs from other financial centres in the area in the fact that it has the largest concentration of investment banks and investment banking management in the Gulf region. As a result it has become the investment banking centre of the Middle East, with the main financial institutions playing an important regional role in the arranging of finance for domestic and international borrowers. The oil price increase in 1973 has, no doubt, immensely helped the establishment of most of the investment institutions in Kuwait. For example, the Industrial Bank of Kuwait was established in 1974; the Kuwaiti Real Estate Consortium in 1975; the Financial Group of Kuwait and the Arab European Consortium in 1975; the Financial Group of Kuwait and the Arab European Financial Management Company in 1976. These new institutions coupled with the already established Kuwaiti Investment Company (KIC), 1961, Kuwaiti International Investment Company (KIIC), 1973, and Kuwait Foreign Trading Contracting and Investment Company (KFTCIC), 1965, which are better known as the 3Ks, helped greatly in developing Kuwait's medium-term capital market. In addition to the 3Ks, there are at least 15 smaller private investment companies in Kuwait.

Kuwait also differs from other Gulf countries by the fact that it has a well-developed banking system. Its largest bank, the National Bank of Kuwait is ranked among the top 200 banks in the world in terms of total assets and profitability. Unlike banks in Bahrain and the UAE, Kuwaiti banks enjoy a confortable existence due to the fact that no foreign banks have been permitted to operate in the country. This is reflected by the large amounts of inflows and outflows of funds managed by the Kuwaiti financial institutions since the early 1960s, as Table 6.2 shows.

As the table illustrates, the two oil price increases of 1973 and 1979, created the high growth rate in the volume of outflows of funds that are exclusively managed by the Kuwaiti financial institutions. There was a 107 per cent increase in total outflows following the first oil price increase and a further 70 per cent increase following the second oil price increase. These massive outflows combined with other factors, such as the very wealthy private sector and the availability of well-developed financial institutions, have assisted Kuwait in establishing the first capital market in the Arab region, and in becoming an important investment centre.

Another assisting factor was the stability of the KD. Until 1975, the KD was tied to the US dollar and remained within the IMF's 2.25 per cent margin on either side of parity. In March 1975, however, due to the depreciation of the US dollar on the foreign exchange market which resulted in the devaluation of the KD against the currencies of several major trading partners, the Kuwaiti authorities decided to set the value of the KD on the basis of the values of a weighted average of trade related currencies. The

Kuwaiti government does not disclose the composition of the basket of currencies, nor the prospective weight associated to each currency.

Table 6.2 Financial flows managed by Kuwaiti financial institutions, 1961-84

US $ billion

Period	Imports	Aid	Workers remittances	Private investment	Total outflows	Total export
1961-73	7.0	1.4	1.5	1.5	11.4	20.2
1974-78	16.7	4.4	1.7	4.1	26.9	49.1
1979-84	41.3	6.0	4.1	4.3	55.7	89.8
1961-84	65.0	11.8	7.3	9.9	94.0	159.1

Sources: Total exports and imports are from Foreign Trade of Arab Countries, Arab Monetary Fund Publication, 1987 (Arabic). The rest from Naiem Sherbing, Arab Financial Institutions and Developing Countries, World Bank Staff Paper no. 794, series on International Capital and Economic Development no. 6, 1985

The movement of the KD, however, has been closely linked to the US dollar which suggests the dominance of the US dollar in the basket. This dominance of the US dollar is inevitable giving that most of Kuwait's exports are oil or oil-related industries and priced in the US dollar. The other major currencies are believed to be of those countries that enjoy strong trade links with Kuwait; Japan accounted for an average of 24.4 per cent of Kuwait's total imports for the period 1980-85, followed by the United States with

12 per cent, West Germany with 10.6 per cent and the United Kingdom with 7.6 per cent.

Dealing in KD is confined to Kuwait and to a much lesser extent to the offshore market in Bahrain where a forward market in Gulf currencies is firmly established; the KD accounts for 1 per cent of all regional currencies traded in Bahrain. This is due to the protective policies adopted by the Kuwaiti monetary authorities to prevent the internationalisation of the KD, as already mentioned in Chapter 5.

Historically the US dollar/KD interest rate differentials have been mostly positive and have played a very important role in triggering capital outflows from Kuwait. The relatively stable KD/US$ exchange rate, as seen in Table 6.3 has moved the exchange risk element from investing in US dollars rather than in KD, and allowed speculators to benefit from the higher US dollar interest rates.

Table 6.3 Kuwaiti dinar exchange rate against the US dollar and other major currencies, 1980-86

	1980	1981	1982	1983	1984	1985	1986
KD/US$	.27130	.28186	.28901	.29256	.30365	.30908	.29203
KD/£	.64732	.53258	.46516	.41897	.35489	.32687	.42201
KD/DM	.13832	.12430	.12130	.10655	.09743	.09000	.14421
KD/FF	.06011	.06162	.04285	.03477	.03173	.02927	.04383
KD/SF	.15419	.15525	.14429	.13380	.11824	.10643	.16990
KD/100 yen	.13384	.12711	.12116	.12537	.12255	.11837	.18930

Source: Gulf Economic Financial Report, no. 11, vol. 1, December 1986

6.2.1 The KD bond market

The Kuwaiti bond market is the most developed in the Middle East. Since 1968 when the market was established, there have been more than 80 KD denominated eurobond issues. The borrowers, generally, are large foreign companies, banks and government agencies from a wide range of countries.

The development of this market has been rapid since its establishment. By 1980, it had reached a total float of bonds in excess of US $1.6 billion. In the period between 1968-73, the World Bank effected six private placements in KDs to the amount of KD 130 million. In 1974, the first internationally publicly quoted issue was launched by KICC, followed by eight more in 1975, 13 in 1976 and the highest number of bond issues came in 1978, as Table 6.4 illustrates.

One of the most important features of the Kuwaiti bond market was the diversity of the investors. About 30-40 per cent of all bond issues between 1968-78 were bought by foreign investors. This was mainly due to the high return of the KD denominated bonds during that period. But the picture changed by the end of 1979, following the Kuwaiti central bank's decision to distinguish between lending in the local Kuwaiti market and the foreign markets. As a result the cost of lending to foreign markets went up by 2 per cent compared to local markets. The main reason for this action was to prevent the internationalisation of the KD. This led many foreign companies to liquidate their KD denominated bonds. Inevitably, the demand on these bonds went down dramatically, and with supply of these bonds still unaffected, prices went down.

Table 6.4 KD denominated bond issues, 1974-87*

	Number of issues	Amounts (US$ million)
1974	1	17.05
1975	8	163.79
1976	13	259.92
1977	7	108.16
1978	16	454.38
1979	13	383.50
1980	1	25.90
1981	5	121.95
1982	8	184.09
1983	4	105.80
1984	2	78.80
1985	1	34.60
1986	1	41.10
1987	2	180.50

Sources: Arab Capital and Financial Markets, AMF publication, 1985
Gulf Financial Markets, GIB publication, 1988

Note: * June 1987

To limit the supply of the KD bonds, the central bank imposed, in November 1979, a moratorium on further bond issues. This action was taken to restore public confidence in these bonds at a time of increasing illiquidity in the domestic short-term money market. The disparity between the domestic interest rate and those prevailing in other international financial markets, was the main reason behind the outflow of capital and, thus, created severe liquidity problems in the Kuwaiti money markets during 1979-80, as will be explained later. However, the ban on new bond issues was lifted in August 1980, though certain measures were imposed to limit these issues. One such measure was that each issue should not exceed KD7 million (US $25.6 million) and, furthermore, no more than 3 issues should be permitted in any 2 month period. This explains the rapid decline in the market from 13 issues in 1979 to only one issue in 1980. Activities in the market have been proceeding quietly since 1982. All issues during 1984 and 1985 went to domestic borrowers; no new KD eurobond issues came to the market during those two years.

A secondary market for KD bonds only emerged in 1977, when a new company, Arab Company for Trading Securities (ACTS) was created by KIIC, which owns 65 per cent of the company, and The Industrial Bank of Kuwait (with 35 per cent). The main reason for the creation of ACTS was to make KD bonds more liquid and, thus, more attractive to investors. The second aim was to promote and develop a viable secondary market for fixed income securities in Kuwait.

A special feature of the eurobond market in Kuwait is that investors can subscribe to new issues in either KD or the US dollar and may opt for interest and redemption capital to be paid in US dollars instead of KD. The advantage of such issues is that by giving the KD bonds holders the choice to receive interest in an international currency such as the US dollar, this market will appeal to international borrowers. One of the major handicaps to face KD bonds was, and to some extent still is, the government's monetary policy, the major feature of which is the direct controls by the central bank on interest rates, whether for borrowing or lending. Instead of leaving market forces to determine interest rates, the Kuwaiti authorities have set ceilings on these rates, as Table 6.5 shows.

Table 6.5 Maximum interest rates for KD loans, 1977-86

Type of loan	Maximum interest rate (% per annum)
Short-term loans to domestic economic sectors (trading, manufacturing, industry)	7.0
All other short-term loans (excluding overnight call deposits)	8.5
Time deposits (with a minimum of 45% on saving deposits)	10.0
All other loans in KD	10.0

Source: Central Bank of Kuwait publication, June 1987

The range of maximum interest rates shown in the table are based on religious and political principles rather than on a market determined range. As mentioned earlier in Chapter Two, according to strict Islamic law which strongly applies in Kuwait, usury is forbidden. Therefore, the central bank may consider that 10 per cent is the absolute maximum interest rate that could possibly be permitted in an Islamic society.

The rigid interest rates structure operating in Kuwait until early 1987, when a more flexible system was introduced, proved to be ineffective mainly because residents have free access to foreign markets where rates obtainable may be at exceptionally high levels. The ineffectiveness of this policy was apparent during 1979 and 1980, when the Kuwaiti money markets suffered from severe lack of liquidity. The outflow of funds from Kuwait was primarily caused by the private sector borrowing Kuwaiti dinars at low interest rates and investing the funds abroad at higher returns. Consequently, there was very little inflow of funds to the market, as foreign investors found the market unattractive. The situation was the same for Kuwaiti commercial banks. They found it more profitable to place their funds in the eurodollar interbank market, rather than the Kuwaiti dinar interbank or lending domestically as can be seen from Table 6.6.

Table 6.6 KD and eurodollar interest rates differentials, 1980-87*

Year	3 months KD interbank	3 months eurodollar interbank	US$/KD**
1980	14.88	17.62	+2.74
1981	9.25	13.75	+4.50
1982	5.88	9.19	+3.31
1983	7.31	9.81	+2.50
1984	8.88	8.69	-0.19
1985	6.25	7.94	+1.69
1986	7.00	6.31	-0.69
1987	6.62	7.06	+0.44

Source: Kuwait & GCC, Economic and Financial Bulletin, National Bank of Kuwait publication, no. 11, Fall 1987

Notes: * June 1987
** Positive for US$ rates higher than KD rates, and negative for KD rates higher than US$ rates

6.2.2 Assessment of the KD bond market

The KD bond market is, as mentioned earlier, the most advanced one in the Arab region whether in terms of the number of issues or their values. Since its establishment, there have been over 86 KD eurobond denominated issues, with a value of just under US $3 billion. In 1979, for example, this market was ranked the third in the world after the US dollar or the Deutschemark bond markets. From 1974 to 1981, the Kuwaiti investment and other financial institutions offered international bonds to the amount of US $1.47 billion to borrowers in more than 15 countries throughout the world. These activities were dominated by the 3Ks, the international network of which is shown in Table 6.7.

Table 6.7 KD international bond issues managed by the 3Ks, 1974-82

KD million

Region	Number of issues	Amount	% of total
1. Arab region	13	99.5	39.1
2. Africa	1	5.0	2.0
3. Asia	6	43.0	16.9
4. Latin America	11	78.0	30.6
5. Eastern Europe	6	29.0	11.4
Total	37	254.5	100.0

Source: KICC Annual Report, 1983

Notes:
1. Algeria, Morocco, Tunisia and Sudan
2. African Development Bank
3. Korea, Philippines and Indonesia
4. Mexico, Brazil and Panama
5. Yugoslavia and Poland

Internationally, the early activities of the 3Ks largely concentrated on international financial instruments with diversified term structure, such as bank deposits, paper and notes, and medium-term loans. These instruments averaged about 70 per cent of the Kuwaiti investment assets during the early to mid-1960s. Since the late 1960s the 3Ks, particularly KIC, started underwriting eurodollar bonds for prime OECD countries, such as in Latin America, the Middle East, Africa and the Far East. As Table 6.7 reveals, over 60 per cent of all KD bond issues went to international borrowers in different countries.

Initially, because of the small size of the market, most KD bond issues were smaller than issues found in other sectors of the eurobond market. Typically, bond issues between 1974-86 varied from KD 5-10 million; there were no KD bond issues during that period in excess of KD 10 million. But as the market developed in early 1987, and foreign borrowers were allowed to tap the market, principal amounts increased, reaching KD 30 million (US $111 million) in the latest KD international bond issues for the World Bank.

Maturities have also been extended from an average of 7 years during the period 1974-86, to 12 years in 1987.

It follows from the previous discussion that the KD bond market has been a success, though not as successful as the Kuwaiti authorities had originally hoped. The market was much needed by the Gulf Arab countries in general, and by Kuwait in particular. The market was originally set up specifically for the development of the Kuwaiti surplus in financial instruments denominated in Kuwaiti dinars, and was not intended to include non-Kuwaitis as investors. But as the market developed, other instruments denominated in currencies other than the KD were adopted. Between 1979-1983, for example, KD bonds accounted for only 22 per cent of the total as Table 6.8 illustrates.

Table 6.8 **Total bond issues by the 3Ks for the period 1979-83**

US$ million

Institution	Bonds	US$ FRNs	KD bonds	Other*	Total
KIC	668.2	246.6	274.5	436.3	1625.6
KFTCIC	203.1	69.3	202.8	305.2	780.4
KIIC	184.8	133.0	269.2	408.1	995.1
Total	1056.1	448.9	746.6	1149.6	3401.2

Source: Nakhjavani, Arab banks and the international financial markets, MEPEP, Nicosia, 1983

Note: * includes French francs and Deutschemarks

The KD bond market offers many advantages both to borrowers and investors. One of the most important advantages is the stability of the KD against major currencies. The market has not experienced the fluctuation in value witnessed by almost all international capital markets. Furthermore, following the central bank's moratorium in 1979, as mentioned earlier, the limited volume of KD bonds has resulted in increasing their value by about 9 per cent in subsequent years, in addition to the 10 per cent annual yield. Finally, a major attraction of the KD bond market has been its relative cheapness when compared with other instruments.

However, there are certain disadvantages associated with the KD bond market. The market is relatively small compared to other international bond markets in the west. Even when compared to bond markets in other developing countries, such as the Asian bond market in Singapore, the KD bond market is relatively small with a far more fluctuating growth rate, as Table 6.9 shows. It ought to be mentioned that such a comparison may not reflect the true nature of the two markets due to the different economic and political conditions prevailing in the two countries. However, the table does provide an insight to the development of the two bond markets that are considered to be among the leading markets in developing countries.

Table 6.9 Total value of Asian dollar bond issues compared to KD bond issues*, 1975-83

	KD bond issues		Asian dollar bond issues	
	Total value (US$ million)	% growth	Total value (US$ million)	% growth
1975	163.8	-	47	-
1976	259.9	58.7	266	466.0
1977	108.2	-58.4	363	36.5
1978	454.4	320.0	403	11.0
1979	383.5	-15.6	358	-11.2
1980	25.9	-93.2	659	84.1
1981	122.0	371.0	1,238	87.9
1982	184.1	50.9	1,018	-17.8
1983	105.8	-42.5	1,145	12.5

Sources: For KD bond market as in Table 7.4.
Figures for the Asian market are from Daiwa Singapore Limited

Note: * Bond issues of both markets have been converted to the US dollar to facilitate uniformity in comparison

Because of the restrictions placed on the market by the Kuwaiti authorities, the KD bond market was unlikely to gain wide international appeal. The closure of the market to foreign investors effectively eliminated this market from becoming a permanent investment and lending centre.

Another obstacle facing the KD bond market has been the lack of a well-developed secondary market. Although a secondary market was established in 1977, as mentioned earlier, KD bonds were not listed in the Kuwaiti stock exchange until 1985, although they have been listed on other markets such as London and Luxembourg since the late 1970s.

6.3 OTHER BOND MARKETS

Among the other Gulf countries, only Bahrain has a small primary bond market for Bahraini dinar (BD) denominated bonds. This market was opened in 1977, with very small and infrequent bond issues. Due to the small number of issues and the absence of an active secondary market, very little trading has been recorded in these bonds during the last decade.

However, through the offshore banking centre, Bahrain does possess an active secondary market in other eurobond issues, mainly those for Gulf offshore companies denominated in KD, and certain other well-traded international bonds.

In Saudi Arabia, a very small Saudi riyal (SR) bond market existed until 1978, when SAMA imposed a moratorium on SR bond issues. Since then the needs of local Saudi borrowers in eurobonds have been met by major Saudi banks and OBUs in Bahrain.

There are no effective bond markets in the UAE, Qatar and Oman.

6.4 STOCK MARKETS

A stock market is a market where securities can be traded. This market usually consists of a new issue market, which is essential for financial institutions to allocate new securities, and a secondary market, which consists of brokers and dealers to facilitate the trading of securities.

The importance of stock markets stems from the fact that their performance influences the financial affairs of a considerable proportion of the population. They also affect the national economy, since these markets provide information to facilitate effective decisions in production activities (Wong, 1986).

The need for such markets in the Arab Gulf region stems from their ability to enhance the growth of enterprise through offering entrepreneurs access to funds. Furthermore, since the production sectors in the Gulf region suffer from the lack of long-term funds which are necessary for project financing, the creation of an effective secondary market would facilitate the financing of long-term investments by short-term funds.

Among the GCC countries, only Kuwait has an official stock market with a centralised system of trading, although there are signs that Bahrain and Oman might develop their own stock markets before the 1990s.

6.4.1 The Kuwaiti stock exchange

Stock exchange operations in Kuwait date back to as early as 1952 with the creation of the National Bank of Kuwait, which was the first shareholding company, and by 1962, nine more companies had been established. Since then the number of shareholding companies has increased rapidly, and by early 1988 there were 47 Kuwaiti companies and eight non-Kuwaiti Gulf companies in the market. The Kuwaiti stock exchange was given a boost during the 1970s following the massive increase in oil revenues, which resulted in the accumulation of wealth in the private sector. Given the limited investment opportunities in Kuwait and the Arab Gulf region, investment in shares and bonds was highly desirable at that time.

Thus, during the 1970s, there was an unprecedented demand on shares by the private sector, not as a long-term investment, as the Kuwaiti monetary authorities had originally planned, but as a means of acquiring a quick profit. Shares traded in the Kuwait stock exchange for the period 1975-85 are shown in Table 6.10.

According to the figures published by the London Stock Exchange, measured by the total value of shares traded (with an average turnover of KD 4.5 million per day), the stock market in Kuwait stood eighth in the world in 1978 and 1979, and was ranked twelveth in 1980 and 1981.

In 1973, there was a remarkably large volume of Kuwaiti shares traded in the stock exchange. The newly found wealth in the country resulted in many small investors entering the market for the first time with very little knowledge of trading principles or of the market mechanism. As a result the number of shares issued rose from 11 million in 1971, to 21.3 million in 1973. This was followed by a noticeable drop in 1974, due to the increased dealing in post-dated cheques and the rise of many speculative activities in the market. One way of reacting to the low level of dealings (and in order to restore share prices), was to limit the supply of these shares. The Kuwaiti monetary authorities reacted by introducing a ban on the

Table 6.10 **Total shares dealings in the Kuwaiti Stock Exchange, 1975-85**

million stocks

	1975	1976	1977	1978	1979	1980	1981*	1982*	1983	1984	1985
Banks	6.7	7.8	2.4	66.0	81.9	47.7	30.5	33.6	12.9	8.4	18.9
Investment	26.2	50.6	15.4	42.2	24.4	24.5	42.8	25.6	10.2	2.9	0.85
Insurance	0.4	0.7	0.2	0.7	3.4	1.1	1.4	3.9	1.8	0.11	0.19
Industry	73.7	63.7	16.0	32.3	22.7	14.8	40.5	39.0	16.2	2.3	5.9
Real estate	26.6	23.6	12.7	4.5	7.9	23.7	34.0	9.4	3.2	-	-
Services	0.7	0.7	0.7	7.7	5.5	9.3	47.8	10.6	5.3	2.5	11.2
Food	27.9	29.1	7.1	20.6	23.1	22.7	49.8	40.1	11.9	4.5	3.8
Total	172.2	176.2	60.0	173.7	168.9	143.7	246.8	162.2	61.5	20.7	40.8

Sources: Kuwait Chamber of Comemrce & Industry (various issues)
Central Bank of Kuwait Quarterly Statistical Bulletin (various issues)

Note: * The market value of traded stocks was US $3.4 billion in 1981 and US $6.4 billion in 1982 usage of post-dated cheques in the stock market. Although this ban was lifted in 1977, many other measures were taken to encourage dealings in the stock exchange. One of these measures was to cease the establishment of new public shareholding companies. Furthermore, to inject liquidity in the market, the government of Kuwait started buying the shares of private companies in large numbers. For example, between December 1977 and April 1978, the value of total shares bought by the government exceeded KD 150 million (US $545.3 million).

Initially, although these two measures were designed to encourage the private sector to deal with shares through the stock exchange, they did not prove to be very effective. While there was a ban on establishing new companies, as mentioned earlier, many Kuwaitis started creating offshore investment companies in other Gulf states, where no such restrictions existed. In 1978, with the newly created offshore centre in Bahrain, there was a rise in the number of new investment companies formed offshore by Kuwaiti businessmen. For example, when the Bahraini based Gulf Investment Company invited subscribers for a total issue of US $25 million, applications totalled more than US $30 billion. It was later found that there had been 30,000 subscribers, all of whom were Kuwaiti nationals. The establishment of such companies, which was encouraged by the oil price rise in 1979/80, led to the creation of the unofficial stock exchange parallel to the stock market, called Souk Al-Manakh, in which shares of these companies were traded. Consequently, the period between 1979-82, witnessed a tremendous influx of currency into the market with trading in shares reaching a record high level. This period was, not surprisingly, characterised by increased speculative activities in the market with share trading in many cases commencing even before the company's founding procedures were completed. Most of the operations were financed by post-dated cheques. Dealers on the Al-Manakh began dealing with these cheques with longer and longer post-dating as mutual liabilities increased, and at increasing premiums, as speculation increased prices and therefore future expectation of profits.

Although there is no precise figure of the total value of operations involving the use of post-dated cheques, it was estimated by the Central Bank of Kuwait to be around US $94 billion (Financial Times, 12 October 1983).

Two important developments occurred in 1982; firstly, the share prices grew rapidly to reach very unrealistic levels. Naturally, this resulted in a noticeable drop in the demand for these shares, as Table 6.10 shows. Secondly and most importantly was the refusal of banks to accept the post-dated cheques that fell due in early 1982. This witnessed the beginning of the Souk Al-Manakh collapse; the market was effectively closed in mid-1982.

It should be mentioned within this context, that some forms of dealings known in the Kuwaiti stock exchange, and which are almost unique to this market, contributed largely to the use of post-dated cheques. One of the most important types of such dealings is 'forward dealing'. This form of dealings was a major feature of the Kuwaiti stock exchange during the boom period in the mid-1970s and early 1980s. The basic procedure for such dealings is that two dealers come to an agreement for a forward deal at an agreed price, which is normally a premium on the current market price. The usual rate is around 25 per cent premium for a maximum of 12 months delivery, with proportionate rate for three or six months. The procedure is that the seller delivers the shares at once and receives in return a post-cheque for the amount due.

In general, two reasons were responsible for the Souk Al-Manakh collapse in 1982. The narrowness of the official stock market compared to the size of domestic liquidity, led investors to look for new opportunities which Souk Al-Manakh helped to satisfy. Furthermore, speculation in the market and allowing claims to be settled by post-dated cheques, resulted in share prices rising to unusually high levels and in a very large influx of currency into the market, which overwhelmed existing regulations. In some cases share prices in Souk al-Manakh were bid up to 15 times their par value (Seznec, 1987).

The effect of the Souk Al-Manakh crisis on the banking community in the Gulf generally, and on Kuwait in particular, was very damaging. This was particularly true for the large Kuwaiti and Bahraini banks that were involved in lending large amounts to Kuwaiti speculators. Seznec (1987) argues that the collapse of the Arab Asian Bank was due to its large exposure to Al-Manakh trader. Since 1972, for example, Kuwaiti banks experienced a cumulative assets rise from KD 800 million to almost KD 10 billion in 1983. Since the last quarter of 1983 and in 1984, however, commercial banks' total assets have been on the decline, as Table 6.11 shows. One can see that after many years of steady growth, commercial banks' total assets registered a growth rate of only 9.3 per cent in 1983 compared to 20.4 per cent in 1982 and to 34.5 per cent in 1981. Furthermore, during 1984-85, and for the first time, Kuwaiti commercial banks witnessed a negative growth rate in their total assets, of -4.1 and -5.6 per cent respectively. It must be mentioned in this context that a combination of factors contributed to the decline in assets and profitability of almost all commercial banks in the Gulf region; such factors like declining oil revenues, and a general downturn in the regions' economies, as will be seen in Chapter 7. For Kuwaiti commercial banks, however, the stock market collapse was an additional crucial factor that contributed to their poor performances. As a direct result of the crash, Kuwaiti banks have been making provisions against possible future losses and in many cases they have written off loans worth hundreds of millions of KDs to customers who have officially been identified as insolvent. There is no precise figure on the numbers of bad loans in Kuwait following the Souk al-Manakh collapse, but it has been estimated by various sources that these loans may have amounted to as much as US $7 billion. Furthermore, central banks' figures for 1983 showed an overall increase in private deposits of only 4.87 per cent, compared with a growth rate of 7.17 per cent in 1982 and 37.5 per cent in 1981. Commercial banks balances with the central bank, together with their purchases of central banks' bills, fell by almost 35 per cent. The direct effect of Souk al-Manakh on the banking community in Kuwait and Bahrain was that, large loans were made by these banks to investors involved in the Souk al-Manakh. The majority of these loans were secured by pledges on Gulf shares and by mortgages on land. The Souk al-Manakh collapse resulted, among other things, in the collapse of the real estate market in Kuwait. Hence, the banks that held such assets as collateral, were left with no security against their loans.

Table 6.11 Total assets of Kuwaiti commercial banks, 1976-86

KD million

	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
Reserves	92.4	271.0	122.7	143.3	221.7	321.6	625.9	372.5	323.0	329.9	288.0
Currency	7.9	10.4	11.3	13.6	17.4	18.8	22.7	24.3	19.7	24.0	25.1
Central banks deposits	84.5	260.6	11.4	129.7	204.3	302.8	603.2	248.2	303.3	205.9	362.9
Foreign assets	674.9	822.4	1214.4	1407.7	1880.1	2245.1	2251.1	2301.2	2507.2	2229.6	2179.1
Claims on private sector	934.3	1236.7	1564.1	2123.6	2767.5	3459.0	4277.7	4743.1	5035.8	5052.5	5154.3
Loans and discounts	849.3	1073.2	1374.5	1917.5	2418.6	3172.8	3897.3	3844.3	4108.9	4198.5	4312.6
Other assets	137.4	264.6	377.3	617.3	870.8	1572.9	1991.6	2577.4	1719.6	1441.3	1684.2
Total assets	1839.0	2594.7	3278.5	4291.9	5649.1	7599.0	9146.3	9994.2	9586.0	9053.3	9305.6
% change	41.4	41.1	26.4	30.6	31.6	34.5	20.4	9.3	-4.1	-5.6	2.8

Source: Central Bank of Kuwait Annual Report, 1987

What made matters worse for these banks was their policy of concentrated lending, as mentioned in Chapter 2. It was found that during the years leading to the crisis, the Kuwaiti banks had lent over KD 500 million to their directors and their relatives (MEED, 4 January 1986).

The Souk Al-Manakh crisis also affected the Kuwaiti government's foreign investments. Some US $7.3 billion of investment assets had to be liquidated to help pay for the various schemes arranged by the government to assist the private sector in overcoming this crisis. Inevitably there was a fall in investment revenues of about 15 per cent in 1983 and 9 per cent in 1985.

The most damaging effect of the Manakh crisis, was the shake of confidence of investors, whether local or foreign, in the stock exchange. This was reflected in the massive fall in share prices. The indexes of Gulf shares and of real estate companies had soared from about 500 in late 1981 to 1,050 in May 1982. In addition, the index of bank shares had grown from 300 in March 1980 to 950 in May 1982 (Arab Banking and Finance, July 1982). After the Souk al-Manakh collapse, however, share prices declined by about 50 per cent in 1983, and a further 60 per cent in 1984. Furthermore, the number of shares traded in the official stock exchange declined rapidly, from 247 million shares in 1981 to just over 20 million shares in 1984. This crisis occurred at a time when the stock exchange was much needed to promote linkages between economic and monetary activities to achieve national economic growth targets. A successful stock exchange would have been able to achieve these targets by fostering productive co-operation among monetary and financial institutions, and the productive economic sectors of the country.

The Manakh crisis coincided with the global move towards the securitisation of debts. In fact, this factor could be used to partly explain the shortcomings of Arab international banks in the eurobond market. While these banks, particularly the Kuwaiti investment financial institutions, achieved prominence and an international status in the eurobonds during the late 1970s and early 1980s, whereby they constantly appeared amongst the top fifty banks in the world, their eurobonds activities had been in rapid decline since the Manakh crisis. The decline continued until 1986, when the 3Ks were ranked among the top Arab international banks in the eurobonds market, as will be seen in Chapter 7. The recovery in the 3Ks activity in the eurobonds market was a direct result of the major efforts by the Kuwaiti authorities to revive the activities in the KD eurobond market and the stock exchange. Many measures were taken by the Kuwaiti government to combat the crisis.

The first of these measures, which was designed to restore share prices, was for the government to buy most of the shares in the market through its agencies. By 1987, the Kuwaiti government owned over 25 per cent of total shares in the market.

It was made obligatory for the dealers and brokers to record full details concerning any operation involving the use of post-dated cheques. Furthermore, to restore confidence in the market the authorities decided in 1986, to liquidate 21 Gulf companies in which the Kuwaiti government had a majority holding.

To prevent the manipulation of share prices and exploiting of insider information, and to facilitate the clearing process of securities traded, a clearing house was established to ensure that market contracts were transacted according to existing laws and regulations.

To attract smaller investors to the stock market, public companies' shares were divided into smaller units worth one tenth of their original face value.

These measures introduced by the Kuwaiti authorities came to fruition in 1986, which was considered to be the best year for the Kuwaiti stock market since 1982. The market value of Kuwaiti company shares grew by more than 50 per cent to reach over US $10 billion in 1986. The revival continued in 1987, whereby share values rose by a further 35 per cent in the first half of 1987.

6.4.2 The Saudi stock exchange

Outside Kuwait only Saudi Arabia has had an official stock exchange. Prior to the opening of the official stock market, buyers and sellers of stock were informally put in touch with unlicensed stockbrokers. The low volume of tradings in recent years and the reduced liquidity in the market resulted in lowering the number of stock brokers from 45 in 1978 to only six in 1984.

The Souk Al-Manakh collapse of 1982 alarmed the Saudi authorities to the existence of the informal system of shares trading in the kingdom. As a result, stock trading, which lacked any form of regulations, was put under the control of SAMA in April 1983. A regulatory committee was set up to supervise and control stock dealings in Saudi Arabia. The most important steps taken by the committee were to ensure that brokerage activities would be confined exclusively to a commercial bank in the kingdom; furthermore, to avoid a recurrence of the Manakh crisis, forward dealings and the acceptance of post-dated cheques were prohibited.

This system, however, did not operate as smoothly as the Saudi authorities had hoped. Firstly there was very little co-operation among banks. Secondly, the system was time consuming; dealing in shares and the registration of transfers would often take up to two months or more. The elimination of the unofficial stockbrokers that the authorities hoped the new system would bring about, did not happen. On the contrary, delays in executing operations through the banks often forced investors to refer to the traditional brokers whether for advice or for providing quick liquidity.

To overcome these problems a new computerised system was introduced, and for the first time an official stock market existed in the kingdom. The market was formally opened in May 1987 and was closed within one month due to technical reasons. However, shares and bond dealings in Saudi Arabia are still carried out by banks. Only shares of Saudi Arabian companies can be traded in the country. There has not at any time been any provision made for the shares of Gulf companies to be officially traded in the kingdom.

By the end of 1987, there were 48 companies whose shares were traded in Saudi Arabia with a total paid-in capital of US $11.34 billion as Table 6.12 shows.

The popularity of share tradings in Saudi Arabia began in the boom period between 1975-80, following the oil price increases of the 1970s. The most important flotations during that period were those of the industrial and the financial sectors. As far as the financial sector is concerned, that period witnessed the nationalisation of the banking industry (as mentioned in Chapter 2). Seven joint venture banks were nationalised and their shares were traded in the market. These new nationalised banks were considered economic gains of the kingdom, and to distribute this new acquired wealth to the public, the Saudi authorities insisted that these shares be offered at par value which is far below the actual value of the shares. As a result, the sale of the nationalised bank shares was largely oversubscribed. This indicates the willingness of the Saudi public to invest domestically, given the right investment opportunities.

Table 6.12 Total shares dealings of Saudi shareholding companies, 1987-88*

Sector	Primary flotation		Number of** shares issued (mn stocks)		Total paid-in capital (US$ bn)	
	1987	1988	1987	1988	1987	1988
Financial	10	11	17.6	20.8	0.48	0.57
Industrial	17	17	87.1	87.1	2.99	2.99
Services	15	17	297.5	306.9	7.55	7.66
Agriculture	6	7	17.0	18.5	0.32	0.33
Total	48	52	419.2	433.3	11.34	11.55

Source: Consulting Centre for Finance and Investment (CCFI) database

Notes: * September 1988
** Excluding issues made for capital expansion between 1987 and September 1988

Like the Kuwaiti stock market, the Saudi market lacks depth, as can be seen from Table 6.13. The table shows the Saudi stock exchange is largely inactive, primarily because there are not enough buyers and sellers to make a continuous and steady market. During 1988, total shares traded in the stock exchange averaged less than half a per cent of total available shares. This, by any measure, indicates a very low percentage in relation to the amount of private wealth available to the public and private sectors in the Kingdom.

Table 6.13 Percentage of shares traded weekly to the total tradeable shares in the Saudi stock exchange (selected weeks, January-September 1988)

Weeks ending on	Number of shares traded weekly	% of traded shares to the total
21.1.88	149,299	0.035
4.2.88	120,410	0.028
28.4.88	167,760	0.040
26.5.88	164,328	0.039
23.6.88	244,475	0.058
7.7.88	200,392	0.047
25.8.88	207,436	0.049
8.9.88	173,066	0.041

Source: Arab Banker, vol. viii, no. 5, September/October 1988, p. 21

There are many reasons for the thinness of stock trading in the market. The most important of these reasons is the large share of the government in the total shares of joint stock companies. In 1986, for example, the Saudi government held around 54 per cent of total shares; therefore, the number of tradeable shares in the market was confined to those shares held by individuals, which only accounted for 38 per cent. Table 6.14 illustrates this point clearly.

Table 6.14 Estimated ownership of shares in Saudi joint stock companies, 1986

Sector	Government	Banks and retirement fund	Foreign ownership	Individuals	Others
Banking	0.1	3.4	39.4	57.1	0.0
Industrial	15.0	7.5	5.8	70.5	1.2
Services	71.3	3.6	-	25.1	0.0
Agriculture	6.3	6.7	-	86.7	0.3
Total	54.1	4.5	2.9	38.2	0.3

Source: Saudi Arabian Monetary Agency, Statistical Bulletin, 1987

Even amongst individuals, the concentration of ownership of shares is in a few hands. With the declining market in recent years, the few individuals who accounted for the majority of share holdings have been reluctant to sell.

However, the new trading system, although short-lived, has proved to be successful in establishing a good base for stock and bonds trading in Saudi Arabia.

6.5 FUTURE PROSPECTS

The prospects for establishing capital markets among the Gulf countries are excellent. The region generates more savings than any other region outside the OECD countries. Such savings, particularly among the private sector are essential for the success of any capital market. The Gulf region has overcome many of the constraints that are responsible for delaying or even preventing the establishment of capital markets in other developing countries. Historically, the establishment of such markets has been severely limited by factors like exchange controls, currency fluctuations, and regulations. The first two factors have caused few problems for the Gulf countries. There is no exchange control amongst the six Gulf countries and the currencies of the region have been relatively stable against the major international currencies as previously mentioned.

Currency stability in the region is a big advantage for GCC countries, and might prove to be a very significant step towards establishing a regional capital market in the Gulf. The importance of currency stability stems from the fact that it eliminates currency risks, which is a very important factor for investors.

However, it is the regulatory framework which exists among the Gulf countries that is partly responsible for the lack of well-developed capital markets and investment centres in the region. As a result of different legislations concerning the establishment of such markets, the existing capital markets in the Gulf are mainly confined within national boundaries. When studying the Kuwaiti and the Saudi capital markets, the differences in regulations become apparent. While the success of the Kuwaiti capital market is attributed mainly to the effective assistance and encouragement by the authorities, to prevent the internationalisation of the riyal, Saudi Arabia actively discouraged the development of a capital market in the kingdom. Both markets, however, are highly regulated and in comparison to other well-known markets, have a small number of shareholding companies and offer a service of limited attraction to local or international investors. Trading in these markets is still relatively undeveloped and unsophisticated even when compared to other markets in the third world, such as the Asian capital market in Singapore. The deregulations of capital markets worldwide are unlikely to take place in the Gulf region in the near future. The concern over a repetition of the deregulated Souk Al-Manakh has called for tighter regulations which will still be enforced until the tensions caused by the Manakh crisis have been completely defused.

Many other factors are affecting the development of capital markets in the Gulf. As mentioned earlier, the high volume of stocks held by the governments of the region have left the market with a small number of tradeable shares, usually held by individuals, and even within the private sector the shares are traded by a small number of people who account for the majority of shares ownership; this is particularly true for Saudi Arabia. An important feature of the Saudi stock market is that the number of shareholders has been on the decline in recent years. In 1981, for example the Saudi-based Arab National Bank had nearly 29,000 shareholders, while five years later and after the stock became available in the secondary market the number of shareholders declined to only 8,900. This concentration of shares ownership has meant that a small number of people can determine market conditions.

Another factor affecting the Gulf capital markets has been the small number of shareholding companies in the market. This factor can be attributed to many reasons. Firstly, many companies in the Gulf are owned by families who have been reluctant to go public and lose control over their companies. This is evident through the Gulf, where business behaviour is deeply rooted in customs and traditions which are resistant to public participation. Secondly, the absence of proper commercial law in some Gulf countries, has discouraged the development of specialised financial institutions that are necessary for capital market operations. The lack of expertise is reflected in the lengthy procedures for companies wishing to go public. In many instances it could take about two years to bring a new issue to the market.

Other factors also negatively affecting the development of Arab capital markets, such as the scarcity of readily available and accurate information concerning investment opportunities, and the exclusion of non-nationals from buying shares in most Gulf countries (notably Kuwait and Saudi Arabia), have further discouraged the development of these markets.

One of the major problems facing the capital markets in the Gulf is that they have not risen to the challenge of securitisation. The lack of bond issues, certificates of deposits, treasury bills and other debt instruments in almost all Arab countries (with the possible exclusion of Kuwait) has been responsible for Arab capital markets lagging behind most international capital markets.

A study of the economic efficiency of the stock exchanges operating in the Arab Gulf region is not possible due to the low level of securities traded in these exchanges and the lack of available data. For such a study to be compiled, a wide base of data is needed; such data as share price changes, and daily opening and closing share price over a period of time, but such data concerning the Gulf stock exchanges is not readily available. Therefore, one can draw only on broad lines and rely on broad efficient market theories. Basically, in an efficient stock market, relevant information should be reflected in stock prices. Therefore, no investor can make excessive profits by exploiting any special information (Wang and Ho, 1986). If this indicator is applied to the Arab Gulf stock exchanges, the inevitable result would be that they are inefficient. This is largely due to the fact that shares traded in these exchanges are greatly oversubscribed, as already mentioned. Furthermore, the region's exchanges (particularly the Kuwaiti stock exchange) have been, until recently, of a speculative nature, where the majority of investors are driven by the desire to gain quick profits, rather than viewing the stock exchanges as a genuine investment opportunity.

In conclusion capital markets are much needed in the Gulf region, particularly at a time of lower oil prices and slower economic growth than were experienced during the boom years of the 1970s. Apart from the obvious effects that a well-developed capital market would have on the economic development of the region, its effects on Arab international banks would be immense. These banks have a very important role to play as intermediaries between sources and uses of funds for the whole region. The ability of Arab international banks to compete in regional and international markets will depend largely on the development of Arab capital markets. Such markets would very much facilitate the Arab-to-Arab lending and could play a major role in transforming the international operations of Arab banks into regional operations. This will not only benefit Arab international banks, but also Arab deficit countries in the sense that the transfer of funds between surplus and deficit countries in the Arab world would by-pass the eurocurrency market. This would be the first major step towards achieving economic and monetary independence in the region, a goal that all Arab countries have been eager to achieve for more than half a century.

The discussion on this chapter leads to the conclusion that contrary to the general belief that Arab Gulf nationals prefer to invest their saving in the international financial markets of London and New York, rather than in domestic markets, the fact that almost all the shares that were available for trading, were largely oversubscribed, has meant that Arab investors are willing to invest their funds locally, provided that a variety of reliable investment instruments exist in these markets. Furthermore, it would be beneficial for Arab investors to buy local shares and bonds even if the risk/return of these shares slightly favours foreign equities; by investing in local currencies, Arab investors could avoid the exchange risks involved in foreign currencies' investments.

After the experience of the Souk al-Manakh, however, it will take Arab investors, particularly those that seek long-term investment, a long time to trust such domestic securities markets.

CHAPTER 7

ARAB BANKS IN THE EUROMARKETS

7.1 INTRODUCTION

The aim of this chapter is to discuss the international operations of Arab banks. Particular emphasis will be placed on the involvement of the international Arab banks in the eurocurrency syndications and the eurobond markets.

Eurocurrency syndications are loans denominated in a currency other than that of the country in which the lending institution is located. *Eurocurrency loans originated in the early 1960s*, where they were almost exclusively fixed-rate loans to sovereign borrowers. The market of eurocurrency syndicated lending has witnessed a rapid growth over the last fifteen years. It exceeded US $70 billion in 1980, compared to a market worth US $9 billion in 1972. The number of financial institutions active in this market rose from 133 in 1972 to around 300 in 1977, and further to 386 in 1980. In the early 1960s and 1970s, the new entrants to the eurocurrency syndicated lending market were mainly western European and Northern American financial institutions. Since the mid-1970s, however, Latin American and Asian banks have entered the market in great numbers. In terms of the number of financial institutions involved in the market, data published by the World Bank in 1986 revealed that Arab banks have been amongst the most successful new entrants into these markets. Between 1972-80, for example, Arab Middle Eastern financial institutions increased their presence from less than one per cent in 1972 (with only one Arab bank involved in these markets) to over eight per cent in 1980, with 31 Arab banks entering the market. Furthermore, between 1977-79 there were more Arab banks entering the eurocurrency syndicated loan market for the first time, than of any other nation in the world. Table 7.1 shows the growing importance of Arab banks in terms of total participating institutions and total loan participations.

7.2 ARAB BANKS IN THE EUROCURRENCY SYNDICATED LENDING MARKET

It is only recently that Arab banks have become seriously involved in the euromarkets, particularly in the eurocurrency syndicated loan market which is sometimes called the euroloans market. Prior to the late 1970s, the activities of Arab banks in the Euroloans market were dominated by Arab consortia banks and the sums involved were considered to be insignificant in relation to the total size of the market. By 1978, however, Arab banks had gained a strong position and built a good reputation in these markets. In the early 1980s, aided by the experience they gained through consortia banks, and the emergence of the newly established large Gulf banks, they reached the stage where they could effectively begin to compete with some of the well-established Western banks. The establishment of the large, highly capitalized Gulf banks in the late 1970s and early 1980s, has greatly enhanced the presence of Arab banks in international financial markets. The success of banks like the Arab Banking Corporation and Gulf International Bank is evident from the fact that in a short time, they managed to take a large share of syndicated lending away from Arab consortia banks. In 1977, for example, 70 per cent of all syndicated loans lead-managed by Arab banks were attributed to Arab consortia banks, while

Table 7.1 Financial institutions* participating in the syndicated loan market and the number of loans managed, by nationality of participants, 1972-80

Year	United Kingdom		United States		Japan		Arab		Other **		Total	
	No of banks	No of loans	No of banks	No of loans	No of banks	No of loans	No of banks	No of loans	No of banks	No of loans	No of banks	No of loans
1972	18	65	31	136	17	51	1	1	66	159	133	412
1973	24	106	40	239	21	99	2	5	19	271	178	720
1974	20	113	41	346	17	37	4	5	125	522	207	1023
1975	18	127	46	503	7	14	8	23	156	741	235	1408
1976	19	156	46	653	13	32	14	27	146	801	256	1669
1977	18	207	43	658	18	97	22	60	187	1109	288	2131
1978	18	280	49	749	24	355	34	156	202	1467	327	3007
1979	19	357	50	613	24	466	29	124	225	1839	347	2399
1980	18	416	54	657	24	258	31	205	259	2187	386	3723

Source: Risk in International Lending, Group of Thirty, New York, 1982

Notes: * Includes consortia
** This group includes Western Europe, Canada, South America, Africa, Asia and Oceania

in 1980 their share declined to only 30 per cent; Gulf banks accounted for the remainder.

By concentrating on the eurocurrency syndicated loan market, Arab banks achieved prominance, so that during the late 1970s and early 1980s Arab banks have been featuring among the top 100 international banks that have been most active lead managers in the syndicated lending market. Among the Arab banks that have consistantly appeared alongside American and Western banks since 1980, were the Arab Banking Corporation, Gulf International Bank, National Bank of Kuwait, National Commercial Bank of Saudi Arabia and National Bank of Bahrain. By 1983, there were 15 Arab banks among the top 100 lead managers in the syndicated loans market.

There is no doubt that the establishment of the offshore centre in Bahrain in 1975, has given Arab banks in general, and Gulf banks in particular, a massive boost in their international activity, whereby, by 1980, Bahrain had become the centre of Gulf banks' syndicated lending, as already mentioned in Chapter 5.

The growth of Arab banks in the euromarkets is represented in Table 7.2. As the table shows, between 1977-82, Arab banks witnessed a very rapid growth in their syndicated lending activities. The turning point came in 1983, when the Arab banks' share of the total market began to decline for the first time since 1977. During that year Arab banks lead-managed syndicated loans of US $7.1 billion, a decline rate of almost 35 per cent from 1982 where they reached their peak level of euroloan activities with a volume of US $10.8 billion. This decline continued during 1984 and 1985 with a total lending of US $5.98 billion and US $4.71 billion repectively. The overall share of Arab banks' euroloans from the total syndicated lending market was also on the decline from the peak level of almost 13 per cent in 1982 to 11 per cent in 1984.

Table 7.2 Arab banks in the eurocurrency syndicated loan market, 1977-85

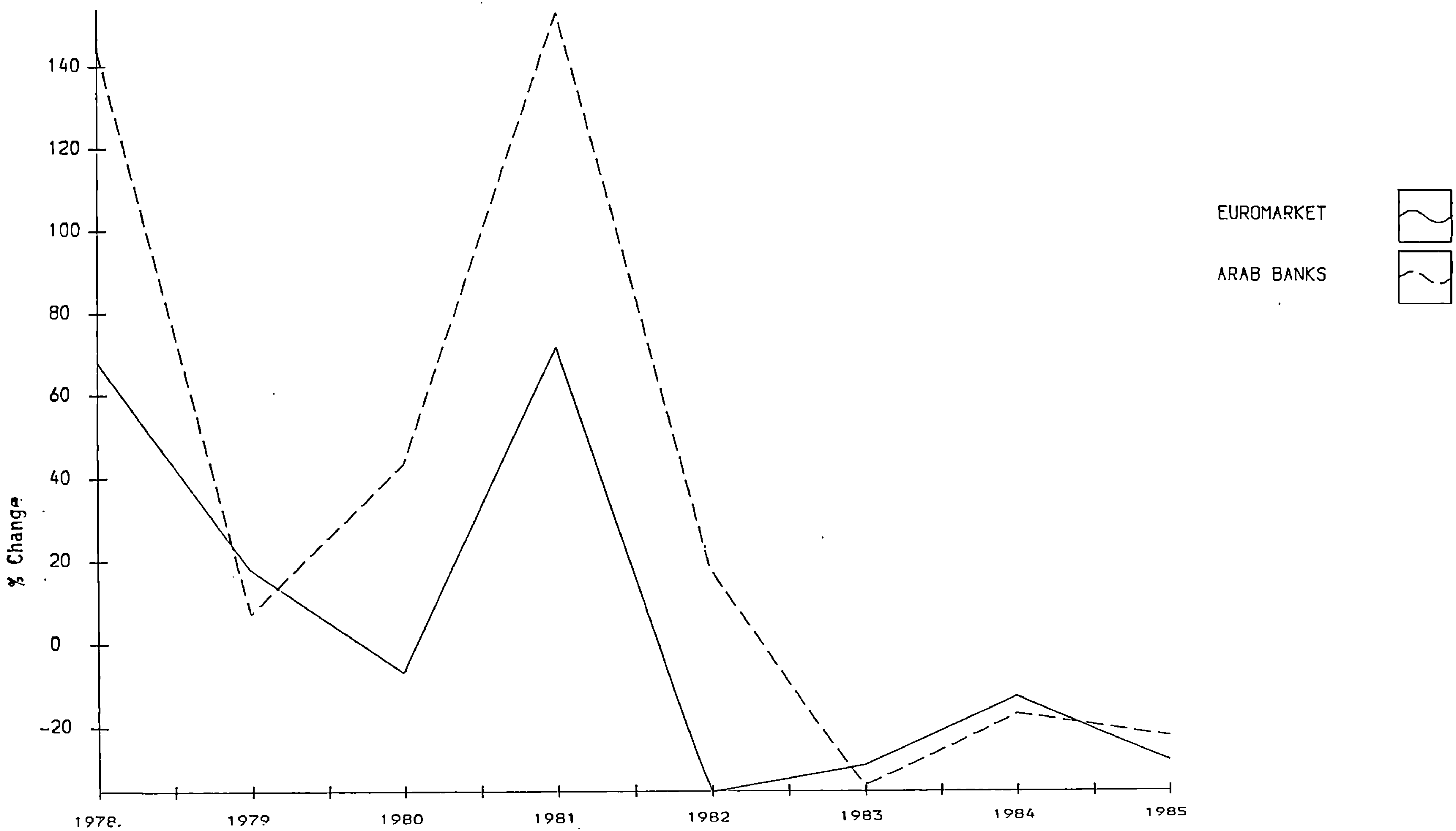
	US $ billion		%
Year	Total eurocurrency credits	Arab banks total	Arab banks share
1977	41.47	0.95	2.29
1978	70.40	2.32	3.30
1979	83.10	2.49	3.01
1980	77.39	3.59	4.64
1981	133.40	9.10	6.82
1982	85.21	10.80	12.67
1983	70.20	7.10	10.11
1984	53.70	5.98	11.14
1985	39.00	4.71	12.08

Sources: Euromoney Syndication Guide, Euromoney International Annual reports (various issues)
Euromoney International Capital Markets Annuals, 1980-1986
Morgan Guaranty Trust Co., World Financial Markets, June 1984 and September 1986

However, the performance of Arab banks seems to match that of the euromarkets in general, as Figure 7.1 reveals. This figure is based on the annual change of the performance of Arab banks in the euroloan market, compared to that of the whole of the euromarkets for the period 1978-85. This figure reveals that although Arab banks, generally followed the ups and downs of the euromarkets, several differences arise between the two. The first noteable difference between the two, is that changes in the Arab banks' performance in the syndicated lending market are much sharper than

Figure 7.1

Growth Rate of Arab Banks' syndicated Lending Compared to the Whole of the Euromarkets,1978-1985



those of the euromarkets. The high increase of 1978, with a growth rate of over 140 per cent in Arab banks' syndicated lending occurred mainly because of the fact that in the year leading to 1978, the share of Arab syndicated loans was negligible. Therefore the year 1978 may be regarded as the most important year in Arab banks' activities in the euromarkets. By 1979, Arab banks seemed to be well-established in these markets and therefore followed a general trend of modest growth rate of almost 7.3 per cent, compared to 18 per cent for the whole of the euromarkets.

The second sharp rise occurred in 1981; while the euromarkets incurred a growth rate of over 72 per cent compared to 1980, Arab banks showed a growth rate of 153 per cent. Furthermore, although the euromarkets experienced a downturn of almost 7 per cent in 1980, Arab banks experienced a growth rate of 44 per cent. These differences can be explained as follows: firstly, many European banks retreated from the syndicated lending arena, opting for the flourishing eurobond market instead. In 1981, for example, nearly 610 banks participated as lead managers in the euroloan market compared to 520 banks in 1982, and further to only 251 banks in 1983.

Secondly, there is very little doubt that the most important reason behind the sharp rise in Arab banks' syndicated lending was due to the fact that many Arab banks entered the euromarkets for the first time in 1980 and 1981. A prime example of such banks is the Arab Banking Corporation, which was established, as mentioned earlier, in 1980. This bank alone contributed to a sizeable proportion of the international operations of Arab banks. In its second year of operations, Arab Banking Corporation lead-managed more syndicated loans than any other Arab bank, whereby its share of the total euroloans lead-managed by all Arab banks amounted to 17 per cent.

Among the other new entrants contributing to the sharp growth of Arab banks' syndicated lending in the euromarkets were, National Bank of Bahrain, Bank of Bahrain and Kuwait and the Commercial Bank of Kuwait.

The third noticeable difference between the euromarket syndicated loan as a whole and the Arab syndicated loans, occurred between 1983 and 1985. Up to 1983, as mentioned earlier, Arab banks were generally performing, in terms of lending, far better than the euromarkets. The average growth rate of Arab banks' euroloans amounted to 73.6 per cent for the period 1978-82, compared to a euromarket growth rate of only 23.4 per cent for the same period.

Between 1983-85, however, the collective performance of Arab banks in the euroloan market incurred a downturn of almost 24 per cent, which was for the first time since 1979, below that of the euromarket, with a growth rate of -22.8 per cent. There are a number of reasons responsible for this decline, which affected all international banks. Such factors like the Latin American debt crisis of 1982, which forced almost every international bank to rethink its lending policies in terms of margins, maturities and geographical placements. The occurrence of the Latin American debt crisis coincided with the growing importance of the thriving eurobond market. Not surprisingly, many of the well-known international banks decided to diversify away from the syndicated lending business, to the eurobonds, with the American banks leading the way, followed closely by the Japanese banks which have achieved prominance in these markets in recent years.

The intense competition amongst international banks to attract good quality borrowers is another reason for the decline of the eurocurrency syndicated loan market. In many cases, the margins on loans to creditworthy borrowers were so narrow (as can be seen from Table 7.3) that they provided very little profit. This made the euroloan market unprofitable for many banks, in particular those that lacked experience and staying power. This inevitably led to a great number of banks abandoning the euroloan markets altogether. It is apparent from Table 7.3, that spreads were narrowing over the last few years, from 65 basis points for OECD borrowers and 85 basis points for OPEC borrowers in 1983, to 39 and 44 basis points for the two groups in 1986. The most noteable feature about Table 7.3 is that the narrow spreads led to a decline in the volume of lending by the same proportion. The fall of Arab banks' syndicated lending in 1983 and 1984, however, appears to follow a sizeable contraction in euromarket lending as a whole. That period also reflected a levelling out of early growth which many Arab banks experienced in their assets during the mid-1970s and early 1980s, as will be seen later. Moreover, the financial difficulties that were experienced by many Arab borrowers (mainly due to lower oil prices) provided another reason for the decline of the Arab banks' share of the total euroloans market.

However, despite the many obstacles that have faced Arab banks in recent years, in general they have been far more successful than most other banks in the euroloan market. They experienced an average annual growth rate in the euroloans over the period 1978-85

Table 7.3 Volume, spreads*, and maturity of international bank loans 1983-86

Borrowers	1983 Volume US$ billion	1983 Spreads basis points	1983 Maturity years	1984 Volume US$ billion	1984 Spreads basis points	1984 Maturity years	1985 Volume US$ billion	1985 Spreads basis points	1985 Maturity years	1986** Volume US$ billion	1986** Spreads basis points	1986** Maturity years
OECD	32.0	65	7.8	28.7	55	7.4	19.3	41	7.3	9.3	39	6.10
Eastern Europe	1.0	118	4.5	3.0	88	5.11	4.5	55	7.5	1.2	26	7.10
OPEC	7.3	85	7.2	3.0	76	7.7	3.0	72	6.11	1.7	44	8.9
Other LDCs	24.9	170	7.0	19.8	144	8.11	13.1	99	9.1	2.8	71	7.9

Source: Financial Market Trends, OECD Publication no. 34, June 1986

Notes: * Weighted average of spreads applied to loans of US $30 million and over, with a maturity of more than three years completed or signed during the period

** January-May

of over 37 per cent, which accounts for more than six times the average growth rate of the whole of the euromarkets, for the same period.

This was the overall picture of Arab banks in the eurocurrency syndicated loan market. The next section will concentrate on the individual operations of Arab banks in these markets. Table 7.4 shows that the Arab banks most involved in euromarkets are The Arab Banking Corporation, Gulf International Bank, the UBAF Group and to a lesser extent, National Commercial Bank of Saudi Arabia, the Arab Bank of Jordan and the Saudi International Bank. The first two have been the most successful Arab banks in the euromarkets with their strong capital base, compared to other Arab banks, enabling them to manage deals larger than any other Arab bank can prudently handle. As a result, their activities within the euroloan market have been dominant. Between 1981-85, Arab Banking Corporation and Gulf International Bank contributed to almost 32 per cent of all euroloans lead-managed by Arab banks. This is an impressive record by any standard, considering that the Arab Banking Corporation was only established in 1980. Furthermore, even outside the Arab region these two banks have almost always appeared in the top 200 banks in the world, in terms of total assets. In 1983, for example, they were ranked 16th and 21st in the world, respectively. Arab Banking Corporation lead-managed more syndicated loans during 1983, than many well-known and experienced international banks such as Lloyds Bank International, Morgan Grenfell Bank, Mitsubishi Bank and Standard Chartered Bank. There is no doubt that the prominent position of these banks in the offshore centre of Bahrain has helped them a great deal in achieving this status.

Table 7.4 Syndicated lengint by Arab banks*, 1976-85

US$ million

Lead Managers	1976-77	1978	1979	1980	1981	1982	1983	1984	1985
Arab Banking Corporation	-	-	-	387	1584	1410	1179	1017	590
National Bank of Kuwait	-	58	185	311	388	737	502	902	320
Gulf International Bank	30	273	344	742	1327	1353	1009	520	1140
National Commercial Bank	-	163	201	213	475	1184	188	522	146
ALUBAF Group	1426	688	426	524	434	417	268	317	200
Saudi International Bank	-	-	16	363	393	411	165	141	192
National Bank of Bahrain	-	-	-	30	75	216	230	323	na
Arlabank International	-	4	77	241	na	212	12	131	na
KFTCIC	100	117	79	120	765	440	324	129	na
Banco Arabe Espanol	500	25	42	162	73	80	154	119	na
Arab Bank	-	26	30	239	1246	652	350	247	227
BAII	403	674	177	175	371	287	224	193	na
Commercial Bank of Kuwait	-	-	-	5	40	88	237	44	na
Bank of Bahrain and Kuwait	-	-	-	5	114	138	178	71	na
All other Arab banks	na	292	915	74	1815	3175	2079	1313	

Sources: Euromoney, Annual Financing Reports, April 1984 and April 1985
Middle East Economic Digest (various issues)

Note: * Sole managers receive full amount, co-lead managers receive apportioned amounts
na denotes not available

National Bank of Kuwait is another Arab bank which has been considered to be one of the most successful Arab banks in the euromarkets in recent years. It was ranked 43rd in the world in 1983. The success of this bank is somewhat different from the two leaders mentioned earlier. National Bank of Kuwait lacks the wide geographical presence that the Arab Banking Corporation and Gulf International Bank enjoy, but its position within the Kuwaiti local market is dominant. In 1984, for example, it lead-managed more syndicated loans than any other Arab bank, but this was mainly due to the many Kuwaiti dinar-denominated loans for local and foreign borrowers. Of the total value of syndicated loans lead-managed by National Bank of Kuwait during 1984-85, over 50 per cent were Kuwaiti dinar-denominated loans, compared to the use of regional currencies of less than 7 per cent for Arab Banking Corporation and 8 per cent for Gulf International Bank during the same period. The international standing of the National Bank of Kuwait was further enhanced in 1986 when it acquired full ownership of the Paris-based Frab-Bank International, as mentioned earlier.

It seems clear from the previous discussion that the total eurolending by Arab banks was dominated by very few of the largest Arab Gulf banks. This dominance was brought about by the withdrawal of many smaller Arab banks that were formed following the 1979-80 oil price increase. The larger banks were aided by their strong capital base and the growing importance and expertise they gained during the early 1980s, when the syndicated lending market was flourishing. The five largest Arab international banks accounted for 55 per cent of total Arab eurolending, in terms of volume during 1985, and 50 per cent of all operations, in terms of the number of operations during the same year. The fact that the majority of these large Arab banks are entirely or partly owned by several governments in the Gulf region, has affected the geographical distribution of their syndicated lending, as will be seen later.

Although most Arab banks in the eurocurrency syndicated lending market have come from different countries with different political and economic systems, they have many features in common.

Almost all active Arab banks in these markets have been described as 'aggressive' and 'rate cutters', particularly in the early years of their involvement in the euromarkets. This was for two main reasons; firstly, their ability and willingness to offer loans at very fine and competitive margins, particularly in the short-term. Secondly, rather than concentrating on immediate profitability, Arab banks (like many other new entrants to the euromarkets) were very much more concerned about developing international assets growth which would enable them to be more competitive in these markets, and to build good reputations and a strong capital base. This policy of long-term view on growth and profitability appears to have come to fruition in 1981 and 1982, when Arab banks experienced high growth rates in their syndicated lending.

The second common feature among Arab banks that are active participants in the syndicated lending market, is the dominance of the Gulf banks. Given that the major share of oil surpluses in the Middle East occurred among Arab Gulf countries, the dominance of Arab Gulf banks was given a boost through increased capitalisation, thriving domestic economies, and the increased experience and sophistication of these banks in international operations through their offices in the offshore centre of Bahrain, as mentioned earlier in Chapter 5. This is represented in Table 7.5.

Table 7.5 Participation of the largest Arab banks in the syndicated lending market, 1978-85

% of total Arab syndications

Year	Two banks	Four banks	Five banks***	Total number of participating Arab banks*
1978	41	78	83	34
1979	31	46	53	29
1980	35	53	59	31
1981	32	54	59	33
1982	26	43	49	30
1983	31	43	47	28
1984	32	50	55	26**
1985	37	48	53	25**

Source: Calculated from data shown in Tables 7.1, 7.2 and 7.4

Notes:
* Includes Arab Gulf and non-Gulf banks
** Estimates
*** The following banks have almost always ranked among the top Arab banks active in the syndicated lending market, they are: Al-UBAF, Arab Banking Corporation, BAII, Gulf International Bank and the National Commercial Bank of Saudi Arabia

Although a large number of Arab banks participated in the syndicated lending market since 1978 (about 30 every year on average), the syndicated lending market managed by Arab banks was dominated by only 2-5 banks.

In 1978, for instance, the largest two Arab banks accounted for over 40 per cent of the total Arab syndication, the largest four accounted for 78 per cent and the largest five for 83 per cent. This means that the remainder (29 banks) accounted for only 17 per cent of total syndicated lending managed by all Arab banks.

This trend continued throughout the late 1970s and early 1980s, whereby the largest five Arab banks consistently accounted for over half the total.

It follows, therefore, that the majority of the Arab banks are not international financial institutions and that international lending represents only a minor part of their total lending, while the largest five are almost purely international banks and international financial operations are their main line of business.

The third common feature among most Arab international banks, is that despite the aggressiveness in their lending, their management generally tends to be more conservative than that of other international banks. This is reflected in the fact that many Arab international banks devote a major share of their eurolendings to sovereign borrowers in their own region. In general, they tend to prefer the less risky trade related loans, rather than pure financial deals. Some Arab banks have benefited from this conservative attitude in times of crisis, like Gulf International Bank in the aftermath of the Latin American debt crisis, where this bank was the Arab international bank least affected by the crisis. The overall effect, however, has been evident in the concentration of Arab banks' eurolending to the Middle Eastern region. Despite the declining creditworthiness of many countries in the region, Arab banks, until recently, viewed the region as less risky than others.

The perception of country risk is considered to be one of the main differences between Arab and other international banks. They look more favourably on the Middle Eastern region and other developing regions, particularly Muslim, than Western banks. Coupled with this, is the political pressure that is brought by the governments that own these banks in the interest of Arab solidarity.

7.2.1 Geographical distribution of Arab international banks' eurolending

One of the distinctive characteristics of Arab banks in international financial markets is the diversification in their lending. With the exception of significant lending to the Middle Eastern region, the geographical placement of Arab banks' eurolending appears to have followed the general geographical distribution of lending for the market as a whole.

As Table 7.6 reveals, the Arab region has always been the most important in Arab banks' syndicated lending. The regions' share of the total syndicated loans lead-managed by Arab banks varied from 72.4 per cent in 1978 to 25.4 per cent in 1980 and to around 45 per cent in 1984. In addition to the political pressures, the dominance of the Arab region can be explained by the fact that Arab banks enjoy a great competitive advantage over their non-Arab competitors. They speak the same language and are better placed to understand the needs of the region and the risks involved, in the same way that the US banks have deals with Latin America or West German banks with Eastern Europe. This factor is illustrated in Table 7.6. The increased competition between Arab and Western European banks, particularly within the offshore centre of Bahrain, and the rapid

Table 7.6 **Regional distribution of Arab banks syndicated lending, 1977-85**

	Arab countries		Western Europe		Eastern Europe		Central and South America		Asian countries		Sub-Saharan Africa	Other countries	Total
	US$ mn	%	US$ mn	%	US$ mn	%	US$ mn	%	US$ mn	%	US$ mn	US$ mn	US$ mn
1977	668.00	70.2	77.00	8.1	-	-	100.00	10.5	67.00	7.0	26.00	13.00	951.00
1978	1679.15	72.4	147.01	6.3	166.50	7.2	200.02	8.6	94.85	4.1	-	33.33	2320.87
1979	1378.75	55.4	563.73	22.7	168.33	6.8	186.81	7.3	192.29	7.7	-	-	2489.91
1980	914.55	25.4	775.44	21.6	333.35	9.3	762.36	21.3	627.33	17.5	169.99	-	3583.02
1981	3009.18	33.1	1957.23	21.5	684.76	7.5	1943.54	21.4	1236.54	13.6	236.05	35.00	9102.30
1982	4283.56	43.7	1496.24	15.3	362.73	3.7	1772.54	18.1	1625.59	16.6	122.69	135.00	9798.35
1983	3583.32	51.3	1527.20	21.9	128.14	1.8	62.49	0.9	1486.21	21.3	65.12	132.74	6985.22
1984	2576.91	45.1	951.20	16.6	323.43	5.1	224.29	3.9	1512.82	26.5	1.86	125.86	5716.44
1985	2054.62	46.4	750.10	16.9	449.70	10.1	52.70	1.2	1104.45	24.9	15.33	-	4426.90
Total	20148.04	44.4	8245.40	18.2	2616.94	5.8	5304.75	11.7	7947.09	17.5	637.04	474.75	4537.01

Sources: Middle East Economic Survey (various issues)
Euromoney, Annual Financing Reports 1980-84

decline in the economies of many Arab countries, have forced many of the latter group of banks to reduce their involvement in the Arab region. A noticeable change occurred in the early 1980s; between 1981 and 1984, for example, Western European banks reduced their lending to the Arab region by 78 per cent. In contrast, the Middle Eastern region remained the main area of lending for Arab banks. Although in 1980 there was a significant drop in the share of Arab banks' lending to Arab countries, to just over 25 per cent of the total, compared to 72 per cent in 1978; there was a recovery in 1983, when Arab borrowers acounted for more than half of the total loans lead-managed by Arab banks. Although a decline occurred again in 1984, to a share of 45 per cent, this decline reflected the general depression in syndicated loans market as a whole, which led to many Arab banks retreating from this market, favouring the thriving eurobonds market or concentrating on domestic business. The increased indebtedness of many Arab countries in recent years is also responsible for the decline in lending by Arab banks to the region. Finally, there was a drop in demand for international capital on the part of Arab creditworthy countries, particularly in the Gulf area, reflecting an end of an era where massive trade and contruction-related financing facilities had been a common feature.

The shrinking market in the Middle East forced Arab banks to look for business overseas. Their overall lending outside the Arab world increased by 17 per cent in 1984. Traditionally, the main markets used to be Europe and the United States, but the comparatively low growth rates of these areas, and the increased competition for business in these two markets, favoured the move to the more active economies of other regions. The Asia-Pacific region has been the main beneficiary of the diversification policy of Arab banks. Within this region, the presence of Arab banks is concentrated in Singapore and Hong Kong, and for the last few years there has been a massive inflow of Middle Eastern capital into that region (as mentioned in Chapter 3). As Table 7.6 shows, the share of Asian countries of Arab banks' total lending has steadily increased over the last few years, from only 4 per cent in 1978 to 17 per cent in 1980, and further to 27 per cent in 1984. Arab banks were also active in lending to South America in the years leading to the financial crisis in that region in 1982, with 21.3 per cent of their syndicated lending in 1980 and 21.5 per cent in 1981 going to Latin America. Although these shares are relatively high considering the size of these banks, their accumulative share was small compared with the leading Western banks. Nevertheless, for Arab banks with relatively recent experience internationally, their involvement in Latin America is considered to be significant in terms of their capital and their overall loans. In the period between 1977-84, the leading eight Arab banks lent in excess of US $5 billion to Latin America, as Table 7.7 shows. As can be seen from the table, the three Bahraini-based offshore banks, Arab Banking Corporation, Arlabank International and Gulf International Bank, had the largest exposure in Latin America. Between them they represented almost 55 per cent of all Arab banks' lending to that region.

With a total exposure of almost US $1.5 billion over the period between 1977-84, Arab Banking Corporation was one of the most heavily affected banks in the region. Between 1982-84, for example, almost 17 per cent of Arab Banking Corporation's total earnings assets were in Latin America. In terms of total assets, this meant that Arab Banking Corporation's exposure to Latin America during that time was ranked alongside the worst of the big American banks.

Table 7.7 Arab banks lending to Latin America, 1977-84

	Amounts (US $ million)	Share (%)
Arab Banking Corporation	1,426	28.4
Arlabank International	671	13.3
Gulf International Bank	647	12.9
Al-UBAF Group	433	8.6
Saudi International Bank	335	6.7
KFTCIC	305	6.1
BAII Group	246	4.9
National Commercial Bank	205	4.0
All other Arab banks	759	15.1
Total	5,027	100.0

Sources: Middle East Economic Survey
Bank of England Quarterly Bulletins (various issues)

In relation to its equity base, Arlabank is considered to be the most heavily exposed Arab Bank to the Latin American region. Its total exposure of US $671 million was more than four times its free capital and accounted for about 95 per cent of its total loans in 1986.

The price of lending to Latin America for Saudi International Bank was a write-off of some 40 per cent of shareholders' equity. This has been the estimated price of reducing the bank's Latin American loans to market price.

During 1980 and 1981, the share of Latin America of the total loans lead-managed by Arab banks was 21.3 per cent and 21.4 per cent respectively, compared to only 7.3 per cent in 1979. This increase in lending to Latin America coincided with the willingness of many international banks to lend, mainly due to their short-term oil deposits. As a result, many countries found it cheaper to borrow than their creditworthiness should permit. Such countries as Mexico, Brazil, Chile and many others relied heavily on borrowing from the euromarkets in the late 1970s and early 1980s to fund their balance of payments deficit. Inevitably, these countries ran into more difficulties and were unable to repay their loans when they fell due. The lender banks did not only have to bear the burden of rescheduling these debts, but also to lend more money to finance the continuing balance of payments deficit of these countries.

Since 1982, however, with the emergence of the Latin American debt crisis, Arab banks are acting more cautiously. They are only involved in very few new activities in Latin America, mainly to meet their obligations with the rescheduling and the various refinancing packages. As was shown in Table 7.6, the share of South America from Arab banks' syndicated loans fell dramatically from 21.4 per cent in 1981 to less than one per cent in 1983.

Sub-Saharan Africa, has been another region that was affected by the diversification policy of Arab banks. Between 1982-84, this region accounted for about only two per cent of total loans arranged by Arab banks.

As previously mentioned, in general, the geographical distribution of Arab banks' eurolending is similar to that of the market as a whole. Between 1981 and 1984, the highest proportion of syndicated lending for the two groups went to developing countries. For Arab banks the shares for 1981 and 1984, were 71 and 76 respectively, compared to 50 per cent and 47 per cent for the market as a whole. This reflects the strong commitment of Arab banks to the developing countries, as mentioned earlier. Lending to Western Europe reveals a difference between Arab banks and the euromarkets, however; although both devoted a high proportion of their lending to that region, the share of Arab banks with 21.5 per cent in 1981 and 16.6 per cent in 1984, represented less than half that of the euromarkets with 47 in 1981, and 45 in 1984. Considering that lending to the Western European region is less risky than other groups of countries in the world, the competition among banks wishing to lend to Western Europe has become very intense in recent years. This competition is reflected in the decreasing margins attached to loans to that region, whereby even the existing loans to that region were renegotiated at finer margins. Consequently, there was a decline in the share of Arab banks lending to Western Europe from 23 per cent in 1979, to 16.6 per cent in 1984. Adding to the difficulties of Arab banks syndicated lending in general, and to lending to Western Europe in particular, was the rise of the eurobonds market; a market which covered almost all the borrowing needs of that region in recent years.

The previous discussion in this chapter leads to the general conclusion that despite their recent origin in the euromarkets, Arab banks were able to adapt quickly to that market and to participate in it to a substantial degree. Since the beginning of 1980, international bankers increasingly became aware of the willingness of many Arab banks to participate on an increasing scale in the then thriving market for syndicated lending. It was ironic that the increased involvements of Arab banks in the euromarkets (they reached their peak level in 1983), coincided with the decline in oil revenues in real terms.

For Arab banks, considering the Middle East as a priority region in their syndicated lending, has meant that any economic or political change within that region could affect their international business drastically. Although Arab banks were affected by the general decline in the euromarkets since 1982, in line with other international banks, they were further influenced by factors in their own region. The first of these factors was political, that is the Gulf war. This war affected the whole of the Middle East, but the Gulf region, due to its geogrpahical proximity to the war zone, was particularly affected. The overall affect of the war was to unsettle the region, and eventually led to the cancellation of many infrastructural projects in Iraq, Kuwait and other countries. In addition, the Gulf war also caused a large draining of the financial resources of many countries, in their aid to Iraq. The size of the financial aid to Iraq from Kuwait and Saudi Arabia alone ran into billions of US dollars.

The second factor that affected the Gulf region, and consequently Arab banks, was the decline in oil revenues due to lower oil prices since the early 1980s. The effect of this factor on Arab banks will be analysed later in this chapter.

Perhaps the most important factor that was responsible for the decline in Arab banks' syndicated lending to Arab countries was, and still is, the increased indebtedness of many countries in the Middle

East region that used to be not only borrowers of funds but also suppliers of funds.

With the beginning of the decline in the oil revenues, the debts of most Arab non-oil countries to the banking system, nationally and internationally, have become more apparent, exaggerated by the high interest rates which have prevailed in recent years. As mentioned earlier, the commitment of Arab international banks to the Arab region has probably exceeded the level that would justify lending to countries with small economic bases and few identifiable investment opportunities, particularly those Arab countries outside the Gulf region. The ratio of transactions lead-managed for Arab borrowers in relation to non-Arab borrowers, by Arab banks was about 1:3; this is certainly much higher than the volume of loans lent to Arab borrowers by the market as a whole. The external indebtedness of Middle Eastern countries is shown in Tables 7.8 and 7.9. Table 7.8 shows the long-term external debt of most Arab countries. The rapid increase in these debts was due to low oil prices and the lower US dollar value of recent years. Considering that most Arab currencies are either pegged against the dollar or have a sizeable link with it, the fall in the value of the US dollar, which depreciated by about a third between 1985-87, has had a very damaging effect on the purchasing power of most countries in the region.

One of the most common ways of judging the risk and the creditworthiness of any borrowing country is to measure the ratio of foreign debts to the GDP of the country. This is shown in Table 7.9. Considering that a ratio of 40 per cent is critical (Azzam, 1986), the problems that face Arab international banks that are

Table 7.8 External indebtedness of selected Arab countries, 1975-85

(US$ million)

	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
Jordan	519	683	1182	1166	1911	2559	2734	2761	3197	3620	4206
Tunisia	1757	2310	3185	4065	4843	5242	5471	5718	6257	6536	7047
Algeria	9589	12181	14968	21989	26706	25941	22606	20309	18859	16812	18365
Sudan	1828	2313	3202	3532	4468	4958	5381	5924	6354	6206	5582
Syria	1994	3288	3873	3657	4536	4077	3856	3782	3940	3785	3874
Lebanon	80	73	190	379	373	425	386	332	286	238	207
Egypt	7633	8789	12581	14248	15883	17578	18588	19331	20005	20419	21615
Morocco	2409	3141	5097	7429	8607	9265	11138	11517	13683	13761	14998
N. Yemen	452	585	793	1089	1478	1636	2000	2361	2433	2532	2559
S. Yemen	282	371	435	576	891	1222	1292	1501	1747	1756	2502
Oman	262	390	424	606	548	407	355	328	307	342	339

Source: Arab contries, Economic Statistics, Arab Monetary Fund Publication, 1986

Table 7.9 Ratio of foreign debts to GDP of some Arab countries 1976-85

percentage

	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
Jordan	32.3	39.9	40.7	41.8	38.7	43.7	49.2	56.9	63.8	67.5
Tunisia	26.6	36.1	41.1	41.8	37.3	39.4	44.0	47.8	47.8	54.0
Algeria	36.4	42.3	52.9	51.4	38.7	34.5	30.9	26.6	23.2	23.5
Sudan	30.8	31.0	30.1	43.4	46.9	46.8	71.7	83.9	63.0	85.3
Syria	15.5	21.9	20.9	23.0	16.1	13.1	12.8	12.3	12.5	13.6
Somalia	35.9	39.0	42.5	48.1	45.6	41.2	63.5	84.9	96.5	169.4
Egypt	33.7	38.5	39.4	63.6	48.1	46.1	45.7	43.4	41.1	38.2
Morocco	25.2	39.0	38.9	39.0	39.9	53.6	59.9	76.3	88.7	94.4
N. Yemen	19.1	18.9	21.1	19.1	32.3	38.9	36.5	40.7	46.8	50.5
S. Yemen	44.7	61.8	70.3	74.9	74.8	73.3	83.1	88.3	95.7	127.5

Sources: Arab countries, Economic Statistics, Arab Monetary Fund, 1986
The Banker, May 1985

committed in their syndicated lending to the Arab region becomes clear. In recent years, many Arab countries have had a ratio of foreign debt to GDP of over 40 per cent. Table 7.9 also reveals that the ratios for some Arab countries have reached exceptionally high levels, probably unmatched anywhere else in the world. Figures published by the World Bank in its 1988 annual report on debt support this view. The debt servicing difficulties of several Arab countries are in many cases similar to the worst affected Latin American debtors.

Although the size of the Arab countries debt is much smaller than that of Mexico or Brazil, for example, (whereby the outstanding debt of Mexico alone is greater than the debt of all Arab countries put together), the severity is still the same considering the small economies of most Arab countries.

Debt service ratios for many Arab countries are worse than those of Latin American countries. Egypt and Morocco, for example, have higher debt to GDP ratios than Mexico, and Jordan and Tunisia have a higher debt to GDP ratio than Brazil.

The dilemma facing Arab international banks, therefore, seems to be in finding the balance between political and commercial aspects when lending to Arab borrowers. The political pressure stems from the fact that many Arab international banks, Gulf International Bank is an example, are owned by governments in the region. These banks are directly under the influence of these governments, which want to achieve Arab unity with little attention being paid to the country risks involved and the profitability of such deals.

However, it appears that Arab banks have reached their maximum exposure in lending to Arab countries that are considered to be heavily indebted. The choice for Arab international banks, therefore, is to find other less risky alternatives to generate income. These could be found in the domestic markets, through trade, construction and the industrial sectors. Although these opportunities may provide the safest option for Arab banks, there are two main problems associated with them. Firstly, the domestic investment opportunities have been on the decline in recent years following the decline in oil revenues and the reduction in government expenditure, as will be explained later in this chapter. Secondly, for Arab banks that were set up purely to penetrate the international financial markets, the problems of finding domestic business opportunities is further complicated by the fact that these banks, unlike national banks, lack domestic bases. For them to find domestic market share means that they have to compete with national and other privately-owned banks, that have been serving the region for over 50 years. For these Arab international banks to survive in international financial markets, the concentration on other financial instruments away from the declining syndicated lending market is very important.

The more obvious alternative to the syndicated loan market is the increasingly growing eurobond marekt. The next section in this chapter will concentrate on the success and limitation of Arab banks in the eurobond market.

7.3 ARAB BANKS IN THE EUROBOND MARKET

7.3.1 Introduction

The eurobond market is a market dealing in long-term transactions, and is separate from, although related to, the eurocurrency market. This market (as the name implies), operates largely outside the jurisdiction of the countries in whose currencies the bonds are denominated. The eurobond market has been more volatile and smaller in the volume of new issues than the eurocurrency market. It represents a major source of funds for international borrowers. These tend to be prime well-known governments and corporate names, with a credit superior to many borrowers in the eurocurrency market. The market for eurobonds represents one example of the phenomenon of external markets that co-exist and compete with their domestic counterparts.

Prior to 1964, the supply of eurobonds was inhibited for a long time by the cost of issue and by the absence of well-developed secondary markets. Therefore, it can be argued, that the Eurobond market did not develop until 1964, when the US balance of payments programme, in particular the Interest Equalization Tax, closed the US market to foreign borrowers.

A significant acceleration in market growth did not take place until the mid-1970s. By that time, the volume of bonds outstanding had reached the critical point, at which economies of scale in the secondary market came into play. For example, it grew from less than US $1 billion in 1964 to US $7 billion in 1975, and then to US $220 billion in 1986 (Table 7.10).

Table 7.10 The international bond markets*, 1981-86

	Type of issue		Currency of issue							Total eurobonds		Total euroloans	
	Fixed-rate issues	FRNs	US $	Swiss franc	Deutsche-mark	ECU	Yen	£	Other	US$ billion	% change	US$ billion	% change
1981	36.2	7.8	24.9	8.5	2.6	0.2	3.1	1.4	3.3	44.0	-	96.4	-
1982	59.1	12.6	44.1	11.5	5.6	1.0	3.8	2.0	3.7	71.7	63	85.2	-12
1983	56.8	15.3	39.2	14.0	6.4	1.7	4.0	2.9	3.9	72.1	0.6	60.7	-29
1984	73.9	34.0	68.4	13.1	7.0	2.9	5.9	5.5	5.1	107.9	50	53.7	-12
1985	107.8	55.9	97.8	15.0	11.3	7.3	12.2	6.6	13.5	163.7	52	39.0	-27
1986	172.5	47.8	120.1	23.1	16.2	6.8	22.6	10.9	20.4	220.3	35	49.0	26

Sources: Bank of England Quarterly Bulletin, May 1987
Morgan Guaranty Trust Co, World Financial Markets (various issues)

Note: * Fixed rate bonds and FRNs

Interest rates on eurobonds are closely tied to those prevailing in the domestic markets. The slight difference between the two rates exists because of regulatory and institutional barriers. Taxes on interest payments on domestic bonds provide an example of the different regulations that exist domestically. The absence of these regulations on the eurobonds has given them a greater advantage over domestic markets.

A simple comparison between the eurobond and the euroloans markets, indicates the success of the eurobonds in recent years, as can be seen from Table 7.10. A close study of this table reveals a number of observations. The most important one is that the success of eurobonds and the move towards securitisation appears to have happened at the expense of the syndicated lending market. Secondly, the US dollar is the major currency of issue in these markets. Between 1981-86, for example, an average 58 per cent of all international bonds issues were US dollar bonds. Thirdly, is the dominance of fixed rate issues of bonds compared to floating rate notes. About 76 per cent of all bonds issued between 1981-86 were fixed-rate issues, compared with only 24 per cent floating rate notes.

The increased importance of the eurobonds market has posed a great challenge for Arab international banks. If they are to survive in international financial markets, the move to the eurobonds is of great importance.

7.3.2 Arab banks eurobond activities

It took Arab banks a long time to realise the importance of the eurobonds markets as a means through which supplementary channels for international capital could be provided. They still view these markets as a major challenge. The decline in oil revenues in recent years and the depression in most Middle Eastern countries that followed, resulted in limiting the investment opportunities in the region. Furthermore, the decline in the syndicated lending markets and the increased indebtedness of most Arab countries (that used to contribute to a major portion of Arab banks' business) have made Arab financial institutions look more closely at the potential of the eurobonds market, and concentrate more on ways of rising up to its challenge. This is particularly so for those Arab banks that were set up mainly for international business. Such banks as Arab Banking Corporation, UBAF and Gulf International Bank, do not enjoy the domestic base that is available for other banks in the area, particularly national banks, as mentioned earlier. Therefore, international operations, whether inside or outside the Arab region, are a priority for these banks. For these banks to survive in international markets they must conquer the eurobond markets in line with other international banks.

Unfortunately for Arab banks, the rising and the growing importance of the eurobonds market coincided with the Kuwaiti stock market crash in 1982. The closure of this market, which was considered to be the leading trading place for shares and bonds in the Arab Gulf region, resulted in the shaking of confidence of Arab companies, banks and customers alike.

Furthermore, the global change from eurocurrency syndicated loans to the securitisation of debts occurred at a time when Arab banks were becoming accustomed to, and increasingly dependent on, the euroloans for their international assets growth.

Like the euroloan market, Arab banks role in the eurobonds was dominated by the larger banks, whereby in 1984, for example, the leading five Arab banks accounted for over two thirds of eurobonds managed by all Arab banks. Although these large Arab banks have developed their bond issues management to a point where it has contributed to a major portion of their international business, they are still in the learning process in the eurobonds market. They are subsequently not making full use of these markets. Because their managements are not adapted to the techniques of the securitisations, they have until recently limited themselves to only one section of the eurobonds market, namely the floating rate notes (FRNs) (Nashashibi, 1984). This is mainly due to the simplicity and the similarity of the issuing technique of the FRNs to those of the syndicated loans. FRNs contributed to more than 50 per cent of total bonds lead or co-managed by all Arab banks in the years leading to 1986, compared to a share of less than 25 per cent for the total international bonds issued worldwide during the same period.

The concentration on FRNs dominated by the use of the US dollar is certainly a good starting point for Arab banks in the eurobond market, but the obvious disadvantage of this policy is that these banks are limiting themselves to only one section of the market which between 1981-86 contributed to only one quarter of the market, as mentioned above.

So far the individual performance of Arab commercial and investment banks in the eurobond market, compared to other well-known institutions, is recent and relatively modest and inconsistent. Table 7.11 reveals this fact clearly.

Apart from the three largest Kuwaiti investment banks which have greatly benefited from the capital market in Kuwait, Saudi International Bank has been one of the very few Arab banks to realise the importance of the eurobond market. In 1983, for example, there was a deliberate attempt to cut back on its syndicated loans in order to concentrate on gaining market share and building up expertise in the eurobond market. This policy seems to have succeeded, as Saudi International Bank became the leading Arab bank in the eurobond market during 1984-85.

The comparison between Arab and other international banks in the eurobond market reveals that Arab banks are lagging behind. Any of the five international banks, that were chosen at random, and represented in Table 7.11, led and co-led more eurobonds during 1984-85 than all Arab banks put together.

When considering the collective performance of Arab banks in the eurobond market, the picture is the same. Data in Table 7.12 shows that in the period between 1974-82, Arab banks only managed to play a negligible role in this market. During that period, their highest contribution to the total market occurred in 1981, with a share of only 3.8 per cent. This is in sharp contrast to their active role in the syndicated lending market, where since 1982, Arab banks' share of the total market was over 10 per cent. In 1984, a year that is considered to be the most successful for Arab banks' eurobond issuance in terms of number of issues, they only succeeded in lead-managing 11 bond issues, of which two were in the Kuwaiti Dinar bond market. Their bond issues during 1984, represented only 1.5 per cent of the total bonds issued during that year.

Table 7.11 **Arab and other international banks in the eurobond market 1984-85**

	Lead-managers		Co-managers	
	Amount (US $	Number of issues	Amount (US $	Number of issues
Saudi International Bank	222.1	5	431.4	68
Arab Banking Corporation	128.3	5	337.2	66
BAII	70.5	2	21.0	4
Gulf International Bank	45.51	1	150.5	33
Al-Mal Group	44.2	4	118.7	36
National Bank of Kuwait	40.0	1	158.9	33
Arabian Gulf Investment Corp	20.0	1	13.0	4
United Gulf Bank	15.0	1	-	-
KIIC	10.0	1	213.4	50
Solomon Brothers	24,533.3	367	3,817.4	504
Lloyds	3,185.6	31	-	-
Chase Manhattan	1,426.2	36	-	-
Bank of Tokyo	1,714.0	45	2,934.2	462
Citicorp	3,215.6	76	2,393.1	363

Sources: Euromoney Bondware
Middle East Economic Survey (various issues)
Euromoney Annual Financing Report, 1986

Note: Sole lead managers receive the full amount of each bond. Co-lead managers receive an apportioned amount.

Although the market as a whole is generally dominated by the US dollar bond issue, as mentioned earlier, with a percentage of around 55 per cent, for most Arab banks the US dollar contributed to almost 85 per cent of all bonds led or co-managed by all Arab banks during 1984 and 1985.

Table 7.12 Volume and currency classifications of Arab international banks in the eurobond market 1968-82

	Regional currencies*			Foreign currencies				
	Total US$ million	KD %	Others** %	Total US$ million	US$ %	Total Arab US$ mn	Total market US$ billion	Arab banks as % of the market
1968-73	450.0	100.0	-	-	-	450.0	21.2	2.12
1974	68.2	100.0	-	-	-	68.2	12.2	0.60
1975	163.9	100.0	-	-	-	163.9	22.8	0.72
1976	316.0	92.0	8.0	-	-	316.0	34.3	0.92
1977	380.9	-42.1	57.9	150.0	100.0	530.9	36.1	1.50
1978	619.5	90.2	9.8	150.0	100.0	769.5	37.3	2.10
1979	535.8	100.0	-	204.9	82.5	740.7	37.1	2.00
1980	62.9	100.0	-	793.6	63.0	856.5	40.9	2.10
1981	445.2	100.0	-	1230.6	75.7	1675.8	44.0	3.81
1982	185.5	100.0	-	1432.8	92.5	1618.3	71.7	2.27
Total	3227.9	90.5	9.5	3961.9	81.4	7189.8	357.6	2.01

Sources: Nakajivani, Arab banks and the international financial markets, 1983
Euromoney Annual Financing Report, 1985
International Capital Markets, IMF Occasional Paper, no. 1, September 1980
Bank of England Quarterly Bulletin, May 1987

Note: * Conversion of regional currencies into US dollars was done at exchange rates prevailing at end of each year.
** This includes Bahraini dinar, Abu Dhabi Dirham and the Saudi Riyal

Regional currencies bond issues were almost entirely dominated by the KD bonds, which were led exclusively by Kuwaiti financial institutions. Apart from the KD bonds, bonds denominated in all other regional currencies contributed to less than 10 per cent of the total. The decline in Arab currency denominated bonds in recent years (following the collapse of the Kuwaiti unofficial stock exchange in 1982, and the relatively inactive role of other centres in the region) is probably the most important reason behind the modest involvement of Arab banks in the eurobonds market.

Apart from the KD, Arab banks' involvement in regional currencies bond issues has been rare and inconsistent. During the period between 1968-82, there were only five Bahraini dinar bond issues, five Saudi riyal issues and two Abu Dhabi dirham issues.

Since the early 1980s, Arab banks' involvement in eurobond issues in currencies other than the US dollar, can be summarised as follows: two French franc issues, one Dutch guilder, one SDR, one equity convertible issue in Australian dollars, one issue in Canadian dollars, two issues in Norwegian kronar, and finally one ECU issue (Nakhjavani, 1983).

It is clear from the previous discussion that while Arab banks' syndicated lending activity was highly successful in the years prior to 1982, their involvements in the eurobonds shows rather less commitment. Many factors are responsible for this trend; most of them lie within these banks and the capital markets in the area. One of the major problems that face Arab international banks in the eurobonds market, is that this market requires far more expertise and sophistication than syndicated lending. For Arab banks used to the euroloans market, and having the management attitude associated with it, they will take some time before developing the management talent that could adapt to the techniques that are required in the eurobonds market. Such techniques as legal documentation, project assessment and evaluation, negotiation, disbursements and conditionality, amongst many others, are essential in the eurobonds market.

Capitalisation is another factor that may be responsible for the small role that Arab banks play in eurobonds. To be able to play an active role in these markets at a time of fine margins and increasing risks, Arab banks will require to strengthen their capital base. Although they are considered to be highly capitalised in relative terms, as will be seen in Chapter 8, but having to compete for market share with some of the largest banks in the world, places them at a disadvantage in a market that is dominated by the most experienced and highly capitalised international banks. None of the Arab banks rank among the top 100 banks in the world in terms of equity. In fact, the total equity for all Arab international banks in 1986, was around US $8 billion, compared to other international banks like Nomura of Japan, for example, with a working capital of US $33 billion.

Another reason for the late arrival of Arab banks in the eurobonds market is the nature of the market itself. In contrast to the syndicated lending market where the success of Arab banks was due to their determination to tap these markets, and they were aided by the open nature of the market (where new entrants found it relatively easy to enter through syndication and later subparticipation), the nature of the eurobonds market was different. The eurobond market was, and to some extent still is, a market of prestige whereby eurobond issues are dominated by a number of securities houses that are very well known in these markets (Nashashibi, 1984). This is mainly due to the fact that such houses as Solomon Brothers, The Bank of Tokyo, Credit Suisse First Boston, Morgan Stanley and many others, were behind the establishment of the first eurobonds in the 1960s. Therefore, the nature of a market where connections and reputations play a very important role, does not make it easy for new entrants to participate, and Arab banks were no exception.

Other factors responsible for the minor role played by Arab banks in the eurobonds market include, the rarity and inefficiency of capital markets and stock exchanges in the region; political pressure on Arab banks not to deal with some securities houses; and finally the lack of financial awareness in the region about the true nature of the bonds, particularly on the part of the private sector, a sector that plays a dominant role in the eurobonds market worldwide. These three factors will be explained in more detail in Chapter 9.

In light of these difficulties facing Arab banks in the eurobonds market, the fine margins that have prevailed in international financial markets in recent years, and the increased indebtedness of many developing countries that occupy a major portion of Arab banks international business, the retreat of Arab banks from these markets may appear natural. To appreciate the importance of international operations to international Arab banks, particularly in the eurobonds market, the next section will be to analyse their other alternatives; that is, their domestic business.

7.3.3 The domestic alternative

Arab banks differ from any other group of banks in the world in the fact that they are, particularly in the Gulf region, based in countries whose economies rely almost entirely on the export of oil and other related substances. Despite the fact that Arab banks' involvements in international financial markets occurred at a time when oil revenues were on the decline, the persistent decline in these revenues has resulted, amongst other things, in the decline of banks' business in the region.

In contrast to the mid-to-late 1970s and early 1980s, when all Gulf countries experienced a massive balance of payments surplus, and all sectors of the economy flourished following very optimistic government plans, the fall in oil revenues has affected the Gulf economies in many ways. As mentioned earlier in Chapter 4, although oil revenues have had very little direct impact on the internationalisation of Arab banks in the sense that very little oil money found its way directly to them, oil revenues of the 1970s did influence these banks, through increasing their capitalisation and through creating favourable business environments, whereby banks played a major role. It is natural, therefore, to assume that falling oil revenues would have an adverse effect on Arab Gulf banks. Traditionally, a major portion of commercial banks' lending in the domestic market is provided for guarantee business, letters of credit, contract financing and most importantly, import financing. In recent years about 70 per cent of total domestic lending by Gulf banks went to these sectors.

The decline in these sectors in recent years has, therefore, resulted in the decline in demand for finance and for banks' services. The slowdown in business in the Gulf has come at a time when the region has become more overbanked than ever before. In the six Gulf countries alone, there are at present 112 Arab banks and over 150 foreign banks chasing an ever declining business. This has resulted in the regions' banking environments being very competitive, and margins on domestic business being at a low level. This competition was increased further by the globalisation of banking services worldwide, and the technical advance in computers and telecommunications, which has meant that many international banks can compete for Gulf business without necessarily being present there.

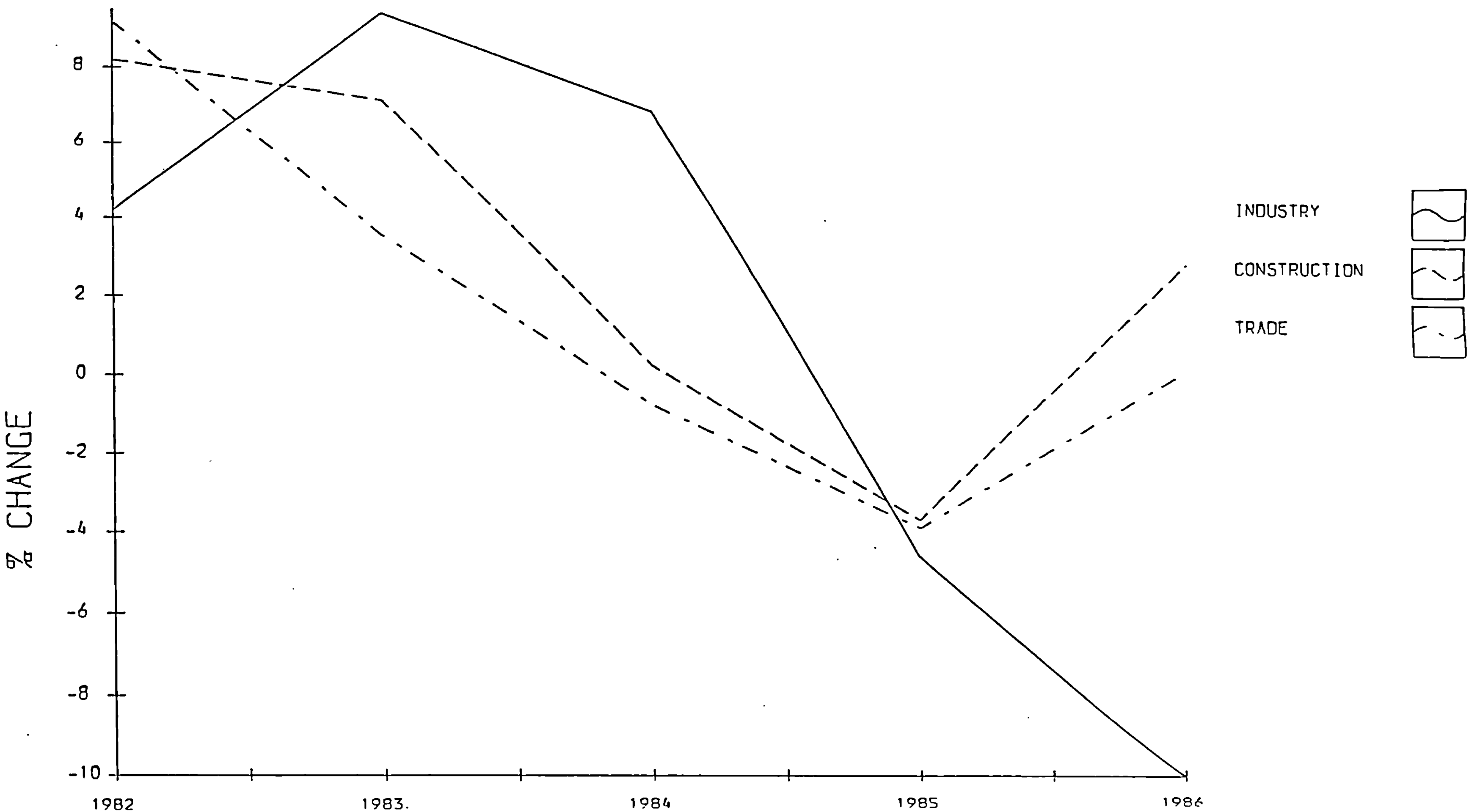
The slowdown in the Arab Gulf regions' economies since 1982, has sharply reduced business opportunities available for commercial banks. The effect of this slowdown is clearly reflected in profitability figures of these banks, as will be seen in Chapter 8. The largest two sectors within the economy which have generated most of the banks income in the years leading to 1982, are trade and construction. Between them they represent over 50 per cent of total banks' total domestic loans.

With the decline in the volume of imports by Gulf countries of 35 per cent between 1982-85, and a 60 per cent drop in the level of exports, credit facilities made by Gulf banks to the trade sector declined accordingly. Although credit facilities by commercial banks to the trade sector varied from one Gulf country to another, they all had one thing in common; between 1984-86, lending to this sector of the economy was on the decline in every Gulf country. In the UAE it dropped from 35 per cent to 28 per cent, Kuwait and Bahrain from 24 per cent to 21 per cent and Oman from 46 per cent to 40 per cent. Figure 7.2 reveals this fact. As the figure shows, despite the slight improvements in all three sectors since 1986, their levels are still well below those experienced in 1981 and 1982.

The construction sector, which contributes to an average of 21 per cent of all Gulf banks' credit facilities, was also on the decline. This was due to the completion of many infrastructural projects and the cancellatioon of many new projects. Accordingly the percentage of banks' credit to this sector of the total lending was on the decline; it dropped from 22.6 in 1981 to 20.1 in 1985. The industrial sector followed the general trend of the Gulf economies, and was on the decline since 1981. Commercial banks' lending to the industrial sector is far more complicated than the other two sectors mentioned earlier. First, the borrowing needs of industry is usually of a long-term nature, which in the absence of well-developed capital markets in the Gulf region, leaves the banks in a difficult position, as the majority of their deposits are of a short-term nature. Secondly, the experience of many commercial banks in the area with the industrial sector, left these banks with heavy losses, whereby, in the 1970s, many projects were established in the boom period and disappeared shortly afterwards as the oil revenue declined. The third difficulty in lending to industry is that most banks in the region do not possess the management that is capable of assessing the viability of industrial projects. These three factors explain why the share of credit facilities made by Gulf banks to industry from their total lending, is very modest.

Figure 7.2

% Change in GCC Commercial Banks' Lending by Sector,1982-86



Between 1981-86 this percentage was only just over 6 per cent, despite the strong encouragement by the Gulf states for the banks to finance and assist in the development of the industrial sector.

Another indicator for the depressed economies of the Gulf region during the 1980s, is the rapid slowdown in the government's expenditure. In Saudi Arabia, for example, government expenditure declined from US $84 billion in 1981 to US $55 billion in 1985.

Adding to these difficulties, is the increased awareness of many investors in the Gulf region, of the investment alternatives that exist in international markets. This means that if Arab traditional banks are to survive in the very competitive environments, they will have to broaden their services to match those offered elsewhere.

However, for Arab international banks, like Arab Banking Corporation, Gulf International Bank and many others, that have the disadvantage of lacking the domestic base that other banks enjoy, it seems that there is only one alternative; that is to concentrate on the international financial markets. Hence, the importance of the eurobonds market.

The depressed economy in most Gulf countries combined with a major slowdown in syndicated lending, have forced many Gulf banks, particularly those based in Bahrain, into entering these markets. The ability of these banks to adapt to the new market conditions was, no doubt, enhanced by the vast improvement in their managements which is largely attributed to the success of the offshore centre of Bahrain, in which they are headquartered. By 1986, there were many Arab international banks involved in the eurobonds market, with heavier weight and more commitment than in previous years, as Table 7.13 shows.

It is clear from this table that the leading Arab Gulf international banks, being affected by various factors in their own region, have succeeded in adapting to the new management techniques, that are necessary in the eurobonds market, to a point where eurobonds have contributed largely to their international activity. A comparison between Tables 7.11 and 7.13 reveals this fact. In the years leading to 1986, the presence of Arab international banks in the eurobonds market was very tentative, while in 1986, these banks started to show full commitment to their eurobonds activity. The involvements of Arab Banking Corporation, which is considered to be the most consistent Arab financial institution in this market, and the largest FRNs trader among all Arab international banks - with some 120 different issues in its portfolio and an FRNs turnover of over US $1 billion a year, support this view. In 1982, for example, this bank lead and co-managed eurobonds to the amount of US $261 million; in 1984, there was an increase of 78 per cent to the amount of US $466 million. The biggest increase, however, occurred in 1986, when Arab Banking Corporation's eurobonds activity amounted to US $3.5 billion. The same applies for other banks in the area; eurobonds managed by KIIC, for example, increased from only US $0.22 billion in 1984 to over US $3 billion in 1986.

The increased volumes of eurobonds managed by Arab banks in 1986, was accompanied by a reduction in the number of bond issues. This suggests that these banks are gaining importance in the eurobonds market, where they are no longer confined to the role of co-managers with very small amounts involved.

Table 7.13 The leading Arab banks in the eurobonds market, end-1986

Bank	FRNs		Straight issues		Equity linked		Total	
	Number	US$ million	Number	US$ million	Number	US$ million	Number	US$ million
National Commercial Bank (SA)*	6	1433	18	3251	8	860	32	5544
Arab Banking Corporation	6	1396	15	1568	6	513	27	3477
KIIC	-	-	15	1780	16	1267	31	3047
KFTCIC	-	-	5	499	19	2179	24	2678
Saudi International Bank	11	2094	4	429	-	-	15	2523
National Bank of Kuwait	9	1072	8	675	1	316	18	2063
KIC	-	-	9	1313	8	676	17	1989
Gulf International Bank	3	410	5	900	4	370	12	1680

Source: Middle East Economic Survey, 23 February 1987

Note: * Saudi Arabia

The other observation drawn from Table 7.13 is the increased awareness and sophistication among the leading Arab banks' managements. This is reflected in the diversification in their bond issues, not only in terms of geographical placement but also in terms of types of bonds. In the early 1980s, Arab banks' activities in the eurobonds market was almost entirely confined to FRNs, as mentioned earlier. In 1986, however, with the exception of Saudi International Bank, FRNs contributed to only 28 per cent of the total. This shows a sign of maturity among most Gulf international banks, as they have entered the markets for straight bonds issues which contribute an average of 44 per cent of the total, and equity linked bonds (convertible bonds and bonds with equity warrants), which amounts to 28 per cent of the total bonds.

In general, Arab banks that are active in the euromarkets can be divided into two groups. First, are the small Arab banks that are domestically orientated but decided to venture into the euromarkets for the sake of reputation and connections; their experience in the euromarkets has proved to be an expensive one. These banks, which include the smaller Kuwaiti and UAE banks, have withdrawn from the markets and are generally worse off than when they first joined the euromarkets.

The second group represents the larger Arab banks with high capital base and long-term commitments. Such banks as Arab Banking Corporation and Gulf International Bank were established following the first and second oil price increases, mainly to assist in the recycling process with the long-term Arab wealth that is invested in the developed countries. In terms of profits, these banks rank alongside the largest Arab banks that dominate their domestic markets, and which have been in existence for many decades, such as the Rafidian Bank of Iraq and National Commercial Bank of Saudi Arabia. The majority of their profits is generated from their international activities, firstly, from the syndicated lending market, a market they dominated for a long period, and then from their growing activities in the eurobonds market.

In conclusion, since the late 1970s and early 1980s, international financial markets have become accustomed to the large scale participation of Arab banks in the thriving syndicated lending market which was considered to be the major vehicle for the recycling process.

The fact that the greater involvement of Arab banks occurred at a time when the oil revenues were on the decline, indicates the growing importance and maturity of these banks in the euromarkets. Whatever measures are applied, Arab banks have been very successful in the euromarkets, considering that they only entered these markets less than a decade ago. It is true that their eurobonds activities have not been as impressive as their syndicated lending. But since 1986, the larger Arab banks appear to have developed the management techniques and strategies that are essential prerequisites in this market. This has resulted in a steady growth rate of their eurobonds lending, which reflects the resiliance of these banks and their ability to adapt to new market conditions.

Generally, Arab banks' performance in the euromarkets was similar to that of the market as a whole. One major difference separates Arab banks from other international banks; that is, their strong commitment to the development of third world countries. This commitment by Arab banks and Arab governments is not a new phenomenon. It dates back to as early as 1961, with the establishment of the Kuwaiti Fund for Arab Economic Development, and continued throughout the 1970s with the establishment of special funds such as the Arab Bank for Economic Development in Africa, in 1975. Although concessionary aid institutions are the only institutions set up purely to directly assist Arab and other developing countries, as mentioned in Chapter 4, Arab commercial banks also played an important role throughout the 1970s and early 1980s, through syndicated lending and bond issuance. The difference between Arab banks and other international banks in their lending to developing countries is shown in Table 7.14.

Table 7.14 Arab international banks' eurolendings, compared to that of the euromarkets, end-1984

Percent

Lending facility	Euromarkets Developed	Euromarkets LDCs	Arab banks Developed	Arab banks LDCs
Syndicated loans	61.6	38.4	24.1	75.9
Bonds	86.9	13.1	55.0	45.0

Sources: Figures for Arab banks are calculated from Nakajavani, Arab Banks and the International Financial Markets, 1983, and various MEED issues
Figures for the euromarkets are from Financial Market Trends, OECD publication, no. 34, June 1986

As can be seen from the table, euromarkets' lending to LDCs in relative terms has been half that of Arab banks for syndicated lending, and less than one-third for bonds.

Despite the rapid growth of the eurobonds market over the last decade, developing countries' share of the market is diminishing in accordance with their declining credit rating. This explains why their share of the whole market was only 13 per cent in 1984. In comparison, the high share of Arab banks' eurobonds lending to LDCs can be explained by the fact that almost two-thirds of that share went to Arab borrowers.

Although Arab banks are trailing most international banks in the eurobonds markets due to the fact that most Arab banks have limited their bonds placements to their home governments, recent evidence suggests that Arab banks are closing the gap between themselves and other well-known international banks. The fact that 55 per cent of all eurobonds managed by Arab banks in 1984 went to industrial countries suggests that these banks have managed to diversify and broaden their bonds placements.

The concentration of Arab banks on the Middle East region might prove to be a significant factor in the future, especially if Arab banks are able to capitalise on the great potential of Arab-to-Arab eurobonds lending. Many Arab borrowers are yet to enter this market, provided they develop the required management techniques, Arab banks stand a good chance of meeting this need, particularly if Arab capital markets were to offer more technical advice and support than has been the case so far.

CHAPTER 8

EVOLUTION OF RESOURCES AND PERFORMANCES

8.1 INTRODUCTION

Having established the reasons behind the international expansion of Arab banks and their involvement in eurocurrency markets in the previous chapters, the aim of this chapter is to analyse the performances of the largest Arab international banks. The following aspects will be studied in detail; profitability, capital adequacy and liquidity. These measures are considered to be the best indicators for banks' operations.

Profitability occurs, in normal circumstances, as a result of the banks' management efficiency in deploying available resources. The other two measures: capital adequacy and liquidity are useful indicators to the banks' prudency and safety. Various ratios will be used to calculate these measurse for Arab international banks, and a comparison with other international banks will be made in order to establish Arab banks' relative position internationally. It is worth mentioning that the use of several other measures, particularly those related to the cost of intermediation of banks, to complement the above mentioned ones, was not possible due to the lack of detailed data concerning the majority of Arab banks, notably those of Kuwaiti banks. The use of consolidated data will be applied whenever possible in order to facilitate the comparison of different financial ratios concerning different banks in various countries.

8.2 PROFITABILITY

One of the most common measures that could be applied to assess the performance of international banks, is their profitability. The importance of profitability is that it represents the only single item which results from all the banks' activities. The lack of data on Arab banks' profits generated from international operations, has necessitated the use of overall figures of profitability, which includes profits gained from domestic as well as international operations.

By the nature of their operations, lending constitutes to the majority of financial institutions' business, and accordingly generates the largest portion of their profits.

For Arab international banks, international lending since the early 1980s, has consistently contributed to a large share of their overall lending as Table 8.1 shows. Therefore, the overall profitability figures could probably be used as a proxy for profits gained from international operations.

This table illustrates the importance of lending internationally, compared to total lending made by the leading Arab banks. In 1982, the top three Bahraini banks experienced the highest ratios among all other Arab international banks. With ratios ranging from 55 per cent for Arab Banking Corporation to 40 per cent for Gulf International Bank, these banks may be ranked amongst the most active international banks in the world. The decline in these ratios after 1982 can be explained by the fact that many Arab banks decided to diversify away from the depressed syndicated lending market to the eurobonds market. Therefore, in terms of contribution to profits, the decline in syndicated lending was offset by the increased involvements of Arab banks in the eurobond market in recent years.

Table 8.1 Syndicated lending of Arab international banks as a percentage of total lending 1982-85

percent

	1982	1983	1984	1985	Average
Arab Banking Corporation	55.1	35.1	21.9	11.6	30.9
Gulf International Bank	40.5	25.0	12.5	27.5	26.4
National Bank of Bahrain	45.0	38.0	49.0	na	44.0
BAII	na	21.7	15.9	na	18.8
UBAF	na	17.4	19.5	11.4	16.1
National Commercial Bank	na	3.1	9.2	2.5	4.9
Commercial Bank of Kuwait	2.9	7.8	1.4	na	4.0
Arlabank International	17.1	1.0	10.8	na	9.6
National Bank of Kuwait	21.2	13.0	22.0	8.1	16.1

Source: Compiled from various issues of MEED and the banks' annual reports

Note: na denotes not available

As far as the profitability of Arab banks is concerned, in the 1970s, when Arab banks first entered the euromarkets they were willing to offer loans at very fine and competitive margins, as mentioned earlier. In 1979, for example, Arab banks' margins in the eurocurrency syndicated loan market, although approaching the world's average weighted spread of 0.79 basis points, were below those of the top American or Western European banks with an average weighted spread of 0.88 basis points. Therefore, most Arab banks like other recent entrants to the international financial markets, were competing aggressively to gain market share. To their disadvantage, the period in the late 1970s, when Arab banks started their international operations, witnessed a very competitive environment in international financial markets, where even the world's largest banks and the more established institutions adapted a policy of cutting price to increase their market share. This policy was greatly enhanced by the huge deposits that these banks accumulated following the oil price increase of 1978-79. Furthermore, the entry of many new banks into the euromarkets and the expansion of the international activities by some of the previously established institutions, have contributed to maintaining intensely competitive conditions.

Table 8.2 illustrates the profitability of some of the leading Arab banks that are active in international financial markets. Arab banks proved to be highly successful in the early years leading up to 1982. This success is reflected in their profitability figures, where they witnessed a massive growth rate in these profits of almost 91 per cent between 1979-81.

It is not a coincidence that the turning point in the profitability and the general performance of Arab banks occurred in 1982 and after. Two major events took place in 1982, which had a devastating effect on international banks in general, and on Arab banks in particular. First, was the collapse of the unofficial stock exchange in Kuwait; this, in addition to the shaking of confidence it caused in the banking industry, led many Arab banks to write off loans worth millions of US dollars. United Gulf Bank of Kuwait, for example, had to write off loans worth US $12.1 million, in 1983. Second, was the occurrence of the Latin American debt crisis, and the increased indebtedness of many Arab countries, which Arab banks were heavily exposed to.

Table 8.2 Pre-tax profits of some of the leading Arab international banks, 1976-87

US$ million

	1976	1979	1981	1982	1983	1984	1985	1986	1987
National Commercial Bank (Saudi Arabia)	67	165	167	168	156	140	27	21	0
Al-UBAF Group	4	6	18	28	42	27	35	59	-110
Arab Bank	37	45	91	63	65	65	75	88	92
Arab Banking Corporation	-	-	139	115	107	110	109	107	0
Gulf International Bank	-	7	36	51	58	64	67	71	-179
Arab International Bank	26	25	33	33	24	22	18	18	9
Bank of Oman	7	13	18	24	16	12	11	19	23
BAII	1	3	na	19	20	13	15	10	7
National Bank of Abu Dhabi	11	13	26	54	28	10	3	17	-38
Arab African International Bank	11	17	29	30	32	17	-97	na	-184
Arlabank International	-	6	16	23	20	26	14	27	-124
Total	164	300	573	608	568	506	277	437	-504
Change (%)	-	82.9	91	6.1	-6.6	-10.9	-45.3	57.8	-215.3

Sources: Annual Reports, Middle East Economic Digest (several issues), The Banker (several issues)

The length of the recession in the Middle East and other developing countries that Arab banks were exposed to, weakened the financial situation of many of these countries to a degree where some of them were unable to service their debts. This resulted in a significant rise of bad and non-performing debts in the books of many Arab banks. The decline of loans quality has necessitated a strengthening of bad debt provisions for all Arab and other international banks.

Information on the extent to which the growth in provisions for bad debts is attributed to international lending operations, is very limited, and in the case of Arab banks is non-existent. However, figures represented in the balance sheets of many Arab banks concerning these provisions can be used as indicators for the international component of loan loss provisions, particularly for banks that are purely international such as Arab Banking Corporation, Gulf International Bank and National Bank of Bahrain. On average, the international lending of these three banks during 1982-1985 was over 25 per cent of total lending, ranging from 31 per cent for Arab Banking Corporation, 26.4 per cent for Gulf International Bank and 44 per cent for National Bank of Bahrain (Table 8.1).

The size of these provisions for bad debts varies from one bank to another and while these provisions were left entirely to the banks' managements' judgement in some countries, other countries encouraged the banks to set up provisions for bad debts. Other Arab banks, particularly those that are based outside the Middle East, were forced to increase their bad debt provisions in order to meet the requirements of the monetary authorities of the countries in which they are based. The London-based Al-UBAF is a typical example; it witnessed the biggest increase in its provisions from US $7 million in 1986 to US $170.4 million in 1987, in line with the Bank of England matrix. Table 8.3 shows the increase of provisions for bad debts for some of the leading Arab banks for the period 1984-87.

Although all international banks were advised to increase their bad debt provisions, Arab banks increased their provisions to a level far higher than that of an average international bank. For example, in 1985 the norm amongst most international banks was a growth rate of these provisions of around 10.15 per cent, and further, many of these banks showed a negative growth rate during 1986, compared to much higher provisions in relative terms for Arab banks, as Table 8.3 shows. The effect of the increased provision for loan losses amongst Arab banks became clearer when the ratios of these provisions to pre-tax profits are used. These ratios are presented in Appendix G, Table 1, which shows that during the period 1983-1986 the average ratios of provisions for loan losses to pre-tax profits, are much higher for Arab banks than for other international banks which are represented by the four largest British banks in this analysis. The average ratios vary from 182.7 per cent in 1983 to 287.7 per cent in 1986 for Arab banks, compared to 120.7 per cent to 48.5 per cent for the British banks during the same period. The difference between the ratios for the two groups of banks can be explained by the fact that the majority of international banks had already established provisions for bad debts and loan losses well before the occurrence of the Latin American debt crisis in 1982.

Table 8.3 The growth rate of provisions for bad debts for selected Arab banks 1984-87*

	1984		1985		1986		1987	
Bank	Amount US$ million	% change	Amount US$ million	% change	Amount US$ million	% change	Amount US$ million	% change
Arab Banking Corporation	45	125	61	36	53	-13	375	608
Bahrain Middle East Bank	na	-	8	na	9	13	22	144
Al-UBAF Group	na	-	5	na	7	40	170	2329
National Commercial Bank (SA)	194	na	229	18	122	-47	na	na
Royal Bank	62	na	83	34	91	10	112	23
BAII	5	na	9	80	34	278	na	na
Bank of Bahrain and Kuwait	na	na	na	na	144	na	274	90
Saudi British Bank	37	na	59	60	69	17	na	na

Source: Calculated from annual reports

Note: * Conversion of currencies into US dollar was done at exchange rate prevailing at end of each year

Furthermore, because of the strong capital base and domestic market of these banks, they were better able to absorb the heavy losses incurred from their exposure to Latin America.

These differences between Arab and other international banks may be used to explain the sharp differences between them, in terms of total profits. In the period between 1983-86, the overall view of Arab banks was one of rapid decline compared to a modest growth rate, since 1982, of other international banks' profits. Furthermore, judging by returns on eqiuty and assets, these ratios were lower in more cases between 1984-86, than their levels which had already fallen considerably in 1983 (see Appendix G, Tables 2 and 3). Although Arab banks followed an international trend towards lower profitability, the decline in their ratios was much steeper than that of their western European and American competitors.

However, the comparison between Arab and other international banks has its limitations, which may make the results less valid. The first of these limitations is that, while it has been established by the World Bank and the Bank of International Settlements that international operations contribute to an average of 25-40 per cent of total profitability figures of Western banks, mainly US banks, the same may not apply for Arab banks. Therefore, the early increase in Arab banks' profits may not be attributed to such an extent, to their international business, although such business has, no doubt, contributed someway towards these profits.

The fact that most Arab banks active in international markets are of recent origin, with initially, small balance sheets as their operations rapidly grew, due to thriving domestic economies following the accumulation of massive oil revenues and their involvement in international financial markets, it is natural that their profits grew accordingly and at a much faster pace than their well-established Western competitors.

The same argument could be applied to assess the performance of Arab international banks during the declining period, 1983-86. The decline in their profitability during that period was due to constraints prevailing in the domestic markets, rather than the international exposure of these banks. In fact, it could be argued that Arab banks witnessed a slowdown in their profits despite their international operations. The fact that during 1983, Arab banks reached their peak level in eurolending operations with a share of 11.7 per cent of the total euromarkets, while a slowdown in the domestic market began during the same year, supports this view.

Apart from the provisions for loan losses, there were other major reasons for the decline in Arab banks' profits during the period 1983-1986. Firstly, the decline in interest rates in the local and international markets after 1982, generally contributed to lower profits. In 1985, for example, there was a two per cent drop in interest rates which wiped out a considerable share of Arab banks' profits. Although all international banks were affected by the low interest rates prevailing in the international financial markets, Arab banks were particularly affected due to their heavy reliance on inter-bank deposits as Table 8.4 illustrates. Secondly, was the general tendency amongst private sector depositors to move deposits out of interest free accounts to interest bearing ones; this affected many banks in the region, particularly the Saudi banks where free deposits usually contribute to 40 per cent of total deposits, and which proved to be very profitable, as their cost to

Table 8.4 The ratio of deposits with banks to total assets, Arab vs international banks*, 1983-86

	1983	1984	1985	1986	Average 1983-1986
United Saudi Commercial Bank	na	66.71	68.83	73.39	69.64
Al-Ahli Bank of Kuwait	36.45	32.80	31.41	22.40	30.77
Burgan Bank	15.60	24.72	21.24	20.88	20.61
Gulf Bank	46.97	36.10	32.21	30.08	36.34
National Bank of Kuwait	41.54	36.65	34.46	39.23	87.95
Bank of Kuwait and the Middle East	38.51	24.66	18.87	16.54	84.65
Commercial Bank of Kuwait	40.76	30.74	24.20	20.68	29.10
Allie Arab Bank	38.45	27.93	42.61	40.87	37.47
UBAF-Group	65.93	61.02	58.67	60.89	61.63
BAII	53.16	42.52	32.74	33.38	40.45
FRAB Bank International	52.83	50.84	54.92	29.70	47.07
Banque International Arabe	79.46	79.77	77.81	66.87	75.98
Riyad Bank	54.37	49.84	57.24	59.94	55.35
National Commercial Bank	45.47	51.77	51.30	43.74	48.07
Average	46.88	42.64	42.49	38.22	42.56
International Average*	22.64	25.53	23.95	24.62	24.19

Source: Based on figures published in the balance sheets of these banks

Note: * These figures are based on the collective performance of the following banks; National Westminster Bank, Midland Bank, Lloyds Bank International, Fuji Bank, Barclays Bank, Dai-Ichi Kango Bank, Bank of Tokyo, Mitsui Bank and Chase Manhattan Bank the bank is almost zero. The biggest problems for banks in the Gulf region is concerning the use of collateral and the payment of interest. The inability of courts to enforce interest payments on loans, in line with Islamic law, resulted in shaking the banks confidence in the legal system, and gradually forced many banks to cease lending to the private sector. This resulted in the reduction in overall lending by banks and, therefore, less profits were generated.

Another contributing factor to the decline in Arab banks profitability, is that Arab banks generally have higher operating expenses than their Western counterparts. They rely heavily on imported management and technology, in particular, after 1982 when their international operations were expanding. Data related to the ratios of personnel expenses to net profits (Appendix G, Table 4) support this view. The average ratios for these banks during the period 1983-1986, amounted to in excess of 413 per cent, compared to 279 per cent for the largest British banks during the same period.

Another factor which may also be responsible for the low profitability ratios of most Arab banks, is the structure of their ownership. The majority of Arab banks are owned either entirely or partly by the region's governments. In his study concerning the relationship between concentration of ownership and banks' profitability in some EEC countries, Short (1979) found that government ownership of banks is correlated inversely with profitability, which tends to support the above argument.

The combination of all these factors, coupled with the slow or negative growth in almost all Middle Eastern economies in recent years, have contributed largely to the poor performance by the international Arab banks, since 1982.

There is no doubt, however, that the most important reason for the decline in Arab banks' profitability was, and still is, the rapid growth of their bad debts provisions, as mentioned earlier. It ought to be mentioned in this respect that profitability figures represented in Table 8.2 do not reflect the true nature of Arab banks' operations during that period. In 1987, for example, the collective profits of all Arab banks represented in the table, shows a loss of over US $500 million. In reality, each of these banks generated profits for that year, but they increased their bad debts provisions at a level higher than their profits generated during that year. Arab Banking Corporation is a typical example; its profits during 1987 amounted to US $375 million, which represents its highest profits since its establishment in 1980. However, the increased bad debt provisions completely absorbed this profit, which meant that the profits of Arab Banking Corporation, after provisions for that year was zero.

The basic determinant of commercial banks' profitability is the net interest revenues margin, which represents the relationship between interest paid and interest earned. This margin, less expenses, is the basis of bank profitability. As can be seen from Appendix G, Table 5, wide differences occur between different banks. Between 1983-1986, for example, Al-Saudi Banque experienced an average ratio of 1.35 per cent compared to 0.35 per cent for Al-UBAF Group. Even wider differences occur between Arab and other banks. From the same table, keeping the limitations of the average figures in mind, the average ratios of net interest revenues to total assets for the six Arab banks used in the analysis for the period 1983-1986 was only 0.67 per cent, compared to a ratio of 3.27 per cent for the four British clearing banks, for the same period.

The ratios of net interest revenues to total assets, and the provisions for loan losses to profits, which are summarised with other profitability ratios in Table 8.5 are probably the best indicators that could be adapted to judge the quality of management that operates in the two sets of banks. This is so, in theory at least, because a successful bank management should maximise loan income (increase net interest revenues), without causing loan losses to rise unduly (reduce the provisions for loan losses). It follows, therefore, that in order to increase banks' profitability at a time of low margins, decreasing trade fiance and depressed economies, the crucial role of Arab banks' managements would be to assume more risk in their lending than has been the case so far.

8.3 SOLVENCY AND LIQUIDITY OF ARAB INTERNATIONAL BANKS

Although most Arab banks failed to take full advantage of the oil surpluses in the 1970s, there was a significant increase in their capital following the second oil price rise in 1979 as mentioned in Chapter 4. This increase, although small in monetary terms compared to the volume of the surpluses, is considered to be large relative to the size of most Arab banks. The second oil price increase coincided with the realisation of many Arab governments, especially those in the Gulf region, not only to support their existing national banks, but also to establish new highly

Table 8.5 **Average profitability indicators, 1983-1986**

Ratios (average)	1983	1984	1985	1986	Average 1983-1986
Net income/Equity	9.66 (12.08)	10.88 (9.07)	5.78 (12.17)	5.94 (15.02)	7.89 (12.09)
Staff expenses/Total assets	286.8 (310.5)	180.1 (294.6)	451.5 (283.8)	414.1 (226.6)	413.3 (278.9)
Pre-tax profits/Total assets	0.52 (0.74)	0.49 (0.72)	0.20 (1.00)	0.32 (1.14)	0.38 (0.90)
Net interest revenues/total assets	0.66 (3.33)	0.56 (3.36)	0.63 (3.09)	0.70 (3.30)	0.67 (3.27)
Provisison for loan losses/pre-tax profits	182.7 (180.7)	120.3 (191.6)	136.8 (64.8)	287.7 (48.5)	208.6 (106.4)

Notes: Figures in brackets are those of the British banks
For details of these figures, see Appendix G, Tables 1, 2, 3, 4 and 5

capitalised ones mainly geared for the international markets. This new dimension of Arab banking is confirmed by the fact that the new generation of Arab banks dominate the list of all Arab banks in terms of paid-in capital. Riyad Bank of Saudi Arabia is a prime example of the old generation of Arab banks that benefited largely from the oil surpluses; its paid-in capital in 1978 was only US $415 million, but by 1981 it had grown to almost US $686 million and by 1986 it had further grown to US $1.1 billion. Arab Banking Corporation provides an example of the new generation of Arab banks. With a capital of US $1.26 billion in 1986, this bank enjoyed a higher capital base than any other Arab bank active in the euromarkets. The expansion of Arab banks in international financial markets, has called for increased capital measures and the majority of banks that are active in these market have, in line with other international banks, significantly increased their capital base, as Table 8.6 illustrates. As can be seen from the table, which shows the capital growth of the ten most active Arab banks in the euromarkets, throughout the 1980s, there has been a continuing growth of Arab banks capital, with growth rates ranging from over 100 per cent in 1981, to about 6 per cent in 1986.

Unlike other international banks, with Arab banks being recent in the euromarkets, their major aim in the early 1980s was to strengthen their capital base, which would provide them with greater capacity to support more assets. However, the increase in capital during the early and mid-1980s was not unique to Arab banks; they followed a general trend among most international banks to strengthen their capital. With country risks increasing in recent years, while the spreads were narrowing, the quality of some banks'

Table 8.6 Paid-in capital of some of the leading Arab banks in international markets, 1980-1987

US $ million

	1980	1981	1982	1983	1984	1985	1986	1987
Riyad Bank	398	686	686	842	967	1079	1099	1068
Arab Banking Corporation	420	889	950	1028	1114	1188	1261	1058
National Bank of Kuwait	372	420	475	557	614	696	742	874
National Commercial Bank	475	586	699	806	900	854	854	854
Arab Bank	234	347	401	444	474	576	677	785
Gulf International Bank	125	223	414	449	580	715	748	569
National Bank of Abu Dhabi	71	458	484	495	501	501	507	509
Arab African International Bank	136	184	208	242	249	248	251	254
Saudi International Bank	98	111	124	145	183	196	209	217

Source: Figures are taken from Annual Reports and various issues of MEED assets became suspect; therefore, the increase in capitalisation was a pre-requisite for Arab banks to survive in these markets. The global change in international financial markets from syndicated lending to securitisation, has meant that for Arab banks to succeed in these markets, greater placing power is needed.

One of the measures that could be employed to judge the capitalisation of Arab international banks, would be to apply the new proposals on capital adequacy, proposed by the Bank for International Settlements (BIS). Although these proposals are aimed at banks in Europe in preparation for 1992, they provide good indications as to the international standing of Arab banks concerning capital adequacy. The BIS proposals state that minimum capital which is defined as core and supplementary capital, should be at least 8 per cent of total assets. Figures in Table 8.7, representing the capital/assets ratios of the six GCC members' commercial banks, show that banks from all the Gulf states would meet the 1992 requirements, with Bahrain and the UAE showing particularly high capital adquacy. A comparison between the capital/assets ratios of Arab Gulf banks and banks from other regions, reveals that Arab banks enjoy higher capital ratios than banks from almost any other region in the world. Figures published by Euromoney in July 1989 support the view that the Arab banks are ranked amongst the top banks in the world in terms of capital adequacy. The Euromoney survey covered banks in 56 countries throughout the world. Using the widest measure of capital adequacy (shareholders' equity divided by total assets), for the years 1987 and 1988, the Arab Gulf countries are ranked in the top 15 countries in the world as Table 8.8 indicates.

Table 8.7 Capital/assets ratios of Arab Gulf banks by country, 1980-86

(%)

	1980	1981	1982	1983	1984	1985	1986
Bahrain	4.7	6.5	11.4	11.2	10.9	12.7	16.3
UAE	10.6	12.5	13.9	14.5	13.1	14.6	12.8
Oman	4.9	7.6	9.8	10.8	11.1	11.9	11.8
Kuwait	6.0	5.4	6.3	6.6	8.6	9.4	9.7
Qatar	7.7	5.9	6.4	7.5	7.8	7.6	8.4
Saudi Arabia	5.1	5.0	6.0	7.0	7.6	8.4	7.7

Sources: Money and Banking in the Arab Middle EaAst, Arab Monetary Fund publication (Arabic), 1987
IMF International Financial Statistics, January 1987

Table 8.8 Ranking of the Arab Gulf and other countries in terms of capital adequacy of their commercial banks, 1987-1988

per cent

Rank	Country	Average capital adequacy 1987	1988
4	UAE	12.43	11.78
8	Qatar	8.25	10.10
9	Kuwait	10.22	9.82
12	Saudi Arabia	8.02	8.04
14	Bahrain	6.69	7.39
26	United Kingdom	6.22	6.23
28	United States	6.03	6.14
50	Japan	2.76	2.87

Source: Euromoney, July 1989, p. 63

It ought to be mentioned in this respect that the comparison between capital ratios of Arab and other banks mentioned earlier may not necessarily reflect the true standing of these banks. This is due to the fact that the figures related to the American and European banks represent only the largest banks in these regions. Such banks like Citicorp or Lloyds Bank International, with a good base of loyal customers and highly efficient and experienced managements, may not need capital ratios as high as those of Arab banks. In addition, most Arab international banking accumulated considerable reserves over the years due to the lack of regulations governing financial disclosure and lax accounting standards and provisioning practices. Furthermore, smaller banks generally tend to be more heavily capitalised, particularly in politically unstable regions, due to the unpredictable nature of their deposits.

The comparison between capital ratios of Arab and other international banks may not necessarily indicate the relative strength or weaknesses of these banks, but it does indicate that Arab banks generally maintain higher capital raitos than is prudently necessary, as Table 8.9 indictates.

Table 8.9 Capital adequacy indicators, 1983-86

per cent

Ratios (average)	1983	1984	1985	1986	Average 1983-86
Loans/risk capital	9.54 (12.41)	9.54 (15.96)	8.45 (10.79)	7.14 (9.03)	8.67 (12.05)
Risk capital/total assets	7.27 (6.87)	6.79 (5.92)	6.60 (3.98)	5.78 (5.07)	6.61 (5.46)
Internal capital generation	7.71 (8.63)	5.59 (9.77)	2.49 (4.89)	3.55 (12.75)	4.32 (9.01)

Notes: Figures in brackets are those of the British banks
Details of these figures are represented in Appendix H, Tables 1, 2 and 3

While the high capital ratios of the Arab Gulf banks may indicate that these banks are well-equipped for future challenges and uncertainties, they also reflect the conservative nature of these banks. Arab banks' managements are probably better advised to maintain a balance between the benefits that are gained from achieving high capital ratios, and the costs associated with such a policy. The importance of an adequate bank's capital stems from its function as a first line cushion against unforeseen losses and its important role in financing the bank's infrastructure.

Against these advantages, high capital ratios have their limitations and costs. Fingleton (1985) argues that 'banking may become less stable because with higher capital, lenders will have to take on riskier business to earn a reasonable return on equity'.

Many factors may be used to explain the high capital ratios of Arab banks. The most important of these factors are; the banking environment, the banks management and the quality and character of ownership of banks. The banking environment affects capital ratios by affecting the quality of banks assets. The quality of Arab banks assets has, no doubt, been on the decline in recent years. This is due to the increased indebtedness of most Arab borrowers whether individual or sovereign, as explained in Chapter 7. Therefore, Arab banks may have good reasons to maintain relatively high capital ratios, as any decline in the quality of assets would certainly necessitate an increase in the capital ratios which is required to give the same degree of protection.

Like Arab banks other international banks have also been affected (to varying degrees) by the issue of rising bad debts. However, they have managed to operate profitably and safely by maintaining lower capital ratios than those of Arab banks. The differences between the two groups of banks exist because of quality of banks' management which is usually highly developed in such international banks like the British or American banks, for example. In this connection Mitchell (1984) argues, 'improvements in the quality of bank management have probably reduced slightly the capital ratios necessary for a given level of protection'.

The third important factor that is responsible for the high capital ratios of Arab banks is the ownership of these banks. As has already been established, the majority of Arab banks and joint ventures are owned by the governments of the Arab Gulf region. Furthermore, it has been established in Chapter 4 that these governments may regard the safety of their assets, higher than the potential profitability that such assets can generate. It is possible to draw the similarities between the foreign investment policies of these governments and their ownership of banks in the region. To concentrate on safety and liquidity, a reduction in lending and the maintenance of high ratios of liquidity and capital adequacy are essential.

Related to these factors, there is a fourth important reason which may also be responsible for the high capital ratios; that is, the concentration of loans. This is regarded to be a major feature of Arab banks' lending, whether to domestic or international borrowers. When lending internationally, Arab banks concentrate on lending to the developing countries, as mentioned in Chapter 7. Their domestic lending has also been concentrated on a small section of the society (usually the wealthy and influential). This policy has its grave limitations, as events in recent years have proved. The Latin American debt crisis and Souk Al-Manakh collapse has shown the vulnerability of concentrated lending and therefore, created greater need for high capital ratios.

Finally, the differences in the capital ratios of Arab and other international banks, may also be attributed to the relatively lower ability of Arab banks to generate capital from internal resources. The internal capital generation (ICG) is calculated from the following formula:

$$ICG = \frac{\text{net income - distributed income}}{\text{total equity}} \times 100$$

The results are represented in Appendix H, Table 3, which shows that during the period 1983-1986, the average ICG ratio for Arab banks of 4.32 per cent was less than half that of the British banks with an average 9.01 per cent for the same period.

This may indicate that although other international banks maintain relatively lower capital ratios, their ability to absorb unexpected losses is probably a match, or even higher than that of Arab banks. Therefore, Arab banks may be justified in keeping higher capital ratios.

Related to the high capital adequacy ratios of the Arab banks are the solvency ratios. One of the best ratios that illustrates the preference of Arab banks to hold a major portion of their total deposits in the form of liquid assets (which constitutes cash or other items that can easily be transformed into cash, such as investment securities), is the ratio of liquid assets to deposits. For the period 1983-1986, Arab banks ratios averaged 64.1 per cent compared with an average ratio of 32.1 per cent for the British banks. These ratios (similar to thsoe of capital adequacy), reflect the conservative attitude of Arab banks managements and major shareholders. They also reflect the banking environment in which Arab banks are operating, which is dominated by major uncertainties concerning political and religious factors, as will be discussed in Chapter 9.

Table 8.10 Liquidity indicators, 1983-1986

Ratios (average)	1983	1984	1985	1986	Average 1983-1986
Loans/deposits	45.3 (69.8)	48.3 (71.2)	48.5 (71.8)	48.7 (71.3)	47.7 (71.0)
Liquid assets/ deposits	65.3 (34.1)	64.9 (31.3)	64.4 (31.3)	61.7 (31.7)	64.1 (32.1)

Notes: Figures in brackets are those of British banks
Details of these figures are represented in Appendix I, Tables 1 and 2

These ratios suggest that Arab banks are considered to be amongst the least leveraged banks that are active internationally. The loans/deposits ratios of some Arab international banks is shown in Table 8.10. The table illustrates that the average loans/deposits ratios held by most Arab banks between 1983-86 is only about 48 per cent, compared to an average ratio of 71 per cent for the four British clearing banks for the same period. These ratios indicate that Arab banks may be ranked amongst the world's most conservatively run banks, but they also indicate that Arab banks are financially sound and, provided they develop advanced management techniques, are capable of meeting the challenges they have been facing in the domestic and international markets.

CHAPTER 9

THE LIMITATIONS OF ARAB INTERNATIONAL BANKS AND FINANCIAL MARKETS

9.1 INTRODUCTION

The aim of this chapter is to analyse the limitations of Arab banks in the euromarkets. It has been established in Chapter 4, that Arab banks did not directly benefit from the huge oil surpluses that the Middle East region witnessed in the 1970s. It appears that Arab banks were the economic sector benefiting least from these surpluses. While we accept that some of the reasons that led Arab governments to invest their surpluses in the west were out of the control of Arab banks, in general, the inefficiency of these banks was to blame, as will be seen later.

The depressed economies in the Middle East and the deregulation and securitisation of the international financial markets, left Arab banks behind banks from other regions. The inability of their managements to adapt to the conditions in international financial markets, has been the major handicap for Arab banks in the euromarkets. The lack of efficient financial and capital markets in the Middle East provides another obstacle in the process of Arab banks' development.

This chapter will concentrate on the major aspects that are considered to be responsible for delaying and hindering the activities of Arab banks in international financial markets.

9.2 FINANCIAL AND CAPITAL MARKETS

The new generation of Arab international banks have been accused of not living up to the objectives and aims that were the main reason for their establishment. Two of the major objectives still largely unfulfilled, are; first, the attraction of local wealth, particularly the major portion that is invested overseas. Second, the initiation and training of local bankers to replace the more expensive expatriates that occupy the majority of executive positions in financial institutions throughout the Gulf region. Furthermore, it has been established in Chapter 7, Arab banks, generally, are behind most other international banks in their eurobond involvements at a time when global change has been made from syndicated lending to the securitisation of debts. The relatively modest success that some of these banks have had in the eurobond markets in recent years, has been a direct result of the total commitment of these banks to tap the securities market, as a result of poor economic conditions prevailing in their home countries. This is particularly true for Arab banks based in Bahrain, which represent the majority of international operations carried out by Arab banks in terms of volume, with a smaller and less dynamic domestic base than most neighbouring Gulf states. While these accusations against Arab international banks are true in some cases, the lack of well-developed capital markets in the region is mostly to blame.

Commercial banks, like any other financial institutions, cannot work in isolation. They only represent one part of a financial system that ideally should include interbank, money, bond and stock markets.

The establishment of such markets would be of great assistance to Arab international banks, whether in their domestic or international operations, in the sense that they would have a wider economic base and gain first hand knowledge and experience in securities dealings. This would be invaluable to them when operating internationally, in the same way that that British, American and Japanese banks benefited greatly from the capital markets in London, New York and Tokyo.

The importance of developing capital markets in the region stems from the fact that such markets could play a very important role in the following areas; creating new investment opportunities (particularly among the private sector and thus, attracting local wealth), providing the region with financial expertise and finally, creating financial awareness in a region that is potentially capable of generating more wealth than most other regions in the world.

As mentioned earlier in Chapter 7, apart from the problems that are negatively affecting Arab banks on the micro level (eg their management), many other factors have also contributed to the poor performances of most of these banks. While Arab banks have control of the first set of problems and are making good progress, they have no control over the second set of several obstacles existing in the region as a whole. The most important of these is the heavy reliance on international financial markets. This is evident when studying Arab banks' international lending. Although most of their lending went to Arab borrowers, this process was made via the euromarkets, where many foreign banks lead-managed the largest of such deals. Another problem is the very low inter-Arab investment compared to foreign investments by Arab governments and private sectors. Therefore, any increase in inter-Arab trade and investment will have a positive effect on the regional operations of Arab international banks.

An efficient capital market in the Gulf region is a major step towards achieving these two goals. With the resources available to Arab banks, they would be able to directly satisfy the needs of Arab borrowers and investors first and then venture into other regions.

After two decades since the establishment of the Arab financial markets in Lebanon and Kuwait, and after more than a decade since the establishment of the Bahraini offshore market, one can conclude that these markets, though successful at first, have not provided the Arab world with a permanent means of investing and borrowing. The nature and development of the Arab financial markets depends largely on the political and economic situations of these countries. The fact that many of these countries (like most developing countries) were, until recently, under British and French influence, has meant that the economic development of Arab countries has been directly linked to the needs of the developed countries. What has made matters worse, is the investment policies of almost all Gulf countries, whereby the bulk of their wealth is invested in the west and, thus, outside the control of Arab countries.

Arab countries (particularly oil producing countries) have been almost completely integrated financially with the international financial markets of the west. The oil revenues of the 1970s have, so far, been directed towards three main vehicles. First, the major part of these revenues have been directly placed in the international financial markets, as mentioned earlier, in Chapter 4. The second part was used domestically, mainly to finance the imports of foreign expertise and technology that are necessary for the implementation of the optimistic development plans set up by the different governments in the region. A third (and relatively smaller part) was directed towards Arab banks and financial markets, which in turn transferred their assets to the international financial markets. This, in effect, has meant that the lion's share of Arab financial resources remains abroad and beyond Arab controls. The net result has been a delay in the creation of developed and independent financial markets in the Arab region. It is this challenge that has made the creation of new financial markets and developing the existing ones in the Middle East, a very important step towards the political and economic independence of these countries.

Many of the problems that affected the individual capital markets in the Gulf region have been discussed in Chapter 6. However, there is a set of general problems that affect all financial and capital markets in the Middle East. These are:

1 the absence of a stable and well-developed industrial base in almost all Arab countries as mentioned in Chapter 1. Such industries have a very important role to play in attracting local capital.

2 the lack of an organised and developed financial system. Almost all Arab countries, with the exception of Kuwait, Bahrain, and until recently Lebanon, lack the specialised financial institutions that play a very important role in the creation of any financial market.

3 the absence of a well-defined and modern commercial law that could adapt to the present financial and economic development. This is particularly true for states like Saudi Arabia, where

the legal development has been described as being mostly backward (Seznec, 1987).

4 the differences in the Arab countries' political and economic systems, have made the task of integrating Arab financial markets very difficult. The differences in exchange rate systems and in interest rate structures, is reflected in the lack of efficiency and co-ordination of Arab markets to intermediate between Arab borrowers and lenders. This is considered to be the main reason for the greater integration between Arab and other international financial markets, rather than with other Arab financial markets. The euromarkets' figures illustrate this point. Borrowing by Arab non-oil producing countries from these markets, whether in the form of euroloans or eurobonds, up until 1984, for example, amounted to approximately US $50 billion, while Arab investments in these markets, for the same period, totalled about US $150 billion. Furthermore, during the period 1986-1988, Arab countries borrowed from syndicated lending markets alone about US $6 billion. Consequently, the deposits placed by the GCC countries during the same period amounted to US $80 billion as Table 9.1 shows.

Clearly, the supply of funds by the Arab surplus countries covers the demand for funds by Arab non-oil producing countries many times over. Ideally, these funds should flow directly from Arab surplus to Arab deficit countries without the need for eurocurrency markets' intermediation. The obvious problem, therefore, lies within Arab banks and Arab financial markets.

These markets do not possess the variety of financial instruments available elsewhere. The creation of such instruments as floating rate notes (FRNs), certificates of deposit (CDs) and note issuance facilities (NIFs) are very important for Arab financial markets to match the maturities of the region's funds.

Table 9.1 Arab deposits and borrowing from the euromarkets, 1986-1988

US$ billion

	1986	1987	1988 1st half
GCC euromarket deposits*	63.5	66.9	66.3
UK	29.6	28.1	27.8
Other EEC countries	14.5	15.2	15.2
Other OECD countries	19.4	23.6	23.3
Arab borrowing from the euromarkets**	3.082	1.461	1.345
Differentials	+60.42	+65.44	+64.96

Sources: Bank of England Quarterly Bulletins, December 1985, March 1986, February 1987, November 1987, January 1988, May 1988 and February 1989
Euromoney Annual Financing Report, 1988
International Financial Law Review, International Loan Database

Notes: * These figures are estimates based on the total foreign assets of OPEC members in which the GCC members account for approximately 75 per cent
** Represent the volume of syndicated loans to the following Arab countries, Algeria, Bahrain, Egypt, Iraq, Jordan, Kuwait, Lebanon, Morocco, North Yeme, Oman, Qatar, Saudi Arabia, Syria, Tunisia, and UAE

On the one hand, the surplus oil-producing countries prefer to place their funds on a short-term basis in order to guarantee liquidity. Arab borrowers, on the other hand, prefer to borrow on medium to long-term periods. The ability to transfer the surplus funds into long-term loans, is the most important challenge that faces Arab financial markets. The evidence, so far, suggests that they have only managed to do so on a very small level, as mentioned earlier in Chapter 5. Although Arab surplus countries have been involved in offsetting the balance of payments of the Arab deficit countries through various aid programmes, greater co-operation between the two groups of countries is needed through the use of Arab financial institutions and markets.

5 the low level of inter-Arab trade; it is noticeable that dealings between Arab and other international financial markets are far greater than inter-Arab dealings. In many ways this reflects the strong economic and trade relations between Arab countries and the rest of the world compared to a very low level of inter-Arab trade. On average, inter-Arab trade represents only about 6 per cent of their total trade, as mentioned previously.

The level of inter-Arab trade has not only been declining in absolute terms but also in relative terms, which suggests that the foreign trade of Arab countries has been growing faster than inter-Arab trade. This suggests, among other things, that Arab economies are not sufficiently open to each other, despite the many agreements between them; such agreements as, the Arab Economic Unity, the Arab Custom Union, bilateral trade agreements and the existence of free trade zones. The low level of inter-Arab trade also reflects the differences in Arab trade and monetary policies. Like their financial and capital markets, Arab foreign trade policies remain fixed along narrow nationalistic lines.

Data related to inter-Arab investments, also supports this view. It is impossible to precisely measure the volumes of inter-Arab investments, particularly those related to the private sector. However, general estimates suggest that these investments are negligible compared to total foreign investments made by the Arab Gulf countries during the 1970s. In 1981, for example, it is estimated that inter-Arab investments represented less than 7 per cent of the total, as Table 9.2 shows.

Furthermore, according to the Bank of England, the six GCC members managed to accumulate net foreign assets, over the period of 1973 until the first half of 1987, of approximately US $320 billion. Although there is no breakdown on whether these assets are held by governments or individuals, the private sector is estimated to have had more than US $125 billion in investments worldwide, for the same period. Out of this total, only US $327 million in 1985 and US $361 million in 1986, was invested in Arab countries.

Until now, the whole of the Middle East has depended on one or two financial markets, namely Kuwait and Bahrain, with Kuwait being the only investment centre in the region. This policy has proved to be highly unsatisfactory judging by the devastating effects that the Souk al-Manakh crash of 1982 left behind, not only on the Kuwaiti financial institutions, but on several Arab banks and Arab

Table 9.2 Inter-Arab public and private direct ivnestments, end-1981

	Private	Government	Total
Number of projects	99.00	57.00	156.00
Amounts (US$ billion)	1.34	9.56	10.90
Total direct investment* (US$ billion)	39.30	117.70	157.00
Inter-Arab as % of total	3.40	8.10	6.90

Sources: N. Sherbiny, Arab Financial Institutions and Developing Countries, World Bank Staff Working Papers no. 794, Series on International Capital and Economic Development no. 6 Bank of England Quarterly Bulletin, March 1985

Note: * Based on the assumptions that the GCC investment is equivalent to approximately 75 per cent of total OPEC investments, and that the private sector investments represent 25-30 of total Arab Gulf investments

investors. Therefore, in order to overcome some of the constraints that affect the various capital and money markets in the region, there is a strong case for a regional capital market. Such a market would make the task of Arab international banks intermediating between sources and uses of funds much more effective, in the sense that it would provide these banks with greater placing power. By providing alternative investment outlets and a variety of financial instruments, a regional capital market has an important role to play in increasing the absorptive capacity of the region. This would undoubtedly be a major step towards transforming the international operations of Arab banks into regional operations. The major effects of this process would be: firstly, greater direct relations between Arab lenders and borrowers; and secondly, the vast amounts of foreign investment made by the Gulf governments and the private sector might be brought back and put to better use domestically, and thus promote economic development.

The accumulated foreign assets by the GCC region throughout the 1970s and early 1980s indicate that significant funds are still available in the region, though the rate of accumulating these funds has been on the decline in recent years. Therefore, the most important role that could be played by a well-developed regional capital market would be to attract these funds from abroad, and most importantly to channel short-term deposits into long-term investments. The task of attracting Arab money invested abroad into the local market has probably been made easier by recent events in international financial markets. The 1987 stock market crash might prove to be a dominant factor in causing Arab investors (whether governments or individuals) to change their investment habits, after the heavy losses they incurred following the crash. Providing that a regional capital market in the Gulf could succeed in creating a variety of financial instruments, such as treasury bills, CDs, FRNs, NIFs and others, it would be a natural development for Gulf investors to switch their investments to the domestic market.

As mentioned earlier in Chapter 4, Arab investors are generally conservative, so it would make sense for them in light of the political and economic uncertainties abroad, to invest their funds in a familiar environment, where there is little or no exchange risk and no taxes.

It is apparent from the previous discussion that a well-developed regional capital market in the Gulf is much needed at a time of declining regional financial surpluses, where the efficient utilisation of savings and capital rationing is becoming a major target for the various Gulf countries.

However, in order to establish a regional capital market, many obstacles will have to be overcome. Establishing such a market requires a high degree of skills and expertise among lenders, borrowers and most importantly, supervisory authorities. Furthermore, for the market to succeed, the contribution of a variety of investors is necessary. In addition, a ready supply of reliable business information and the protection of an adequate legal system to protect the rights of creditors, is very important.

Another important factor is for GCC countries' exchange rates to be market determined, instead of the monitored rates that exist at present. There has been a move by the GCC members to unify their exchange rate systems and their currencies, whereby the six currencies would be tied to a common peg. This move, when finally achieved, will enhance the region's capital markets' growth; this will be achieved by reducing exchange rate risks between these countries.

Perhaps the most important factor towards establishing a Gulf regional capital market, would be to abolish the restrictions imposed on Gulf nationals concerning investments outside the boundaries of their countries. So far, the opportunity for Gulf nationals to invest in companies outside their own countries, has been severely limited. In Kuwait, for example, orders can be placed only by national institutions; other Gulf nations can only invest in the Kuwaiti registered shareholding companies. The number of such companies has been reduced from 34 following the stock exchange crash, to only 8 companies. Bahrain appears to be the only GCC country that allows GCC citizens to own up to 25 per cent of the 34 listed companies, provided that Bahrainis own at least 51 per cent. However, it must be mentioned that serious steps have been taken by the GCC monetary authorities towards creating a free market in Gulf shares. The GCC's financial and economic co-operating committee decided in February 1988 to liberalise share regulations in the Gulf. However, up until the end of 1988 this step had not completely materialised. Monetary authorities in these countries are still finalising details on how the new system will work, in particular, the limits to be set on overseas ownership (MEED, 27 March 1989).

One can conclude that due to the limitations of the various capital markets in the region, the likelihood of creating a regional capital market in the Gulf during the late 1980s and early 1990s, is very limited. A Gulf regional capital market, once materialised, is most likely to be based in Bahrain. This is because Bahrain possesses most of the expertise needed for the initial establishment of a regional capital market. Furthermore, having a wide network of international communications and offshore banking units, and being the headquarters of most Arab banks that are active in international capital markets, Bahrain is ideally placed to be a centre for issuing the instruments for the regional capital market.

9.3 POLITICAL INFLUENCE

The most damaging effect on Arab banks, and Arab capital markets for this matter, has been the political instability in the region. As already mentioned in Chapter Five, the importance of political stability stems from the fact that without it there will be no security for depositors, investors and financial institutions. Indeed, the political instability in the Middle East partly explains the massive outflow of funds from the region.

The political pressure on Arab banks stems from the fact that most of these banks are owned by the governments of the region or their agencies. Therefore, the overall policy of Arab banks, particularly when lending internationally, must represent the policies of the governments. In fact, political influence on banks and other financial institutions is not unique to the Middle East. Many countries have used political pressure on banks, as a weapon at some stage. A prime example is when the US government ordered many US banks to freeze Iranian assets which amounted to billions of US dollars, following the overthrow of the Shah of Iran and the hostages crisis that followed in 1979. Three years later similar action was taken in the United Kingdom, following the Falklands crisis.

For Arab banks, however, the major political influence is that of boycotting Israel and its allies. The only differences between the Arab boycott of Israel and the ones mentioned earlier, lie in the length of the boycott and the many parties affected by it.

The Arab boycott of Israel and Zionism is older than most Arab banks. It began as early as 1921 and continued throughout the 1920s and 1930s on informal levels. In 1945, the newly found league of

Arab states, took the first serious step towards boycotting the Zionist movement which was very active in Palestine. The first policy adopted by the Arab states was the boycott of goods produced by Zionist firms in Palestine. In 1946, a boycott committee was established, and still stands today. With the formal creation of Israel in 1948, further steps were taken to expand the boycott and ensure its strict enforcement.

In simple terms, the Arab boycott can be viewed as a refusal by Arab countries and their nationals to participate in trade activities in any form with Israel and its nationals. In recent years, third parties have become involved in this boycott. As far as the banking and financial business is concerned, this includes the boycott of financial institutions that have branches in Israel, granting Israeli banks licences, investing in Israeli companies, entering into partnerships with Israeli companies or acting as agents for Israeli firms. Furthermore, countries that are seen as principal importers of Israeli products or which export arms to Israel or build ships for Israel, have also been boycotted. However, the boycotting of countries, particularly developed countries, has proved difficult to maintain due to many reasons out of the scope of this study.

One of the most damaging effects of the Arab boycott of Israel on the Arab Gulf international banks was their inability until recently to join the worldwide Interbank Financial Telecommunications, which is better known as SWIFT. Until July 1985, when SWIFT was taken off the Arab boycott of Israel, Arab banks were the only international banks in the world not to be members of SWIFT. Not surprisingly, since then all the major Arab international banks, particularly those based in Bahrain, have decided to join SWIFT.

The importance of joining SWIFT is immense. The major Arab financial institutions and markets, suffer from lack of information. Their membership of this system has undoubtedly enhanced their ability to conduct international banking transactions. The benefits gained from joining SWIFT are primarily those related to the reduced time-scale, accuracy of information and the reduction of costs. All these areas are of prime importance to Arab banks. Because of their late arrival to this worldwide system which has in excess of 2,000 of the world's largest banks as members, Arab banks have probably not yet gained the full advantages of such a system.

From the previous discussion, it is clear that the boycott programme has covered a wide range of financial institutions, firms and even countries, that could otherwise have been potential customers for Middle Eastern banks. Undoubtedly, this pressure on Arab banks has limited the opportunities of their involvements in the euromarkets. They have been denied the right to co-manage many syndicated loans and bonds because the lead managers of such deals have connections with Israel. This is particularly true in the eurobonds markets, where as mentioned in Chapter Seven, very few financial institutions dominate these markets. One such institution that has consistently appeared among the leading institutions in the eurobonds market, with a share of over 8 per cent in 1984, is Solomon Brothers with whom Arab banks could not participate in any deal, due to the former's connections with Israel. In 1980, for example, when Solomon Brothers was not on the boycotting list, Arab financial institutions particularly the 3Ks entered many deals with the above-mentioned institution which, in many ways, was responsible for their good performances in the eurobonds market during that year.

The other example of a financial institution active in the eurobond market, and with which Arab institutions could not participate, was the Banque Bruxelles Lambert (BBL), which was placed on the boycotting list in 1983.

Considering that these two institutions were ranked second and tenth in the eurobond lead-managers league in 1983, the burdens on Arab international banks in the eurobonds market seems clear.

In fact, it was shown that a parallel existed between the slowdown in Arab banks' eurobond activities and the boycott list in the early 1980s (Nakhjavani, 1983).

The Arab boycott programme was not confined to outside the Arab region. Many institutions and countries inside the region have also been affected. For instance, many Arab banks were under political pressure, whether from their shareholders or governments, and as a result refused to do business with Egypt in the period 1977-85. This was due to the political isolation of Egypt in the Arab world as a result of Egypt's peace treaty with Israel in 1977. Considering that accumulated borrowing by Egypt from international financial markets in the period between 1980-1985 was in excess of US $7 billion, the loss to Arab banks, which may have otherwise financed the lion's share of Egypt's financial demands, appears considerable.

Another political factor that affected Arab banks occurred during the Gulf war between Iraq and Iran. Many Gulf countries that supported Iraq during its eight years' long war, prohibited their banks from entering any loan to Iran. This was particularly true for such Arab banks like Gulf International Bank, in which Iraq is a major shareholder. As a result, Iran opted to borrow from Turkish and European banks. Although there is no precise figure on how much Iran borrowed during the course of the Gulf war, it is estimated to run into tens of billions of US dollars.

However, despite the limitations that political pressures have imposed on certain Arab banks' international operations (especially the privately owned Arab banks), it has been argued that these political factors have equally benefited other Arab banks. Wilson (1983) argues that 'the overall political factors are undoubtedly an aid rather than a hindrance to growth'. As a sign of political independence, many governments in the Middle East have preferred to use their own banks rather than foreign-owned banks. This is considered to be one of the main reasons why countries like Iraq, Kuwait and more recently Saudi Arabia, have adopted a policy of nationalising their banking industry and therefore not permitting foreign banks into their countries.

9.4 MANAGEMENT

It was shown throughout this research that the managements of Arab banks are, with very few exceptions, characterised by being conservative, and relatively undeveloped.

The role of management arises because the banking industry in general, and international banking in particular, depends first and foremost on human skills.

Even when banks are financially sound, as is the case with most Arab banks, the role of management would be to deploy the available resources in the most productive manner. The deployment of any bank's resources will inevitably incur assuming risks. The research has shown that the inability of most Arab banks to assume more risks in their lending and to adapt to new financial products, has been their major handicap. A glance at some of the items in Arab banks' balance sheets reveals this fact clearly. The heavy reliance on interbank deposits, the low levels of the ratios of: loans to total assets, loans to capital and net interest revenues to total assets, can only indicate, among other things, a conservative management with priorities of maintaining safety and liquidity. While it is agreed that such a policy is desirable in the Middle East, (political instability, nature of deposits, undeveloped capital markets, unfavourable domestic interest rates and many other factors) may require the banks to be over-cautious, a balance should be maintained between prudency and excessive safety. Judging by evidence presented in the previous chapters, very few Arab banks have managed to maintain this balance.

Indeed, it can be argued, that by concentrating too much on safety and liquidity, Arab banks might have created unnecessary risks. For instance, in trying to reduce risks associated with domestic lending to a minimum level, Arab banks (as the text showed), have limited their lending to a very small sector of the economy, whether in lending to economic sectors (trade sector) or to the private sector (high net-worth individuals). This policy appears to have failed on both accounts. The application of such narrow policies can indicate two things: by concentrating their lending to a particular sector, Arab banks are left vulnerable to any changes in these sectors; secondly, the concentration on the trade sector for example, has created gaps whereby other sectors such as industry and agriculture are largely ignored.

With the resources available to Arab banks, as mentioned in Chapter 8, and with the massive investment potential in the region, an efficient bank's management has a very important role to play in attracting customers, financing viable investment opportunities and most importantly, introducing new financial instruments. This is particularly important for Arab banks located in countries where no foreign exchange controls exist. For Arab international banks, however, the issue of bank management is more important than for those confined to the domestic markets only.

The recent involvement of Arab banks in international financial markets, has brought many challenges for their managements. Firstly, risks involved in international banking are not as limited as previously thought by many banks, the Latin American debt crisis being a prime example. Secondly, due to the intense competition among banks, profitability in international banking operations is almost always lower than that on domestic operations. Therefore, to survive in such environments, the role of bank management is vital.

Many weaknesses can be identified concerning the management structure of Arab banks, they are:

1 It is common practice among most Arab banks to rely on a single manager at the top rather than a management structure. This is particularly true for banks based in the Gulf countries. Such a policy, with too much concentration of power, inevitably

leads to creating management gaps. This policy is reflected in a lack of innovation and often reduces the competitive power for many Arab banks. Their main weakness in this field has been that their general managers do not delegate enough responsibilities in key areas. This has been one of the reasons why some Arab banks are relatively slow to adapt to changing international market conditions, at a time of recession in their region. If Arab banks are to have any success in investment banking, a team approach is needed.

2 The decision-making in most Arab banks is often centred on the board of directors or the chief executive officer (Kirdar, 1989). There is rarely any co-ordination between the two. In the case of Arab Gulf private banks, the decision-making is entirely the duty of the board of directors who own the bank and, in most cases they are businessmen and not bankers. Among government-owned banks, however, the chief executive officer who is appointed by the authorities and usually strongly backed, is the sole decision-maker in the institution, while the board is rather weak and ineffective.

3 In many Arab banks, the annual intake of new employees is selected without particular regard to the level of their academic achievements or particular skills. In their first move towards internationalisation, Arab banks required simple skills such as an understanding of trade finance procedure, a general knowledge of international conditions and relations, and practical skills in money dealings or foreign exchange. The recession in the Middle East in the early 1980s and the declining importance of syndicated eurolending, has brought

about the need for greater variety of skills such as credit management, marketing, and most importantly, has created the need for Arab banks' management to change from assets to liabilities management. Such skills are relatively undeveloped among most Arab banks. This is due to the failure of Arab countries to establish training institutions in the field of banking and finance, or to develop qualified managers who have the expertise needed and are able to keep up with the latest developments in the international financial markets.

4 Arab banks still find it desirable, though expensive, to hire experienced outsiders to occupy the executive jobs. As their international operations and ambitions have increased in the last few years, and in view of their inability to upgrade existing Arab bankers or transfer domestic bankers to the international function, they are obliged to employ more expatriates. In fact, even after a decade of experience in international financial operations, most Arab banks still rely to varying degrees on imported management. When studying the annual reports of the top 25 Arab banks that were active in international operations at the end of 1988, only five have managed to develop local managers to occupy the senior jobs. Leading this group are banks such as Arab Banking Corporation, Gulf International Bank and the National Commercial Bank of Saudi Arabia. The rest, however, still rely partly or exclusively on foreign managements to occupy certain jobs, such as international managers, general managers, treasurers and investment managers.

The policy of employing expatriate managers has, for many reasons, proved to be less effective than Arab banks and monetary authorities had hoped. Problems sometimes arise because of cultural clashes when trying to apply Western style management into a bank that is wholly Arab in character.

Another problem that arises when employing foreign management, is the lack of authority given to this management. As a result, the management in some banks fail to prevent directors and shareholders from imposing policies based on tradition rather than sound banking operations. Such policies occasionally entail heavy lending to the shareholders and directors themselves.

Some of these obstacles could be prevented by employing local staff. There is a very important practical and economic reason for adopting such a policy. An expatriate manager in any Middle Eastern bank, would probably cost the employer 3-4 times as much as would a local employee. Even when compared to the well-developed international financial centres, salaries paid for bankers are generally 15-70 per cent higher in the Middle East, as Table 9.3 indicates. The table compares salaries paid to bankers in London with those based in the Gulf. Although Gulf salaries do vary according to country and size of institution, in general, Saudi banks tend to be the top payers, followed by banks in Kuwait, Bahrain and the UAE.

The high costs of expatriate managers is not confined only to their high salaries, but also to the additional benefits, which a local Arab manager may not receive. Such benefits, like housing, travel fares, school fees, etc, are probably the main reason why

Arab banks have higher staff expenses than other international banks as shown in Chapter 8.

Table 9.3 Indicative annual salaries'* range for senior bankers, end-1986

US $000

	Gulf	London
General manager	165.225	145.180
Treasurer	150.200	100.120
Chief dealer	120.180	62.125
Head of operations	110.140	55.900
Fund manager	90.180	70.900
Head of corporate marketing	80.100	70.125

Source: Middle East Economic Digest, December 1987

Note: * Figures exclude annual bonuses, which may amount to 7 per cent of annual salary

Despite the high salaries paid for top expatriate bank executives, some are reluctant to leave their jobs and move into a region in a recession, where political instability has been a dominant factor in recent years. Therefore, many Arab banks are limited in their access to top quality managers and are in a dilemma whether to increase their already high levels of overheads by paying more to expatriate management, or face the prospect of being squeezed out of new markets through lack of expertise.

Finally, employing expatriates has to a certain extent created a housing problem in the small Gulf states such as Kuwait and Bahrain, where the property market is very limited.

The major weaknesses associated with hiring foreign management highlights the urgent need for Arab countries and Arab financial institutions to take serious measures towards establishing a good supply of trained nationals in order to ensure the stability and continuity of their top management.

It ought to be mentioned in this respect that steps have been taken in recent years in most Arab countries to set up training schemes in the field of banking and finance. Bahrain is a leading example; it insists on foreign banks employing and training local staff. The success of this policy is reflected in the increased number of Bahraini nationals among OBUs, as discussed earlier in Chapter 5.

Efforts have also been made by the Arab Monetary Fund (AMF); the AMF is currently providing courses and seminars geared towards improved technical capabilities in member countries' staff, in the areas of monetary and financial management.

Amongst Arab international banks, Gulf International Bank is leading the way in the process of training Arab bankers. Nationals of the shareholder states are given priority in the employment and training policies of the bank (Annual Report, 1985). Gulf International Bank has a graduate development programme which takes in young nationals and trains them over two years. The training schemes involve on the job training, and regular seminars at the Bahraini Bankers Training Centre and at other institutions, including the Institute of Bankers in London. If Arab banks are to have any success in the international financial markets they will have to follow Gulf International Bank's example. Constant training and development are necessary to create a new breed of Arab bankers who are capable of adapting to the new products and technology that are necessary in international financial markets.

A pressing challenge for Arab banks' management in recent years, has been the growing sophistication of customers at all levels and their demands for correspondingly sophisticated products at competitive prices. To meet the challenges of international banking activities, Arab banks' managements will have to include tasks other than the traditional leadership role. Such tasks like understanding information and budgetary systems, professionalism and connections, off-balance sheet income and greater risk taking, are very important.

International bankers learn not only from formal training programmes, specialised banking schools and short courses and seminars but also from on the job experience. It is very important to keep a balance between these training procedures. The concentration on academic skills only is not enough and often falls short. Equally, on the job training, which characterises most Arab banks managements, has its shortcomings, the most important of which, is that it is slow and time consuming; it often leads to talented people looking for greater intellectual stimulation in other more focused career opportunities, or moving to other institutions. This was apparent when the newly established and larger international Arab banks, managed to attract most of the management talent from the older and often larger national banks in the Arab region.

In general, one can conclude that apart from the few successful Arab international banks, such as Arab Banking Corporation and Gulf

International Bank, the majority do not pay adequate attention to the advantages that rigorous, organised teaching can offer.

9.5 GEOGRAPHICAL SPREAD

A major drive toward the internationalisation of Arab banks occurred in the 1970s and early 1980s, following the oil price increases and other reasons discussed earlier in Chapter Three. As a result, by the end of 1984, there were 340 Arab banks with a large number of branches operating in the Middle East, and 125 based outside the Arab world. The geographical diversification of Arab banks will need to be reviewed in relation to their costs and advantages.

In the early years of their expansion outside the Arab region, many Arab Gulf banks established branches abroad in the form of 'follow the leader', and in many cases the expansion was not considered on an economic basis but rather, on political and sometimes religious considerations. Furthermore, many smaller banks, particularly those owned by families in the Gulf, decided to expand outside their national boundaries, mainly for the sake of connections and reputations.

The picture is the same in local markets. The number of locally owned banks more than doubled in the period 1979-83. The increased number of newly established banks during that period was, no doubt, enhanced by the rise in oil revenues. With the massive amounts of wealth acquired by some of the leading families in the Gulf, it was not unusual for such families to have their own banks. Such banks were created mainly to channel funds into real estate and investments abroad. The majority of these banks, though profitable at the early stage, were not prepared for the recession that the region has been experiencing in recent years.

However, the major expansion of Arab banks occurred outside their own region. In Western Europe alone, by the end of 1985, there were 83 Arab financial institutions with a combined paid-in capital of US $2.4 billion, as Table 9.4 illustrates.

Two important questions arise in this respect; first, is there a real need for such a large number of Arab banks and joint ventures in Europe?; and second, does the performance of these banks justify their existence outside their national boundaries? The answer to both questions will have to be negative. The breakdown of figures on capital and assets of these banks, support this view. Out of the 83 Arab financial institutions operating in Europe, there are very few with a paid-in capital of US $100 million or more. For instance, there are four Arab banks in Belgium with a combined paid-in capital of US $26 million, and 14 Arab banks in Switzerland with a combined capital of US $125 million. These examples suggest that some of these banks are very much too undercapitalised to achieve any degree of financial effectiveness and to offer financial services that are competitive with those offered by banks elsewhere. It is obvious that there is a good deal of Arab banks' capital available, but it has been divided among too many small institutions. Therefore, there is very little justification for such banks to operate in the world's most developed financial centres, which are hosts to the largest multinational banks in the world.

Table 9.4 The expansion of Arab international banks in Western Europe, end-1982

US$ million

Host country	Number of banks*	Paid-in capital	Deposits	Total assets	Loans	Net profits
France	32	345	14,631	24,463	13,580	35.0
Luxembourg	18	1,485	19,344	22,420	na	1.1
Switzerland	14	125	879	1,341	459	10.1
Great Britain	8	282	8,793	9,713	5,448	67.1
Belgium	4	26	1,242	1,405	1,166	3.4
Spain	3	78	1,805	4,026	109	2.1
West Germany	2	34	211	371	82	0.9
Italy	1	22	630	717	113	5.3
Greece	1	15	190	242	na	na

Source: Arab Monetary Fund, basic facts and indicators for joint Arab international financial banking establishments, March 1985

Note: * represents the number of branches only

It follows, therefore, that in order to create relatively large Arab banks that are capable of offering services and products that could provide a reasonable margin of profitability, a merger between some of the Arab banks spread throughout the world is necessary. By pooling their resources and expertise, the resulting larger Arab banks may benefit from the economies of scale. The merger of banks, particularly those owned by the smaller Gulf states, is not an easy task. It will depend largely on settling differences and rivalries between various rulers and families in these countries.

The priority should be to reinforce and develop the existing institutions rather than to expand into markets which may serve individuals or minorities, but which are unlikely to be beneficial to the development and credibility of Arab banking generally. This is particularly important if Arab banks are to have any real financial power in Europe after 1992, with the creation of the unified European market. The number of financial institutions present in Europe will probably be less important than the quality of services offered and the placing power, in a market that is dominated by the largest and most experienced banks in the world.

9.6 OTHER CONSTRAINTS

Supervision and control, the weakness of the central banks' supervisory system has been another handicap for Arab banks and financial markets. Most of the central banks in the Gulf region are of recent origin; they lack the expertise needed to efficiently regulate their banking systems. Until 1982, most central banks in the region did not act as lender of last resort, nor did they have much influence over commercial banks. This was reflected in the fact that during the boom years when the oil price increases occurred, there was very little control over the smaller banks. As a result many banks were run without any proper guidelines, and further licences were issued to such banks without properly checking into their operations. Many banks, for example, had made no provisions for loan losses for years under the pretence that their debts were covered by hidden reserves that never existed. This is particularly true for the Kuwaiti banks where such provisions are never reported. This was evident when in recent years the Bank of England did not accept Kuwait's capital adequacy strategy at face value, when evaluating the balance sheets of some Kuwaiti banks who applied for a licence to operate in London (Habibi, 1988).

Disclosure requirements among Arab Gulf banks is another constraint. Only end of year statements are published for Kuwaiti banks, for example, and the figures published are in many ways inadequate. No detailed breakdowns are provided by deposits or loans, by type; profit and loss statements are also lacking in details, and essentially made in a single line.

In the absence of well-developed stock exchanges in the Gulf region, which usually act as pools of financial information, greater financial information disclosures are much needed.

The most important challenge that faces the regulatory authorities in the Gulf region is the issue of interest. Many banks in the region have suffered heavy losses due to the complications over interest when cases with bad debt customers are taken to court. Among the six GCC countries, only banks in Saudi Arabia and the UAE are directly affected by the issue of interest. In both countries, courts always deduct interest, both paid and outstanding, from the sums they award. In an attempt to solve the issue, the authorities in Saudi Arabia are encouraging banks to put clauses on loan agreements stating that in the event of dispute the parties concerned will go to arbitration and not to court. These new agreements, however, are yet to be tested, but it seems unlikely that this will solve the issue permanently, because even if arbitration committees support interest payments, the debtors will still be able to appeal to the courts.

The previous discussion leads to the conclusion that Arab banks have the resources required to overcome the constraints in the domestic market and the challenges created by the global deregulation and securitisation in international financial markets. The outlook for the future of Arab banks is brighter than most Arab bankers realise. The immediate and most urgent task for Arab banks lies in building an efficient management structure that is capable of anticipating the business and investments opportunities that the region can offer. The potential investment opportunities in the Gulf are enormous. First and foremost, the region (despite the usually overestimated recession in recent years) is still creditworthy and will remain so well into the next century. According to the Bank of England, the Gulf countries are ranked fifth on the list of the largest foreign asset holders in the world. The potential wealth is even greater; total oil reserves of the Gulf states represent almost 90 per cent of total Arab reserves and 55 per cent of world reserves (excluding socialist countries).

Arab banks, in particular those based in the offshore centre of Bahrain, should take full advantage of the recent developments in the region, particularly the change in attitude among Gulf countries towards private sector enterprise. Throughout the Gulf region, authorities are committed to the free enterprise policy. In Saudi Arabia, for example, a great effort has been undertaken to increase the role and initiatives of the private sector. The privatisation of the Saudi Arabian Basic Industries Corporation, is a prime example. The likely increase in the number of projects with private sector participation, will have great impact on Arab banks and financial markets in the coming years. The involvement of the governments in these projects will provide an additional attraction for Arab banks to finance such projects, in the sense that channelling capital into new Gulf projects will hold very little or no default risk.

The availability of cheap labour throughout the Middle East is another added attraction to investment in the Gulf. The GCC countries have access to import labour from other Arab countries in the region, Egypt and Sudan for example, and the cost of such labour is relatively cheap when compared with other regions.

One of the most important developments that occurred in 1988, which might have a long-term positive effect on the investment opportunities in the region, was the end of the Gulf war. The long-term importance of this will be in restoring some political stability in the region, a factor that has been a major hindrance to investments in the past. In the short-term, however, Arab banks will greatly benefit from the reopening of two of the largest markets, with massive investment potential. The cost of reconstructing the damage that the Gulf war inflicted on Iraq and Iran, is estimated to run into approximately US $400 billion (Alnasrawi, 1986). Much of the two countries' manufacturing industries will have to be rebuilt, with the emphasis on heavy machinery, vehicle factories and the petrochemical sector.

Although Arab banks are likely to face intense competition from foreign banks, there are certain factors that could work to their advantage. The first of these factors concerns financing projects in Iran. Political and ideological differences exist on a large scale between Iran and the Western world. As long as these differences exist, Western European and North American banks are not likely to be invited to finance projects in Iran. The competition to Arab banks, however, is likely to come from the Japanese and other Asian banks that kept strong ties with Iran during the course of the Gulf war. Secondly, many European banks are already heavily exposed to both Iran and Iraq, and are unlikely to commit themselves to the region after the losses they incurred during the first two years of the war, due to several cancellations of projects in both countries.

However, for Arab international banks to take advantage of these factors (i.e. the end of the Gulf war and greater private participation), a priority should be given to develop the special skills that are necessary for project financing. To be able to participate in project financing, a variety of financial and non-financial measures are needed. Arab banks must establish project financing units; the main emphasis of such units would be to carry out the risk assessment of potential projects. The lack of these units among the majority of Arab banks have, thus far, prevented these banks from entering the field of project financing in any significant weight.

The large Arab international banks do not lack the financial resources that are necessary to undertake or participate in project financing. The obvious obstacle, therefore, is that of human skills. Some expertise such as corporate finance, leasing and foreign exchange, tax and accounting expertise, and most importantly people with expertise in identifying viable projects, will need to be developed.

It follows, therefore, that for Arab banks to succeed in the field of project financing, a team approach is needed. This implies that a considerable investment in analytical resources and above all in personnel is required. By doing so, Arab international banks will achieve two important objectives; firstly, enhancing project financing may eventually result in increasing the absorptive capacity of the Gulf economies, which in turn will benefit the banks themselves; and secondly, developing a team of skilled nationals in this field, would give Arab international banks the staying power which might prove significant in an intensely competitive financial environment.

The success of international Arab banks in the future will be determined by their ability to provide a variety of financial services, assume more risk in their lending and most importantly to develop efficient management.

The success of Arab banks' international operations has been remarkable. The next phase of their development, should be to concentrate on their domestic and regional operations. Such operations might prove to be of immense importance to support and complement their international operations. In order to achieve this target, a closer co-operation between the region's governments, financial markets, development institutions and commercial banks, is greatly needed.

CHAPTER 10

SUMMARY AND CONCLUSIONS

In contrast to the general belief that the international expansion of Arab banks occurred primarily to recycle the surpluses which resulted from the massive oil price rises in the 1970s, this study has shown that the internationalisation of Arab banks began prior to the major oil price rises in 1973/74. Furthermore, although the major international expansion of these banks occurred in the late 1970s, and coincided with the second oil price increase, this study has shown that the actual role of these banks in directly recycling the oil revenue was minimal. Their share of the revenues has never exceeded 10 per cent.

However, the indirect benefits to Arab banks, from the oil revenues, can easily be quantified. The oil revenues provided Arab banks with an ideal situation in which to operate. These banks were the main beneficiaries of the increased government expenditure and the thriving domestic and regional economies that occurred entirely as a result of the increased oil revenues. This is particularly true for banks operating in Gulf countries where the banking systems are nationalised. The Kuwaiti banks are a typical example; they had no foreign banks in their home countries to compete with and, hence, they gained the full benefits that the increased oil revenues brought about.

Even in countries where foreign banks are allowed to operate, the national banks in these countries have dominated particular sectors in which they have advantages over their competitors. Such advantages arise either because of expertise in such areas like trade finance, or because of tradition and long standing in their countries.

For reasons which were discussed in the text, no other sector in the regional economies benefited more from the increased oil revenues, than the trade sector. Having established that the majority of the region's banks are trade banks by tradition, the benefit from the oil revenues are clear.

Another important aspect which has enhanced the international expansion of the majority of Arab Gulf banks, and which was a direct result of the increased oil revenues, was the accumulation of large foreign assets by the governments and private sectors of the region. This factor favourably influenced the internationalisation of Arab banks in two ways; firstly, the already existing Arab banks found themselves obliged to follow these financial assets into the major international financial countries, if they were to stand any chance of attracting a portion of these assets. Secondly, and most importantly, was the emergence of the new generation of Arab banks, entirely owned by the Arab oil-producing countries, and which were more geared towards regional and international operations, than domestic operations. The emergence of such banks like the Arab Banking Corporation and Gulf International Bank coupled with the creation of many Arab-western joint ventures, represented the first serious move by the Arab Gulf governments to increase the region's banks' involvements in international financial operations (i.e. to recycle the oil revenues).

This process was further enhanced by the creation of major supporting services to their operations in the region. The most important of these services were the establishment of the capital market in Kuwait and the offshore financial centre in Bahrain. The effect of these centres on Arab banks were numerous; they brought much needed financial technology into the region; enhanced the establishment of other supporting industries that are very important to the international operations of Arab banks (i.e. brokers, investment institutions, accountants, lawyers, etc) and they also assisted in creating a foreign exchange and interbank money market. Finally, and most importantly, by inviting the well-known and experienced international banks to open branches in the region, the Bahraini offshore centre assisted in enhancing a healthy competition between banks; this resulted in the large and committed Arab banks developing a new generation of Arab bankers that are accustomed to international financial operations.

Once again, without the oil surpluses of the 1970s, the development of centres like Bahrain and Kuwait, in such a manner, may not have been possible.

However, certain other factors played an equal or probably even more important role in the international expansion of Arab banks. The most important of these factors was, undoubtedly, the open nature of the syndicated lending market in which Arab banks achieved prominence. This market, through its innovative nature attracted banks of different sizes from countries worldwide. Arab banks entered this market in the same way as many other banks from developing countries, primarily in search of high profits at a time of high demand for funds by developing countries. Therefore, there is no reason to suggest that Arab banks would not have been able to participate in these markets even without the oil revenues.

It cannot be denied, however, that by increasing their capital bases, the oil revenues accelerated Arab banks' participation in these markets. Thus, the role that the oil surpluses played in this process was in accelerating rather than initiating it. This is confirmed by the fact that the highest level achieved by Arab banks in the syndicated lending market occurred at a time in the early 1980s, when the oil revenues were declining in real terms.

Finally, two other important factors are believed to have played a significant role in pressurising Arab banks to operate internationally; they are political instability and religion.

The Middle East, in general, has for many decades been one of the most politically unstable regions in the world. This factor has resulted in threatening the safety and stability of the Gulf region, either through internal problems, such as the ethnical problems that have occurred in some Gulf countries in recent years, or through external threats which may destabilise the whole of the region, as with the recent Gulf war between Iraq and Iran. However, in whatever form the political factor manifests itself, the consequences of the banking community are usually the same; capital outflows, large numbers of residents emigrating from the region and a slowdown in the national economies. Therefore, at times of political instability, some Arab banks find it safer to operate outside the region in less risky environments, hence, their heavy involvement in the international interbank market, which is characterised by its safety and liquidity.

While the political factor may have contributed to the international expansion (in varying degrees) of most Arab banks, the religious factor has affected some banks too, notably those operating in countries where the commercial laws are based on the Islamic religion, such as Saudi Arabia and the UAE. The effect of religion is similar to that of the political factor, in the sense that it can lead to the international expansion of some banks as a result of creating insecurity among the banking community. At the heart of this factor lies the problem of interest, which (as discussed in the text) is clearly prohibited under Islamic law. This has been shown to affect domestic lending by banks, whereby it reduces potential bank borrowers to a certain section of the society, whom the banks feel are less likely to run into difficulties. By doing so, the banks hope to eliminate the reliance on the courts of law, which in certain Gulf states would almost always disregard the payment of interest in any settlement. Because of the large number of commercial banks operating in the region, the competition among banks for the top quality customers, is intense, which usually results in lowering the margins; many banks have opted for the international financial markets instead.

Aside from these problems, that are almost unique to the region, the international expansion of Arab banks did follow a similar pattern to that of the early expansion of western European and American banks, with an obvious time lag between the two groups. Arab banks compensated for their late arrival, however, by the speed of their expansion. Apart from the smaller Arab banks that expanded internationally as a result of hasty decisions, the international expansion of the majority of the large and relatively highly capitalised banks, was steady and, at times, a well calculated process, which has only recently started to come to fruition.

For these banks, despite their many limitations, their international expansion was a profitable exercise. In less than a decade, the majority of these banks started to dominate certain sections of the markets, and regularly appeared amongst the top banks in the world. To be ranked alongside banks such as Citibank of New York or Bank of Tokyo, (which have large financial resources and most importantly, efficient and experienced managements) is by any standards, a remarkable achievement. It was not unusual for the list of the largest 100 banks in the world, during the late 1970s and early 1980s, to include at least half a dozen Arab Gulf banks. In 1983, for instance, there were 15 Arab banks among the top 100 syndicated loans lead-managers worldwide, more than half of those originated in the Gulf region.

However, since the mid-1980s, the decline in the syndicated lending market, the global move towards the securitisation of debts and the generally depressed economies of the region due to lower oil prices, have brought the international progress of most Arab banks to a standstill. In common with many other banks that were late arrivals to the international financial markets, the majority of Arab banks found it difficult to switch their operations from syndicated lending to securitisation. One of the most important handicaps that affected their progress in the eurobond market was, and still is, their management. Because these banks had rushed into operating internationally, and due to their recent origin, they were not given a grace period in which to develop the various techniques that are necessary, if they are to have any success in these markets. While the largest and purely international Arab banks, have realised the importance of management, and have succeeded through their short history to develop the expertise that is largely responsible for their success in international financial markets, the smaller banks did not have such management and were faced with the situation of employing expensive expatriate managers, or withdrawing from these markets completely. Many opted for the latter.

In fact, apart from the Arab commercial banks and investment institutions, that are headquartered in Bahrain and Kuwait, which gained the necessary expertise through their operations in these centres, the majority of other Arab international banks did not pay enough attention to the importance of management.

As explained in Chapter 8, the management of almost all Arab Gulf banks that are active internationally, have one feature in common; that is, their conservative attitude. Their financial ratios (despite the limitations of using average figures), indicate that these banks are highly capitalised and have high preferences in holding liquid assets. For many Arab banks, these ratios were twice as high as those of other international banks against which they are competing. Because of these features, it appears natural that these banks would experience lower profitability than their major competitors. This has been the case since the early 1980s. Lower profitability, in turn, has reduced their ability to expand and invest in their banks' infrastructures, a process which is very important for any banks' success and continuation in business. While the above mentioned characteristics may be justified, to some extent, by the unique features of the region, which makes it necessary for banks to prefer high liquidity than is prudently required, their main management problem is the inability to assume more diversified risk in their lending.

The activities of the financial sector, in which commercial banks play a major role, and those of the monetary authorities in the region, should be to participate in the region's development. An essential part of this process would depend on the banks' ability to transfer short-term deposits into long-term loans, for which there is a great demand in the region, a demand which has been enhanced by the recent efforts of the region's governments to give the private sector a greater role in the development process. By doing so, Arab international banks would follow in the footsteps of their western counterparts, whose international expansion was a continuation of their domestic business and not a replacement, as has been the case with some Arab banks.

The reliance on international interbank deposits might be relatively profitable, but it should generally be viewed as a temporary solution to the many problems facing Arab banks in their domestic markets, and not the main line of business.

Thus far, the capital outflows from the region which are due to a combination of factors, have far outgrown the region's demand for finance. The most important of these factors are; low absorptive capacity, low rate of return in domestic markets, political instability and the availability of greater liquidity than could be employed domestically without giving rise to inflation. Arab international banks, as shown in Chapter 7, have helped greatly in narrowing the gap between the Arab surplus and deficit countries, but a great deal more needs to be done. While it is generally agreed that the concentration of lending to one geographic region (particularly a region in depression as the major Arab deficit countries have experienced lately), is not sound banking practice, and a policy of diversification in lending is sometimes necessary, it is very important for Arab banks to win major deals in Arab countries which are considered creditworthy. Considering that these Arab countries have access to the major international financial markets, therefore, for Arab banks to win such deals they will have to compete with the highly capitalised and well experienced international banks. To be able to compete with these banks for the right not only to co-manage but to act as lead-managers, Arab banks will have to develop the range of services that are available elsewhere.

Furthermore, the majority of Arab international banks have, thus far, not succeeded in attracting any significant share of their region's foreign assets. The reasons for this are all too familiar; the lack of well-defined business strategy which is essential in order to comply with the needs of the governments and private sector investments. The priorities of the investing bodies lie in liquidity, safety and confidentiality which is regarded highly in the region. Despite the usually overestimated recession in the region in recent years, the accumulated foreign assets of the region are enormous, varying from US $200 billion to US $300 billion by the end of 1988. Therefore, great potential still exists for international financial operations by Arab banks, provided that these banks follow the global trend of changing their management attitude from traditional management to investment management, which is regarded as a prerequisite for any international bank to have any success in the securities markets.

It has been established in the text, that the foreign investments of the region were dominated by the major international banks in Europe and the United States, out of the Gulf countries' need to maximise their return and due to the special advantages that such banks enjoy over the Arab banks and joint ventures. But this trend continued (though at a slower rate), even after the creation of the large Arab banks. Therefore, with few exceptions, Arab banks are mainly to blame for their low involvement in the recycling process. It follows, therefore, that so long as the major international banks offer the services that meet the needs of the region's investors, Arab banks will have to match these services, otherwise they will always be regarded as secondary banks in their own region.

The evidence discussed in the text, suggests that the following steps are of great importance, in order for the Gulf banks to compete successfully with other international banks:

- Investment in banking technology which is essential for the international financial operations. Such investments should include, payment transfer systems which would speed the banks' ability to collect and invest the region's funds.
- The establishment of research investment units, which if successfully operated, would provide the banks with a greater ability to identify viable investment opportunities. Such opportunities could lead to increasing the absorptive capacity of the region as a whole, which in turn would benefit the banks themselves.

- Because the emphasis in recent years has been to concentrate on marginal profitability, the development of a management that is capable of assessing credit/risk analysis is essential, particularly in areas related to investment portfolio management. The prime target of such a management would be to maximise profits by maintaining a good client base, broader services and most importantly, reducing overheads. The latter is of particular importance, although it has only surfaced in recent years.
- The increased competition among banks (whether locally or internationally), and the growing sophistication of most Gulf nationals as to the alternatives available elsewhere, have necessitated an aspect of banking which might have appeared unnecessary in the boom years of the 1970s; that is, marketing. Since the eventual aim of the Arab Gulf international banks is to manage a greater share of the region's foreign assets, it seems important that these banks should establish marketing units geared towards private Arabs, high net worth individuals. So far, very few institutions have adopted such a technique, notably Gulf International Bank and Investcorp of Bahrain. These two banks have demonstrated that the market potentials for Arab banks in the field of investment banking is great, provided that an efficient management, a variety of services and good marketing policies exist.
- Another area which is also related to management, is that of concentration in lending. As shown in Chapter 7, Arab banks although they followed a similar pattern in their

geographical distribution of their international lending, differed from the majority of other international banks, by concentrating their lending on developing countries. This concentration on geographic area, or on one financial service, has been shown to be ineffective and at times very risky, as the Latin American debt crisis and the declining role of the syndicated lending market have proved. Because lending decisions represent one of the prime tasks of the bank's managements, the weakness of such managements among most Arab banks have become apparent. Apart from the very few purely international Arab banks which participated in the syndicated lending market, mainly to book assets and to earn sufficient income, while at the same time develop management strategies and a variety of financial services, the majority of Arab banks relied heavily on the syndicated lending markets. Such banks were hardest hit by the recent decline in these markets, and most of them have reduced their international expansion to a minimum level, or even completely withdrawn to their domestic markets.

It should be mentioned that while some Arab Gulf states have (to varying degrees) started to appreciate the importance of developing local management to effectively run their national banks, initial steps have been taken, but a great deal more is required. The most pressing need in this respect is to establish local training institutions; such institutions could be modelled on those that exist in the developed international financial centres. So far, Bahrain appears to be the only GCC country to have moved in this direction. The Bahraini initiative in establishing the Bahraini-training centre for bankers, should be followed by other Gulf states. In addition, there is no reason why Bahrain should not develop into a useful regional training centre, in the same way that it has become an important regional financial centre. If this objective is achieved, it may only be a matter of time before a new generation of Arab bankers will emerge to gradually replace the most expensive expatriates. Meanwhile, the reliance on foreign managers will probably continue well into the 1990s. If this is the case, the Arab Gulf banks should seek higher quality managers in areas that are not yet developed in the region.

It should be noted, however, that the above mentioned weaknesses are not unique to Arab banks, and they should not take the full blame for their shortcomings. Many of the obstacles that are hindering the growth of these banks are not directly related to them, but rather they were unfortunate to find themselves surrounded by them. Because Arab international banks represent only one aspect of their countries' financial systems, other financial institutions and markets and the region's monetary authorities are also to blame.

Ideally, because the oil revenues occurred in the region in which Arab Gulf banks operate, these banks should have been given the chance to manage some of these revenues within the region instead of having to compete for them in the major international financial markets. This problem was caused, as discussed in the text, by the major capital outflows from the region. Therefore, any measure to reduce these outflows may directly benefit Arab banks. It follows that the government should, ideally, be geared towards eliminating some of the factors that give rise to capital outflows. Such policies as developing efficient capital markets and the removal of interest rate ceilings, would, no doubt, attract regional funds to be deployed domestically. But because of the economic and religious repercussions or rising interest rates, this policy is not always possible or even desirable. Therefore, creating efficient capital markets might be the most important means through which the region's governments could reduce or even eliminate capital outflows, particularly among the private sector.

As shown in Chapter 6, capital markets, if successful, can play a very important role in identifying viable investment opportunities and, thus, enhance the region's development through the efficient allocation of resources. The experience of the region's capital markets proved that there is a great supply of funds if genuine investment opportunities exist. By investing domestically and in local currencies, the private sector will be able to eliminate one of the great dangers of foreign investment; that is the foreign exchange risk, which can have devastating effects, as the October crash of 1987 proved.

The previous success of the GCC capital market, has unfortunately been completely overshadowed by the Souk al-Manakh collapse of 1982, which resulted in (among other things) encouraging more capital outflow from the region.

However, recent events suggest that the effects of that collapse might have started to disappear; the establishment and initial success of the newly established Saudi stock market, suggest that local demand for domestic investments is still very high.

In general, because of the special place that the region's capital markets could occupy in assisting economic development in the region and in enhancing the role of Arab international banks in intermediating between the sources and uses of funds in the region, and in light of the weaknesses of the existing markets, there is a strong case for creating a regional capital market. An efficient regional capital market would overcome the two most important problems that face the individual capital markets that exist in the region, which are: the inefficiency of the secondary markets and the small number of investors in each of the Gulf states.

Although Kuwait and Saudi Arabia have made good progress in establishing their own capital markets, this research has shown that neither is willing or equipped to become a regional capital market, unless they change their narrow nationalistic policies. Therefore, once again, Bahrain is probably the most likely Gulf state to occupy the role of a regional capital market which would complement the financial market that already exists on the island. It is only the establishment of such a market that would allow Arab international banks to play a bigger regional role. Considering that in the long-term no bank can be successful internationally without relying on a good domestic and regional business to support its international operations, the importance of a successful regional capital market to Arab banks seems immense.

The larger Arab international banks have made excellent progress in their international financial operations. The fact that most of them survived the late depression in their own region and in international financial markets, and at the same time remained profitable, can only indicate their resilience and competitive nature.

This thesis has shown that the international operations of Arab banks are not necessarily related to the increased oil revenues of the 1970s, as often assumed. This fact coupled with the lack of a solid domestic base for Arab banks to rely on, has made their success internationally even more remarkable.

The fact that most Arab international banks have succeeded in markets that host the largest and most experienced banks in the world may indicate that these banks are very much underrated in their own region.

The future success of the international operations of these banks will largely depend on their ability to overcome the many problems that hindered their progress in the past, and on their regional business to support their international business.

Appendix A **Origin and numbers of commercial banks operating in the Arab Gulf region, end-1988**

Bank	Year founded	Number of branches D[1]	F[2]	Total	Paid-in capital[3] (US$ million)
Bahrain					
Al-Ahli Commercial Bank	1977	na	na	na	54.3
Arab Banking Corporation	1980	1	6	7	
Bank of Bahrain and Kuwait	1972	15	1	16	247.9
Bahrain International Bank	na	1	-	1	515.2
Gulf International Bank	1975	1	3	4	531.0
Grindlays Bahrain Bank[4]	1984	na	na	na	na
National Bank of Bahrain[5]	1977	19	1	20	169.3
Total		**36**	**11**	**47**	
Kuwait					
Al-Ahli Bank of Kuwait	1968	17	1	18	472.8
Bank of Kuwait and the Middle East[6]	1971	20	-	20	282.2
Burgan Bank	1977	11	-	11	518.8
Commercial Bank of Kuwait	1961	36	1	37	425.3
Gulf Bank	1961	30	2	32	530.9
National Bank of Kuwait	1952	49	4	53	748.7
Total		**163**	**8**	**171**	
Oman					
Al-Bank Al-Ahli Al-Omani	1976	9	-	9	15.4
Bank of Muscal[7]	1986	4	-	4	13.9
Bank of Oman and the Gulf	1978	na	na	na	9.0
Bank of Oman, Bahrain and Kuwait	1974	29	-	29	28.0
National Bank of Oman	1973	49	3	52	57.9
Oman Arab Bank[8]	1984	5	-	5	17.3
Oman International Bank[9]	1979	28	1	29	24.9
Union Bank of Oman	1976	11	-	11	13.6
Total		**135**	**4**	**139**	

Appendix A (contineud)

Bank	Year founded	Number of branches D[1]	F[2]	Total	Paid-in capital[3] (US$ million)
Qatar					
Commercial Bank of Qatar	1975	na	na	na	35.6
Doha Bank Limited	1979	4	-	4	58.7
Qatar National Bank	1965	11	3	14	203.8
Total		15	3	18	
Saudi Arabia					
Al-Bank Al-Saudi Al-Fransi	1977	55	-	55	265.2
Al-Bank Al-Saudi Al-Hollandi	1977	27	-	27	152.7
Arab National Bank[8]	1980	85	-	85	333.8
Bank Al-Jazira	1976	26	-	26	117.5
National Commercial Bank	1954	180	3	183	854.0
Riyad Bank	1957	145	1	146	1007.0
Saudi American Bank	1980	29	-	29	387.2 (1985)
Saudi British Bank	1978	29	-	29	169.3
Saudi Cairo Bank	1979	46	-	46	80.1
United Saudi Commercial Bank[10]	1983	12	-	12	66.9
Total		634	4	638	

Appendix A (contineud)

Bank	Year founded	Number of branches D[1]	F[2]	Total	Paid-in capital[3] (US$ million)
United Arab Emirates					
Abu Dhabi Commercial Bank[11]	1985	22	1	23	342.6
Bank of Oman Limited	1967	22	13	35	151.1
Bank of Sharjah	1973	1	-	1	32.1
Bank of Arab Coast Limited	1975	na	na	na	26.9
Commercial Bank of Dubai Limited	1969	7	-	7	72.3
Emirate Bank International Limited[12]	1988	7	8	15	136.9
First Gulf Bank	1979	na	na	na	61.6
Middle East Bank Limited	1976	9	8	17	71.2
National Bank of Abu Dhabi	1968	34	11	45	506.4
National Bank of Dubai Limited	1963	15	1	16	651.8
National Bank of Fujairah	1982	na	na	na	42.6
National Bank of Ras Al-Khaima PSC	1976	5	-	5	31.6
National Bank of Sharjah	1976	8	na	8	97.2
National Bank of Umm Al-Qaiwain Limited	1982	4	-	4	76.8
United Arab Bank	1975	5	1	6	36.2
Union Bank of the Middle East Limited	1977	7	7	14	136.9
Total		**146**	**50**	**196**	
Grand Total		**1127**	**71**	**1198**	

Sources: Annual Reports
Saudi Arabian Monetary Agency Statistical Bulletin 1987
Kuwait in Figures, The National Bank of Kuwait SAK publication, 1986/87
The Bankers Almanak, vol. 1, January 1989

Appendix A (continued)

Note:

1 Denotes domestic branches.

2 Denotes foreign branches, including those located in other Arab countries.

3 Figures are those of end-1986, unless indicated.

4 Replaced the Bank of Bahrain which was established in 1957.

5 Took over the opeations of the Bahraini branch of Grindlays Bank plc which owns 40 per cent of the new bank.

6 Replaced the Kuwaiti branch of the British Bank of the Middle East.

7 Replaced the Oman Overseas Trust Bank which was established in 1982.

8 Replaced the branches of the Jordan-based Arab Bank Limited.

9 Initially it was called Oman Arab African Bank to take over the operations of the Muttrah branch of Arab African International Bank. In early 1984 its name changed as listed.

10 Established in 1983 as Al-Bank Al-Saudi Al-Tejari Al-Muttahed until April 1987 when name changed as listed.

11 Established as a result of a merger of Khalij Commercial Bank, 1975; Emirates Commercial Bank, 1975; and Federal Commercial Bank, 1976.

12 Established in 1977. In 1985 acquired the shares of Emirates National Bank and the majority shareholding of Dubai Bank Limited. In 1988 the name changed as listed.

Appendix B Largest GCC financial institutions and joint ventures, end-1987

Rank*	Bank	Year founded	Total assets (US$ billion)	Total deposits (US$ billion)	Capital and reserves (US$ billion)
1	Bank of Credit and Commerce	1972	19.64	17.73	0.98
2	National Commercial Bank	1983	18.86	17.25	0.85
3	Arab Banking Corporation	1980	17.55	14.95	1.06
4	Al-UBAF Banking Group	1970	14.35	12.68	0.56
5	National Bank of Kuwait	1952	11.18	10.25	0.87
6	Gulf International Bank	1975	8.94	8.20	0.57
7	Riyad Bank	1957	8.88	7.28	1.07
8	Gulf Bank	1960	6.81	6.08	0.21
9	Commercial Bank of Kuwait	1961	6.38	5.81	0.57
10	Al-Ahli Bank of Kuwait	1967	5.95	5.37	0.52
11	National Bank of Dubai	1963	5.73	4.82	0.75
12	National Bank of Abu Dhabi	1968	5.43	4.81	0.47
13	Saudi American Bank	1980	5.21	4.10	0.40
14	BAII Group	1973	5.20	3.76	0.24
15	Al Bank Al Saudi Al Fransi	1977	4.53	3.96	0.27
16	Burgan Bank	1975	4.43	3.83	0.59
17	Saudi International Bank	1975	4.40	3.96	0.34
18	Kuwait Finance House**	1977	3.92	3.63	0.16
19	Bank of Kuwait and the Middle East	1971	3.79	3.34	0.46
20	United Bank of Kuwait	1966	3.70	3.26	0.22

Appendix B (continued)

Rank	Bank	Year founded	Total assets (US$ billion)	Total deposits (US$ billion)	Capital and reserves (US$ billion)
21	Arab National Bank	1980	3.45	2.99	0.38
22	Qatar National Bank	1965	3.06	2.67	0.25
23	Al Bank Al Saudi Al Hollandi	1977	2.85	2.09	0.16
24	Bank of Oman	1967	2.51	2.21	0.17
25	Saudi British Bank	1978	2.48	2.27	0.17
26	KFTCIC	1965	2.25	1.77	0.04
27	Abu Dhabi Commercial Bank	1985	2.16	1.45	0.34
28	Saudi Cairo Bank	1979	2.01	0.81	0.11
29	Banco Arabe Espanol	1975	1.83	1.60	0.15

Sources: Compiled from the Arab Banker, vol. viii, no. 6, November/December 1988, pp. 16-17
Annual Reports
Bankers Almanak, vol. 1, January 1989

Note: * The ranking was based on total assets
** This is an Islamic financial institution

Appendix C   Major joint banking by Arab Gulf and western banks

Institution	Head office	Founded	Major ownership	(%)	Paid-in capital[1]
Kuwait Investment Company (KIC)	Kuwait	1961	Arab Gulf banks	35	US $188.3 million (1985)
			Japanese banks	35	
			Brazilian banks	10	
			Canadian banks	10	
			Australian banks	10	
National Bank of Dubai	Dubai	1963	Arab Gulf banks	86	US $752 million
			European banks	10	
			American banks	4	
Banque Franco-Arabe d'Investissements[2] Internationaux (FRAB)	Paris	1969	European banks	45	US $235.3 million
			Arab Gulf banks	41.82	
			Arab non-Gulf banks	8.18	
			Japanese banks	5	
Union de Banques Arabes et Francaises (UBAF)	Paris	1970	Arab non-Gulf banks	53.04	US $555 million
			European banks	39.95	
			Arab Gulf banks	6.91	
			Other	0.10	
Compagnie Arabe et Internationale d'Investissement (CAII)	Luxembourg	1973	na		US $243 million
Arab International Finance Company	Beirut	1974	Arab Gulf banks and other investors	50	na
			American banks	25	
			Japanese banks	12.50	
			European banks	12.50	

Appendix C (continued)

Institution	Head office	Founded	Major ownership	(%)	Paid-in capital
Arab Finance Corp	Beirut	1974	Arab non-Gulf banks	36	na
			European banks	28	
			American banks	18	
			Arab Gulf banks	18	
International Financial Advisers	Kuwait	1974	Arab Gulf-private investors	55	na
			European banks	30	
			American banks	15	
UBAN-Arab Japanese Finance Ltd	Tokyo	1974	Japanese banks	40	US $9.73 million (1981)
			Arab non-Gulf banks	28	
			Arab Gulf banks	17	
			European banks	15	
National Bank of Sharjah	Sharjah	1975	Arab Gulf private and public investors	85	US $97.2 million
			European banks	10	
			Japanese banks	5	
Ajman Arab Bank	Ajman	1975	Arab Gulf private and public investors	60	na
			American banks	40	
Banco Arabe Espanol	Madrid	1975	European banks	40	US $146 million
			Arab Gulf banks	30	
			Arab non-Gulf banks	30	

Appendix C (continued)

Institution	Head office	Founded	Major ownership	(%)	Paid-in capital
Kuwait Pacific Finance Co. Ltd	Hong Kong	1975	Arab Gulf banks	35	na
			Japanese banks	35	
			Australian banks	10	
			Brazilian banks	10	
			Canadian banks	10	
Saudi International Bank (SIB)	London	1975	Arab Gulf banks	55	US $339 million
			American banks	20	
			European banks	20	
			Japanese banks	5	
Al-Jazira Bank	Jeddah	1976	Saudi banks	65	US $117.5 million
			Pakistani banks	35	
Al-Bank Al-Saudi Al-Hollandi	Riyad	1976	European banks	60	US $155 million
			Arab Gulf banks and private investors	40	
Arab-Malaysian Development Bank	Kuala Lumpur	1976	Malaysian banks	55	US $12.73 million (1980)
			Arab Gulf banks and private investors	45	
Al-Saudi Banque	Paris	1976	Saudi and French banks	99.95	US $54.2 million
			Al-Saudi directors	0.05	
Banque Internationale Arabe de Tunise	Tunisia	1976	Tunisian private sector	60	10 million Tunis dinar 1987
			Arab Gulf banks	24	
			French banks	16	

Appendix C (continued)

Institution	Head office	Founded	Major ownership	(%)	Paid-in capital
Arab Latin-American Bank (Arlabank)	Lima	1977	na		US $255.9 million (1985)
Arab Turkish Bank	Ankara	1977	Turkish banks Arab non-Gulf banks Arab Gulf banks	40 40 20	US $7.9 million
Al-Bank Al-Saudi Al-Fransi	Riyad	1977	Saudi public European banks	60 40	US $106.8 million
Allied Arab Bank	London	1977	Arab Gulf banks British banks	76 23	US $24.0 million
Saudi British Bank	Riyad	1978	Saudi shareholders British banks	60 40	US $80.1 million
Arab Hellenic Bank	Athens	1979	Greek banks Arab non-Gulf banks Arab Gulf banks	40 30 30	US $7.93 million
Saudi European Bank	Paris	1979	Saudi Arabia and European Finanz Corporation BV	100	US $56.2 million
Saudi American Bank	Riyad	1980	Saudi shareholders Citibank	60 40	US $300 million

Appendix C (continued)

Institution	Head office	Founded	Major ownership	(%)	Paid-in capital
Arab Bangladesh Bank Ltd	Bangladesh	1981	Arab Gulf banks	60	na
			Bangladesh nationals	35	
			Government of Bangladesh	5	
Saudi Investment Bank	Riyad	1984	Saudi public	36	US $24 million
			Saudi banks	34	
			American banks	20	
			Japanese banks	5	
			European banks	5	
Saudi Swiss Bank	Geneva	1988	European banks	51	US $39.1 million
			Saudi banks	29	
			Saudi individuals	20	
United Bank of Kuwait	London	1987	Owned by a large number of Kuwaiti financial institutions and private shareholders		US $53.4 million

Appendix C (continued) Inter-Arab consortian banks

Institution	Head office	Founded	Major ownership	(%)	Paid-in capital
Arab International Bank[3]	Cairo	1974	Central Bank of Egypt Libyan Arab Foreign Bank Governments of UAE, Oman, Qatar and private Arab investors		US $150 million
Gulf International Bank (GIB)	Bahrain	1975	Equal ownership by the following governments: Bahrain, Iraq, Kuwait, Oman, Qatar, Saudi Arabia and the UAE		US $530 million
Arab Bank for Investment and Foreign Trade		1975	Equal ownership by the governments of UAE, Libya and Algeria		US $106.2 million
Jordan Gulf Bank	Amman	1976	Jordan nationals Gulf nationals	60.0 40.0	
Arab Jordan Investment Bank	Amman	1978	Gulf banks		US $14.5 million

Appendix C (continued)

Institution	Head office	Founded	Major ownership	(%)	Paid-in capital
Arab African International Bank (AAIB)[4]	Cairo	1978	Governments of:		US $400 million
			Kuwait	43.64	
			Egypt	43.64	
			Iraq	10.00	
			Jordan	1.00	
			Algeria	0.62	
			Qatar	0.25	
			Private investors	0.85	
Al-Bahrain Arab African Bank	Manama	1979	AAIB	74.50	US $138 million
			Arab Gulf banks	14.10	
			Arab non-Gulf banks	11.85	
Arab Banking Corporation (ABC)	Manama	1980	Equal ownership by the governments of Abu Dhabi, Kuwait and Libya		US $750 million
Alexanderia Kuwait International Bank	Cairo	1980	Private Arab ownership	66.5	US $25.7 million
			Arab non-Gulf banks	25	
			Arab Gulf banks	8.5	
Egyptian Gulf Bank	Cairo	1981	Private	56.3	
			Arab non-Gulf banks	28.8	
			Arab Gulf banks	14.9	
Bahrain Middle East Bank	Manama	1982	Private Arab	72	US $140 million
			Arab Gulf banks	28	

Appendix C (continued)

Source: The Bankers Almanak, vol. 1, January 1989

Notes:

1 Figures are thoseof 1987 unless otherwise stated

2 Name changed on 31 August 1987 to the National Bank of Kuwait (France) SA, and the structure of ownership changed when the National Bank of Kuwait acquired all non-Arab shares, consequently its shareholding increased to 97.61 per cent

3 Replaced the former Egyptian International Bank for Foreign Trade and Development which was established in 1971

4 Replaced the Arab African Bank which was established in Egypt in 1964

Appendix D Arab Gulf financial institutions operating in London, April 1987

Institution	Status	Date of entry	No. employees in London
C.E. Coates & Co. (Arab Asian Bank)	Subsidiary	1948	25
United Bank of Kuwait	Recognised bank (consortia)	1966	255
Al-UBAF Bank	Recognised bank (consortia)	1972	155
Gulf Bank (Kuwait)	Representative office	1973	4
Saudi International Bank	Recognised bank (consortia)	1975	245
European Arab Bank	Recognised bank (consortia)	1976	66
Qatar National Bank	Branch	1976	27
Khalij Commercial Bank	Representative office	1976	1
National Bank of Abu Dhabi	Branch	1977	60
Al Saudi Banque	Branch	1977	55
Allied Arab Bank	Recognised bank (consortia)	1977	92
Gulf International Bank	Branch	1978	90
Bank of Oman	Branch	1978	35
International Trade and Investment Bank	Representative office	1979	1
National Commercial Bank	Branch	1979	34
National Bank of Kuwait	Branch	1980	150
Oriental Credit (Oriental International Holdings)	Subsidiary	1980	46
Arlabank International	Representative office	1980	4
Middle East Bank (UAE)	Branch	1981	36
Arab Banking Corporation	Branch	1982	55
Arabian Investment Banking Corporation (Investcorp)	Representative office	1982	40
Investcorp International	Subsidiary	1982	na
United Gulf Bank	Representative office	1983	2
Riyad Bank	Branch	1983	36

Appendix D (continued)

Institution	Status	Date of entry	No. employees in London
Saudi American Bank	Branch	1984	35
National Bank of Dubai	Branch	1984	14
Abu Dhabi Commercial Bank	Representative office	1985	1
Bahrain Middle East Bank	Representative office	1985	2
Commercial Bank of Kuwait	Representative office	1985	2
Sharijah Investment Company	Subsidiary	1986	18
Arab National Bank	Representative office	1986	2

Sources: Compiled from Euromoney, April 1987, pp. 127-57; Arab Financial Institutions in London, Arab Banker, vol. v, no. 1, January/February 1985, p. 17

Appendix E

Year	GCC Current Account Surplus US $bn (X)	Arab Banks' Euro lendings US $bn (Y)
1974	37.8	0.07
1975	24.2	0.16
1976	22.3	0.32
1977	19.0	1.48
1978	10.3	3.09
1979	32.0	3.23
1980	72.0	4.45
1981	68.8	10.75
1982	6.6	12.42
1983	-4.6	8.00
1984	-4.2	7.00
1985	0.7	6.10

The regression equation is
Y = 5.08 - 0.0135 X

Predictor	Coef	Stdev	t-ratio	p
Constant	5.077	1.747	2.91	0.016
X	-0.01353	0.05115	-0.26	0.797

s = 4.352 R-sq = 0.7% R-sq(adj) = 0.0%

Analysis of Variance

SOURCE	DF	SS	MS	F	p
Regression	1	1.32	1.32	0.07	0.797
Error	10	189.40	18.94		
Total	11	190.72			

Correlation of Y and X = -0.083

Appendix F

Year	GCC Current Account Surplus US $bn (X)	Arab Banks' Euro lendings US $bn (Y)
1974	37.8	0.07
1975	24.2	0.16
1976	22.3	0.32
1977	9.0	1.46
1978	10.3	3.09
1979	32.0	3.23
1980	72.0	4.45
1981	68.8	10.78

The regression equation is
Y = - 0.91 + 0.108 X

Predictor	Coef	Stdev	t-ratio	p
Constant	-0.907	1.913	-0.47	0.652
X	0.10767	0.04587	2.35	0.057

s = 2.778 R-sq = 47.9% R-sq(adj) = 39.2%

Analysis of Variance

SOURCE	DF	SS	MS	F	p
Regression	1	42.516	42.516	5.51	0.057
Error	6	46.297	7.716		
Total	7	88.813			

Unusual Observations

Obs.	X	Y	Fit	Stdev.Fit	Residual	St.Resid
8	68.8	10.780	6.501	1.804	4.279	2.03R

R denotes an obs. with a large st. resid.

Correlation of Y and X = 0.692

Notes to Appendices G, H and I

1 In calculating the profitability ratios of Arab and other international banks, profit before tax was used whenever possible, in preference to income, because of its independency of the tax regimes in different countries.

2 Risk capital refers to equity and near equity.

3 Total deposits refer to demand, saving and time deposits and interbank borrowing (demand and time).

4 Liquid assets refer to cash and due from banks and investment securities (gilt holding).

5 To eliminate any further variation for the calculated ratios, the comparison was made against the four largest British banks. These banks probably represent the best international indicator against which Arab banks performances can be measured. This is due to the following reasons:

   - Almost all Arab banks have been modelled on the British banks, this stems from the existence of a large number of English bankers who occupy senior position in Arab banks and also due to the important role played by the British banks such as BBME and Grindlys in the Middle East prior to the establishment of Arab banks in large numbers.
   - Because of the largest concentration of Arab international banks in London, they often compete directly with the British banks for Middle Eastern business. It is possible that the ratios concerning British banks may represent the potential required from Arab banks to successfully compete internationally.

6 The Kuwaiti banks have been excluded from some of the tables due to the low reporting standards.

Appendix G

Table 1 Provision for loan losses as a percentage of pre-tax profits of Arab* vs British banks, 1983-86

per cent

	1983	1984	1985	1986	Average 1983-1986
Al-Saudi Banque	1328.6	55.3	54.5	1475.0	728.4
National Commercial Bank**	68.3	85.1	693.8	1044.9	473.0
Kuwaiti French Bank	233.3	400.0	266.7	250.0	287.5
Al-UBAF Group	329.7	216.3	279.5	185.3	252.7
Arab Bank International	345.5	333.3	na	0.0	226.3
BAII	70.6	86.0	111.7	425.5	173.5
BIA	212.5	107.7	130.3	114.7	141.3
Riyad Bank***	na	37.7	58.7	175.8	90.7
Arab Banking Corporation	18.7	40.9	56.0	49.6	41.3
Arab National Bank	11.0	17.0	21.4	56.9	26.6
Arab banks (average)	**182.7**	**120.3**	**136.8**	**287.7**	**208.6**
British banks (average)	**120.7**	**191.6**	**64.8**	**48.5**	**106.4**

Sources: Computed from MEED (various issues), annual reports, International Bank Credit Analysis (IBCA), London and Economic Intelligence Unit (database), 1987

Notes:
- * The Kuwaiti banks have been excluded as none of them list provisions in their annual reports
- ** Data refers to the following dates: 6.10.19834, 25.9.1984, 14.9.1985 and 4.9.1986
- *** Data refers to the following dates: 1.4.1984, 21.3.1985, 10.3.1986

Table 2 The ratio of net income to equity of Arab vs British banks, 1983-86

	1983	1984	1985	1986	Average 1983-1986
UBAF	12.04	12.23	10.41	8.35	10.76
Gulf International Bank	12.86	11.01	9.37	9.36	10.65
BAII	19.88	13.39	12.74	7.54	10.38
National Commercial Bank	19.88	16.12	3.05	2.47	10.38
Riyad Bank	18.35	13.97	4.80	4.17	10.32
Arab Banking Corporation	10.41	9.87	9.18	8.48	9.49
BIA	5.88	7.72	7.43	7.01	7.01
Al-Saudi Banque	0.96	19.34	3.14	0.64	6.02
Al-Ahli Bank of Kuwait	na	8.93	3.36	3.52	5.27
Kuwaiti French Bank	1.61	0.71	1.27	2.52	1.53
FRAB-Bank International	7.41	4.69	-39.15	14.79	-2.82
Arab banks (average)	**9.66**	**10.88**	**5.78**	**5.94**	**7.89**
British banks (average)	**12.08**	**9.07***	**12.17**	**15.02**	**12.09**

Sources: Computed from MEED (various issues), annual reports, International Bank Credit Analysis (IBCA), London and Economic Intelligence Unit (database), 1987

Notes: * the low ratio for British banks in 1984 results form the exceptionally low ratio for Lloyds Bank of -1.10 during that year

Table 3 The ratio of net income to total assets of Arab vs British banks, 1983-86

per cent

	1983	1984	1985	1986	Average 1983-1986
Arab Banking Corporation	1.40	1.10	0.90	0.80	1.05
Gulf International Bank	0.90	0.90	0.90	0.90	0.90
Riyad Bank	1.99	1.65	0.61	0.52	0.58
National Commercial Bank	1.07	0.93	0.18	0.14	0.58
BAII	0.30	0.21	0.25	0.22	0.25
BIA	0.16	0.23	0.23	0.33	0.24
Al-Saudi Banque	0.06	0.45	0.12	0.05	0.17
Al-UBAF Group	0.10	0.10	0.11	0.11	0.11
Kuwaiti-French Bank	0.06	0.05	0.05	0.08	0.05
FRAB-Bank International	0.19	0.14	-1.09	0.52	-0.06
Arab banks (average)	**0.59**	**0.45**	**0.22**	**0.34**	**0.36**
British banks (average)	**0.74**	**0.72**	**1.00**	**1.27**	**0.90**

Sources: Computed from MEED (various issues), annual reports, International Bank Credit Analysis (IBCA), London and Economic Intelligence Unit (database), 1987

Appendix G

Table 4 The ratio of staff expenses to net profits of Arab vs British banks, 1983-86

	1983	1984	1985	1986	Average 1983-1986
Al-Saudi Banque	2600.0	156.1	900.0	3800.0	1864.0
Kuwaiti French Bank	900.0	2100.0	1300.0	775.0	1268.8
National Commercial Bank**	105.2	124.2	691.9	820.9	435.6
BAII	167.8	216.0	195.0	290.2	217.3
Al-UBAF Group	193.6	213.7	214.8	235.2	214.3
Riyad Bank	82.1	96.6	255.6	258.7	173.3
FRAB Bank International	172.7	233.3	na	104.78	170.3
BIA	181.3	137.5	141.7	156.5	154.3
Arab banks (average)	**286.8**	**180.1**	**451.5**	**414.1**	**413.3**
British banks* (average)	**310.5**	**294.6**	**283.8**	**226.6**	**278.9**

Sources: Computed from MEED (various issues), annual reports, International Bank Credit Analysis (IBCA), London and Economic Intelligence Unit (database), 1987

Note: * includes Lloyds Bank, Barclays Bank and National Westminster Bank

Appendix G

Table 5 The ratio of net interest revenues to total assets* of Arab vs British banks, 1983-86

	1983	1984	1985	1986	Average 1983-1986
Al-Saudi Banque	1.35	1.22	1.22	0.77	1.35
FRAB Bank International	0.51	0.70	0.74	1.09	0.76
BIA	0.59	0.66	0.54	0.74	0.63
BAII	0.65	0.34	0.21	0.72	0.48
Kuwaiti French Bank	0.41	0.17	0.67	0.60	0.46
Al-UBAF Group	0.45	0.27	0.39	0.28	0.35
Arab banks (average)	0.66	0.56	0.63	0.70	0.67
British banks (average)	3.33	3.36	3.09	3.30	3.27

Sources: Computed from MEED (various issues), annual reports, International Bank Credit Analysis (IBCA), London and Economic Intelligence Unit (database), 1987

Note: * net interest revenues represents interests received from borrowers less interest paid to depositors

Appendix H

Table 1 The ratio of toatl loans to risk capital of Arab vs British banks, 1983-86

per cent

	1983	1984	1985	1986	Average 1983-1986
Al-UBAF Group	31.86	36.15	21.89	19.20	27.28
BAII	24.17	29.87	21.22	13.52	22.20
FRAB-Bank International	12.82	12.15	14.00	9.28	12.06
Commercial Bank of Kuwait	7.53	7.70	7.70	7.86	7.70
BIA	7.67	8.20	7.12	7.22	7.55
Gulf International Bank	9.03	7.19	5.80	5.96	7.00
Al-Ahli Bank of Kuwait	7.28	6.86	6.63	6.36	6.72
National Commercial Bank	7.04	6.53	5.71	5.45	6.18
Burgan Bank	7.08	3.17	3.58	3.83	4.42
Arab Banking Corporation	3.27	4.17	4.29	4.75	4.12
Riyad Bank	3.26	2.94	2.71	2.39	2.83
Arab banks (average)	**9.54**	**9.54**	**8.45**	**7.14**	**8.67**
British banks (average)	**12.41**	**15.96**	**10.79**	**9.03**	**12.05**

Sources: Computed from MEED (various issues), annual reports, International Bank Credit Analysis (IBCA), London and Economic Intelligence Unit (database), 1987

Appendix H

Table 2 The ratio of risk capital to total assets of Arab vs British banks, 1983-86

per cent

	1983	1984	1985	1986	Average 1983-1986
Burgan Bank	15.04	15.22	16.10	7.90	13.57
Riyad Bank	12.42	12.42	12.85	10.86	12.14
Arab Banking Corporation	11.73	10.08	9.09	8.65	9.89
National International Bank	6.01	7.82	9.19	9.29	8.08
Al-Ahli Bank of Kuwait	9.25	7.76	7.22	6.37	7.65
Commercial Bank of Kuwait	8.15	7.70	6.95	6.15	7.24
National Bank of Kuwait	7.53	7.78	7.05	6.15	7.13
National Commercial Bank	5.09	5.93	5.73	5.78	5.63
FRAB-Bank Internatioanl	5.43	2.48	3.16	2.95	3.51
Kuwaiti-French Bank	3.10	2.88	2.57	2.64	2.80
Al-Saudi Bank	3.94	3.01	2.15	1.76	2.72
BIA	3.25	2.31	1.89	1.96	2.35
Arab banks (average)	**7.27**	**6.79**	**6.60**	**5.78**	**6.61**
British banks (average)	**6.87**	**5.92**	**3.98**	**5.07**	**5.46**

Sources: Computed from MEED (various issues), annual reports, International Bank Credit Analysis (IBCA), London and Economic Intelligence Unit (database), 1987

Table 3 Internal capital generation* of Arab vs British banks, 1983-86

per cent

	1983	1984	1985	1986	Average 1983-1986
BAII	18.10	9.37	12.74	7.54	11.92
National Commercial Bank	19.88	16.12	3.05	2.47	10.38
Riyad Bank	16.64	12.28	3.06	1.95	8.48
Al-UBAF Group	6.15	6.72	5.01	8.35	6.56
Al-Ahli Bank of Kuwait	na	7.49	1.89	3.52	4.30
Burgan Bank	na	5.14	na	3.30	4.22
Kuwaiti-French Bank	1.61	0.71	1.27	0.63	1.06
BAI	0.37	0.64	2.48	0.61	1.03
Al-Saudi Banque	-11.01	1.42	3.14	0.60	-1.46
FRAB-Bank Interational	3.37	1.56	-38.15	14.79	-4.61
Arab banks (average)	**7.71**	**5.59**	**2.49**	**3.55**	**4.32**
British banks (average)	**8.63**	**9.77**	**4.89**	**12.75**	**9.01**

Sources: Computed from MEED (various issues), annual reports, International Bank Credit Analysis (IBCA), London and Economic Intelligence Unit (database), 1987

Note: * internal capital generation is calculated by using the following ratio: net income - distribution income/total equity

Appendix I

Table 1 The ratio of total loans to total deposit of Arab vs British banks, 1983-86

per cent

	1983	1984	1985	1986	Average 1983-1986
Arab Banking Corporation	45.1	52.9	49.6	51.6	49.8
Gulf International Bank	62.4	65.8	63.7	67.0	64.7
National Commercial Bank	53.2	43.3	45.9	43.0	46.4
FRAB Bank International	42.5	46.0	41.3	67.3	49.3
UBAF	29.8	29.3	32.0	27.4	29.6
National Bank of Kuwait	46.3	49.7	48.4	44.7	47.3
Saudi British Bank	57.7	60.6	57.7	48.9	56.2
Riyad Bank	47.2	53.2	50.9	43.1	48.6
Banque Internationale Arabe	15.8	16.3	17.3	25.2	18.7
BAII	42.9	51.7	62.7	60.5	54.5
Al-Saudi Banque	43.3	47.9	48.1	52.0	47.8
Arab banks (average)	**45.3**	**48.3**	**48.5**	**48.7**	**47.7**
British banks (average)	**69.8**	**71.2**	**71.8**	**71.3**	**71.0**

Sources: Computed from MEED (various issues), annual reports, International Bank Credit Analysis (IBCA), London and Economic Intelligence Unit (database), 1987

Appendix I

Table 2 The ratio of liquid assets to total deposits of Arab vs British banks, 1983-86

per cent

Bank*	1983	1984	1985	1986	Average 1983-1986
Kuwaiti-French Bank	85.6	85.7	82.9	84.5	84.7
Banque Intercontinentale Arabe	86.2	84.9	84.0	77.9	83.3
Al-UBAF Group	76.6	78.6	73.1	76.8	76.3
Riyad Bank	74.2	72.1	87.8	88.3	80.6
FRAB-International	67.0	69.9	74.6	63.6	68.8
BAII	61.3	52.7	49.3	56.7	55.0
National Bank of Kuwait	54.7	49.5	50.6	53.6	52.1
Al-Saudi Banque	58.7	56.2	56.3	53.5	56.2
National Commercial Bank	64.4	69.2	63.7	49.8	61.8
Burgan Bank	38.7	49.3	42.1	38.4	42.1
Al-Ahli Bank of Kuwait	51.0	46.0	44.2	35.3	44.1
Arab banks (average)	**65.3**	**64.9**	**64.4**	**61.7**	**64.1**
British banks (average)**	34.1	31.3	31.3	31.7	32.1

Sources: Computed from MEED (various issues), annual reports, International Bank Credit Analysis (IBCA), London and Economic Intelligence Unit (database), 1987

Notes:

* Some well-known Arab international banks have been excluded from this table due to lack of data

** Includes Lloyds Bank, Midland Bank and National Westminster Bank

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