6 LESSONS FOR OUR
ECONOMIC SUSTAINABILITY

Souq Al-Manakh & Five Other GCC Crises

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Author's note

Kuwait Financial Center 'Markaz' commissioned Marmore MENA Intelligence (a fully-owned research subsidiary of Markaz) to write this book as part of the ongoing work of providing thought leadership on the most critical issues that have shaped the flow of economic currents in the GCC region. We hope that this book will offer clarity to businesses and investors on some of the previous economic crises that have impacted the GCC countries.

The book is explicitly chronological, divided into chapters covering the periods of the major crises in the GCC. The content of the book will help readers understand both the roots of the current economic situation and the opportunities for constructive change. The book offers information through our detailed research and aims to capture underlying issues. With this, we hope to shed useful insights on some of the most important events that shaped the financial landscape in the GCC region.

The book depicts the analysis and views based on research from sources that we believe are reliable. It is intended as a summary of six major financial crises and should in no way be used as a commercial or investment guide. Moreover, Marmore is not liable for any errors in the information presented regarding the sources or reference materials.

Chapters

1

Souk Al-Manakh Crisis

A slice of history

The Kuwait stock market has surprised many; first in the early 1970s and later in the mid-1980s.

In the early 1950s, Kuwait started emerging as a destination of choice. Those were golden years, when the oil business boomed, major public works programs began, and the surrounding atmosphere was liberal. By 1952, when His Highness Sheikh Abdullah III Al-Salim Al-Sabah ruled Kuwait, the country had become the largest exporter of oil. In the same year, the first Kuwaiti Shareholding Company (KSC) was incorporated and so was the iconic National Bank of Kuwait.

At that time, 40 public companies were listed on the Kuwait Stock Exchange (KSE), popularly known as the Official Exchange. There was a second exchange, an unofficial one, known as Souk Al-Manakh. Up to 46 unlisted Kuwaiti Shareholding Companies (KSCCs), and 38 non-Kuwaiti companies incorporated in other Gulf countries traded on the more famous Souk Al-Manakh.

The companies listed on the Official Exchange were established under the Commercial Law of Kuwait and regulated by the Committee on Securities, appointed by the Ministry of Commerce. The trading of securities on the Souk Al-Manakh, which accounted for 80% of the volume traded, was out of the regulatory reach of the committee.

The Gulf's tragic story is that of a crisis that engulfed the Souk Al-Manakh that had serious ramifications for Kuwait.

It began in the year 1973 when Arab oil embargo was announced, leading to a sharp rise in crude oil price. In the six months ending March 1974, oil price escalated by 400%, from USD 3 to USD 12 a barrel. This surge brought unprecedented cash income to Kuwait, mainly because the country was one of the world's top oil producers. With a production capacity of about 2 million barrels per day, it was generating anywhere between USD 6 million to USD 24 million per day in oil revenue (USD 2.2 billion to USD 8.7 billion annually).

To the Kuwaitis, this was windfall gain. The government used the money productively by investing it in infrastructure. This move changed the landscape of the economy and helped create enormous wealth. Therein began the first signs of trouble. World-over, history records that when people have excessive disposable income, such income somehow finds a way to the equity market. That's what happened in Kuwait as well.

The KSE witnessed a spurt of speculative financing opportunities, which led to a massive rise in Kuwaiti stock prices and, in turn, resulted in a jump in demand for equities. The rally injected an overdose of optimism, and investors began to pay a premium for newly issued shares. The rally was not surprising given that world history is replete with documented examples of how crowds had been swayed the wrong way by sentiments and emotions. History records the South Sea Company bubble of 1711-20, the Mississippi Company bubble of 1719-20 and the much-fancied Dutch tulip mania of the 17th century. One would have thought that people would have learned from those examples. In late 1976, the Kuwait stock market witnessed a significant drop, as the annual index declined 18.7%, from 235.2 to 191.8, and trading volume fell by a whopping 66%.

Government intervention and Souk Al-Manakh

The Kuwaiti Government intervened to take control of the situation. It began by suspending the incorporation of new companies and restraining the existing companies from raising further equity. There was a feeling that excessive Initial Public Offerings (IPOs) were affecting domestic liquidity, leading to a market crash. The government also bailed out the investors by purchasing the shares at a floor price, which resulted in massive losses.

While the Kuwaiti Government bought shares worth approximately KD 150million between Jan 1977 and April 1978, the banks were badly hit after lending to the stock dealers. After that, the Central Bank of Kuwait set up a facility to purchase the bad debts incurred by banks. The market recovered by the end of 1978, with both the official and unofficial markets remaining stable until the beginning of 1981.

During this time, the government banned incorporation of Kuwaiti Shareholding Companies between 1977 and 1979. This made it difficult for the

investors to indulge in speculative trading on the Official Exchange. In Sep 1980, Saddam Hussein's Iraq invaded Ayatollah Khomeini's Iran and the war unsurprisingly led to a rally in crude oil price. By 1981, the price had touched USD 40 a barrel.

The tide changed.

Kuwaiti investors who had a huge stock of petrodollars, were seeking investment opportunities that could generate substantial returns.

The US and European markets were facing downturns at that time, and the official Kuwait Stock Exchange was stringently regulated which made investors look for an attractive alternative forum.

Motivated by the Kuwait Government's bailout of investors during the 1977 crisis, investors began ignoring the risks associated with speculative investments and started investing in the securities listed in this unofficial market. So much was the positive sentiment that Souk Al-Manakh, was ranked third by market capitalization, behind the New York Stock Exchange (NYSE) and the Japanese Stock Exchange (JSE)!

The ban imposed in mid-1977 on the incorporation of KSCs was removed in mid-1979, and this led to a rapid rise in the formation of KSCCs and Gulf companies. According to the Central Bank of Kuwait (CBK), 45 new Gulf businesses and 120 KSCCs were incorporated between 1979 and 1982. These incorporated Gulf companies were Kuwaiti-owned but established in the other Gulf States. Several of them were offshore companies created for a speculative purpose, which meant they were outside the purview of Kuwait's regulations.

During the years of boom, the government reduced the maximum subscription amount, which led to small investors taking up the opportunity to incorporate firms and benefit from the boom. In 1982, traded shares of Al-Manakh's Gulf companies amounted to 3.5 billion, compared with only 837 million on the KSE. Approximately 2 billion shares got traded during the three months between June and August 1982. The market value of the Gulf companies reached KD 2 billion in 1982, as against a face value of only KD 648 million. Around that time, there were about 6,000 individuals and institutional investors trading on the Al-Manakh market, and it was widespread for a new issue to double in value, within a few weeks of its IPO.

The markets were destined to collapse, and it is exactly what happened.

Futures trading triggers the crisis

'Futures trading' was at the heart of the Al-Manakh crisis. Before 1977, 'futures' trading was informal. The traders who were accustomed to dealing in commodities and real estate, found new opportunities in shares.

Here's how it worked.

The seller sells at market price if the buyer pays for the share immediately in cash. This amount is called the spot price.

If the buyer makes the payment using a post-dated cheque (PDC), the seller adds a premium to the spot price. On an average, the premium charged was 60% of the spot price. Sometimes, the premium was as high as 300%, and investors were ready to pay!

Once the PDC was given, the contract was considered closed. Such closure technically locked the price of the stock and protected the buyer from a loss if share prices moved upward, and the seller from a loss if the price moved downward. During the boom, the holders of PDC availed finance from banks against these instruments, and the proceeds were used to purchase further shares.

A Stock Market Committee was established in 1976 to regulate the futures market after the 1977 crisis struck. The Committee laid down specific regulatory requirements for carrying out futures trade. One, all futures traded were to be registered with the Securities Administration. Two, the maximum maturity period allowed would be 12 months. Three, a seller deposit equivalent to 10% of the purchase value or the difference between the spot and futures prices whichever is greater had to be made. And four, the seller retained the title of the shares during the contract period unless the buyer made the total payment.

The new rules turned out to be ineffective without a clearing intermediary, as it meant that the trade was not guaranteed for performance. If either of the two parties to the contract defaulted, the other would be held accountable.

Also, under the Kuwait Commercial Law, a cheque was considered a cash instrument payable upon presentation, and so the investors continued treating the sale as a cash transaction with deferred payments. The future date of the cheque was not a significant concern, as it was overdue beyond a month. For example, the payment for the shares could be deferred for a maximum of 12 months, and the PDCs were valid for encashment up to one month, after the deferred period of 12 months. Otherwise, the cheque was accepted as cash, enforceable by law within the stipulated time.

After the law got amended in 1981, the contract had to be signed by a broker and had to be registered with the Exchange. The agents ensured that the buyer delivered the cheque, and the seller gave the share. The process of registering the contract gave the buyers and sellers the leverage of being protected by the law and led to a significant increase in futures trading in the bullish stock market. However, this also resulted in the dealer's exposure to large, open and unbalanced positions.

There was no intermediary to monitor the 10% deposit requirement during the contract period and to ensure transfer of the title at the end of the duration of the contract. Consequently, the title was transferred at the time of sale itself.

The stock exchange's role continued to be limited to registering the contract, and it had no role in regulating the clearing mechanism. The minimal regulation implemented at that time applied to the trades related to official stock exchange. The business in the rampant parallel stock market continued to be completely unregulated. And thus, the bubble formed.

Bubble burst

The Al-Manakh market index plunged from 240 in March 1982 to 110 in August; a greater than 50% crash in six months flat, leading to an annualized loss of 100%. By August, one of the largest of the 18 major trading companies defaulted on its debts and the Al-Manakh bubble finally burst. Selling shares became difficult as the volume of trade collapsed from 602 million shares in the previous month to 72 million. Yes, there were large sellers, but very few buyers. Though the KSE was initially resilient to the collapse of the Al-Manakh market and declined only by 6.5% between March 1982 and August 1982, the all-share index fell 53% from 509.4 at the end of 1982 to 238.6 in 1984.

Clearly, the contagion effect was at work.

The initial resilience of the KSE was due to the share purchase program of the Government. The securities that traded on Al-Manakh market lost 60 to 90 percent of their peak values. In September 1982, the estimate of the outstanding post-dated cheques amounted to USD 94billion, out of which USD 78billion (83%) were related to transactions in Gulf and KSCC shares. Almost 95% of the total outstanding debts involved only 18 traders, and the bankruptcies during the initial days reached 350.

The collapse of the Al-Manakh market affected a large segment of the Kuwaiti population and triggered a nationwide crisis with regional and international effects. The banking sector had expanded domestic credit issuance in 1982, at almost twice the rate compared to the previous year. And the dealers in the Al-Manakh market issued cheques against the Kuwaiti banks. Since there was no clearing intermediary, these cheques kept accumulating. The challenges with an intermediary offering this service were: one, the cheques originated from transactions that were illegal; two, these were against companies incorporated outside the jurisdiction of Kuwait; and three, the cheques were not issued under the supervision of a regulatory body.

Government response

To limit the fallout of the Al-Manakh calamity and avoid a liquidity crisis, the Kuwaiti Government took a few measures:

The International Finance Advisors (IFA) took over as a clearing agent, with the objective of collecting, matching, verifying, and systematizing the financial accounts of individuals and brokers in 1981. A trust fund of USD 1.7 billion was set up to compensate investors for losses less than USD 1.7million.

An Arbitration Panel finalized the settlements voluntarily reached between traders and effect settlements.

The Government established the Corporation for the Settlement of Company Forward Share Transactions in April 1983, to design and implement policies, and bring an end to the crisis.

A task force headed by the Minister of Finance was set up by the Government to resolve the Al-Manakh crisis. Initially, the government tried to sort out the mess by legally mandating the traders to fulfil their promises and pay their debt in full to all creditors. However, several traders were insolvent and couldn't meet their debt obligations. Furthermore, it was ineffective, as it failed to restore the confidence in the economy and business sentiment. Also, it was impossible to trace the right positions of the traders, due to heavy inter-linkages.

An example of six entangled traders:

Payables from traders

Payables from traders	Trader 1	Trader 2	Trader 3	Trader 4	Trader 5	Trader 6	Total payables
Trader 1	0	62	98	28	8	22	218
Trader 2	84	0	36	85	19	10	234
Trader 3	43	50	0	49	24	28	194
Trader 4	97	50	10	0	52	3	212
Trader 5	37	93	66	53	0	64	313
Trader 6	57	57	41	80	80	0	315
Total Receivables	**318**	**312**	**251**	**295**	**183**	**127**	**1,486**

Source: The Institute for Operations Research and the Management Sciences

On April 20, 1983, the Ministry of Finance established the Settlement Organization for Futures Transactions to handle settlements, liquidation, and bankruptcy procedures. The organization was also given the authority to settle claims amicably and authorized to issue negotiable and transferable bonds against assets, which assisted the payments process for other debtors.

The three kinds of assets held by the debtors were cash and other liquid assets, real estate and KSC shares, and the Gulf and KSCC shares. The organization issued three kinds of bonds depending on the type of assets held by debtors. As and when the assets were liquidated under the government purchase or restructuring program, payments were made to the creditors.

In August 1983 a new law was passed incorporating a number of significant changes. This included a mandate that all debt related to forward shares would mature on the date of effectiveness of the law. The maximum interest rate or premium would be 25 percent. Dealers could insist on clearing claims against other traders.

The first two changes affected the financial position of traders, depending on the maturity and premium profiles of their assets and liabilities. After implementation of the new law, some dealers with surplus accounts changed to a deficit. Moreover, the debtors who made settlements to their creditors under the old law were left with receivables with reduced value.

Response through stock market reform

The Kuwait Stock Exchange was set up as an independent authority chaired by the Minister of Commerce in August 1984. It was bestowed with the responsibility of setting up and supervising trading procedures, registering bro-

kers and developing the market. The Exchange was the foundation for market regulations and legal structure of clearing and settlement.

Two committees were established with full authority to rule on disputes and take disciplinary actions, such as warnings, calling in guarantees, terminating trading in stocks, and withdrawing membership. Both Kuwaiti and foreign shares and bonds and other financial instruments, licensed by the exchange committee, could be traded. All companies were required to provide regular financial data to the exchange.

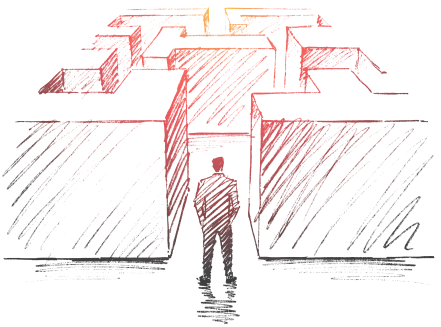
In 1986, the KSE authorities appointed the Kuwait Clearing Company (KCC) to act as the clearing and settlement agent for all security transactions at the KSE. In the same year, in consultation with the KSE, KCC formulated and implemented the necessary mechanisms and procedures for clearing and settlement processes.

By 1986, the worst had subsided to an extent.

However, the crisis had strong repercussions in the market. Many had lost their shirt. It marked the failure of well-known players in the market, while others took the bailout as a personal stigma.

2

Global Financial Crisis, 2008



The year 2008 created a divide in global finance, classifying it into two periods: 'pre-2008' and 'post-2008', just as world Economics is classified into pre-1929 and post-1929. The crisis was a culmination of a series of events that started in the US housing market, spread to the banking sector, and finally made its way to the unknown world of derivatives. It came to be called the sub-prime crisis.

In 2005, many people invested in the US market. Unfortunately, the market went through a prolonged period of low-interest rates. To earn reasonable returns, the US banks began reckless lending to borrowers with poor credit scores, aka sub-prime customers, thereby increasing their default risk.

To build protection, the banks went for financial engineering. They asked investment companies to pool the sub-prime mortgages to create investment products and sold them to retail investors looking for alternative assets. Under the omnibus name of Collateralized Debt Obligations (CDOs), these were ticking time bombs in the hands of those who bought them.

Credit default swaps

One of the front-running derivative instruments, under the umbrella- term CDO, was Credit Default Swaps (CDS). Introduced by JP Morgan Chase in the 1990s, it helped banks insure against loan defaults. These instruments were outside the balance sheet and, as subsequent events showed, in many cases, they were riskier than the liabilities disclosed in the balance sheet!

This is how it worked.

The risky loans were pooled, securitized, and sold to various investors, including banks and retail customers, at a good discount. Thus, a loan portfolio of $10,000 maturing in one year was sold at $9000 to multiple investors by breaking it into instruments of $100. In fact, so attractive were the rates that some investors borrowed from banks to invest in these CDOs, thus increasing their risk manifold!

Worse still, rating agencies rated these instruments as 'investment grade!' The results would have been different had these CDOs been honoured on

due dates. Ironically, most of the AAA-rated CDOs defaulted, leading to a collapse of the investment banking powerhouse, Lehmann Brothers, and the near bankruptcy of JP Morgan and Citi Group.

For once, USA ducked its moniker of being the land of the market economy, when its government intervened and bailed out significant players in the banking industry, to save the country from marching into a 1930s-like depression. But it was too late. By then, people had lost a bulk of their savings. The bailout helped institutions, not individuals.

America's regulatory failure

Lehman Brothers had the reputation of being an institution that was massive enough to withstand failure.

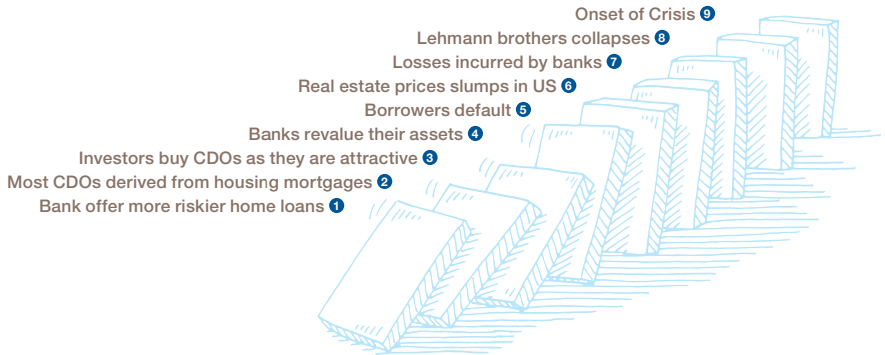
Yet, Lehman Brothers had collapsed. Letting it happen was a regulatory catastrophe as it unleashed waves of negative sentiment. This led investors to back out and banks choose not to lend, leading to a halt in economic activity leading to a halt in economic activity. The Fed not only allowed Lehmann to fall, but it was also guilty of two other things: one, retaining a low-interest rate regime for extended periods of time and, two, not controlling the housing bubble.

The crisis slowed down global growth. For two years, the USA and Europe stared at stagflation. Surprisingly, emerging markets, such as China and India, were more resilient, their prudent central banks having built safety nets. The long-standing Governor of the People's Bank of China, Zhou Xiaochuan, and the two successive heads of the Reserve Bank of India, Y V Reddy, and D Subbarao had ensured that their respective countries came unscathed.

Some investors had invested in the market indices of US (Dow Jones), UK (FTSE), Germany (DAX), Japan (Nikkei), and MSCI-EM and saw their portfolio fall like ninepins. It was an object lesson that would be impossible to forget. In 2008, such a collection lost 45% on average. Emerging Markets, which fell by 53% that year, was particularly disappointing. Lack of investments, reversal of capital flows and a slowdown in global growth were touted as the causes of the fall.

And to top it all off, the CDOs they had bought crashed.

Complex chain of debt crisis



Impact on GCC economy

Players had been sucked into the vortex of the financial crisis that had created shock waves across the world affecting trade balances, financial channels and stock markets in many countries, including the GCC. In GCC, capital inflows reversed that year leading to a liquidity crunch. Investments in CDO had crumbled, and the Middle East markets had gone bankrupt.

The good news was that the sub-prime crisis didn't affect the GCC directly because the banks had limited exposure to sub-prime assets, and this insulated the region from the developments in the global financial markets. However, the crisis was felt indirectly through contraction of the world economy, the decline in oil prices, and fall in real estate prices.

Investor confidence deteriorated. As GCC countries peg their currency to the dollar, interest rates move in tandem with the Fed's policy. Before the crisis, the real annual average credit grew by 23%, mostly in Qatar and the UAE. Such expansion fuelled real estate lending and created a real estate boom.

Those who had bought properties had been positive about the outcome.

But, once the financial crisis took centre-stage, the capital received in 2007 and early 2008 started to reverse, tightening liquidity and affecting investor confidence.

The next shock came in 2009 when oil price made a sharp downturn. Export revenues crashed. The crisis was accentuated by the fact that GCC countries

depend heavily on imports. The combined effect of 'declining export earnings' and 'higher dependence on imports' increased the magnitude of the disaster.

Gulf nations saw their GDP tumble with Kuwait and UAE experiencing negative real GDP growth. Other economies too had their GDP growth slashed. Kuwait, Qatar, and Saudi Arabia had the mortification of watching their current account balance decline, as well.

Impact on stock market

These had their reverberations in the stock market.

The equity markets, for the most part, followed the global trend. Kuwait, UAE, and Bahrain, which allow Foreign Institutional Investments (FIIs), experienced greater shocks than Saudi Arabia, which does not permit FII participation. Asset prices tumbled. CDS spreads widened, indicating that investors had lost confidence in sovereign debts.

The markets collapsed. Though the indices recovered in 2009, it took five years to get past their pre-crisis levels. It was far too long a time for many who had put vast sums of money into it, to wait.

Many thought that, by investing across countries, their portfolio would be well diversified. In the end, it ended up being naive. Same factors prevailed across GCC leading to identical falls in other countries as well.

In Saudi Arabia, the bears had a field day. The Tadawul Index lost 57% in 2008, and every sector in the index declined. Insurance tumbled 74%, followed by petrochemicals, which fell 67%. Retail and Agriculture segments were the least hit, despite registering 32% and 33% losses respectively.

Among stocks, Saudi Basic Industries (SABIC), the largest petrochemical producer in the Middle East, crashed 69%. Worse still, there was prolonged negative outlook on Saudi telecom stocks.

There was wide-scale investment in all these. Suddenly, stocks and shares now read shocks and stares.

In UAE the story was the same. The Dubai General Index toppled by 72%, and real estate stocks bore the brunt of the fall. It dropped off the cliff in 2008, by 83%. Other shares too fell like a pack of cards. Services, Telecom, and Financial services rolled down the hill by 70%. Insurance declined 28%. Energy stocks registered a 70% collapse.

Emaar Properties and DP World, UAE's two blue-chip real estate stocks, lost 85% and 68%, respectively. First Gulf Bank and National Bank of Abu Dhabi went down by 55% and 53% respectively. They all recovered the following year, but by then the damage was done.

Qatar was the least affected. Its general index declined by 28%, while telecom and insurance indices dropped 43% and 32%, respectively.

Government's measures, such as bank asset purchase and capital injections helped Qatari banks recover at a faster pace, in-turn assisting the stock markets to improve.

Annual returns of blue chip stocks (UAE, 2007-2010)

	2007	2008	2009	2010
Etisalat	49.6%	-48.3%	32.9%	8.0%
First Gulf Bank	83.5%	-54.7%	75.4%	13.7%
DP World	N/A	-68.0%	10.3%	46.5%
National Bank of Abu Dhabi	42.2%	-53.2%	54.0%	4.2%
Emaar	22.1%	-84.8%	70.8%	-8.0%

Source: Reuters

Annual returns of blue chip stocks (Saudi Arabia, 2007-2010)

	2007	2008	2009	2010
SABIC	88.6%	-68.9%	60.2%	27.0%
Saudi Telecom	0.9%	-41.4%	-10.2%	-3.4%
Al-Rajhi Bank	35.0%	-52.2%	27.2%	16.5%
Saudi Electric	13.2%	-38.3%	21.6%	24.4%

Source: Reuters

Annual returns of blue chip stocks (Qatar, 2007-2010)

	2007	2008	2009	2010
Qatar National Bank	18.2%	-2.1%	9.0%	62.2%
Industries Qatar	82.2%	-28.1%	13.5%	20.7%
Ooredoo	NA	-43.2%	31.6%	23.4%
Masraf	23.0%	-52.2%	21.8%	42.5%

Source: Reuters

Impact on corporates

Among corporates, the crisis affected the earnings growth.

Non-performing loans in GCC banks increased significantly. There were loans to Saudi Arabian conglomerates, which led to higher NPLs. The Dubai World debt restructuring added to the crisis.

Earnings in GCC declined by 41% in 2008, due to declining sales in real estate. This decrease led to lower growth in the banking industry that constituted 80% of the regional earnings. Financial service industry's revenues dipped by 204% Y-o-Y in 2008. Higher provisioning made by GCC corporates in 2009, led to lower earnings despite stronger revenue growth.

Bahrain and Kuwait were the worst affected, as income from commodities dwindled. Compared to 2007, Kuwait's revenues declined by 94% in 2008. Five investment companies in Kuwait defaulted between 2008 and 2010.

Saudi Arabia's financial services sector's earnings declined 44% YoY in 2008, due to losses incurred on their investments in global equities and commodities.

UAE suffered lower earnings in 2009 and 2010, with the fallout of Dubai World crisis and poor performance of real estate sector. In 2010, revenues of real estate industry in UAE declined unimaginably from USD 282 MN profit in 2009 to a loss of USD 3,773 MN in 2010). Projects were left halfway, and promoters fled. Overnight, construction sites were left deserted.

Earnings in GCC, 2006-2010

	2006	2007	2008	2009	2010
KSA	21,251.9	22,834.7	12,791.0	16,221.0	22,185.9
UAE	9,756.1	13,237.4	12,683.7	8,626.0	4,880.5
Kuwait	7,907.8	13,737.1	860.7	1,503.5	5,507.8
Qatar	3,840.0	5,528.9	7,459.8	9,094.1	8,132.8
Oman	1,032.1	1,509.1	1,400.0	1,457.4	1,649.5
Bahrain	1,897.7	2,630.7	(36.7)	(222.0)	677.8

Source: Reuters

Impact on real estate

In 2002, Dubai allowed non-GCC nationals to own property on a freehold basis. This caused massive interest from abroad. Several projects were launched, but the implementation of these was slower than anticipated. There was shortage of finance and the famed project management skill of Dubai failed. It caused severe shortages in the market and increased the rentals as well as sale prices of the apartments. During 2003-08, Dubai was a 'Punter's Heaven.' Many bought when prices were skyrocketing. They invested in haste and repented in leisure.

When the financial crisis swept through Dubai, the impact on the real estate market was huge: job losses, defaults, and distress sales. It also temporarily stopped the speculation-driven increase in sale prices and rentals. And then

slowly rents started falling, at least until 2011. Apartment prices continued crashing post the crisis. The Business Bay area's sale prices dropped, by as much as 65%, between 2008 and 2009. It fell from AED 2700 to AED 950 per square feet. Similar trends were witnessed in Dubai Marina and Downtown Dubai.

Average values (AED/sq)

District	2007	2008	2009	08/09 Change
DIFC	3,200	4,600	2,200	-52%
Business Bay	1,500	2,700	950	-65%
Burj Dubai Downtown	3,500	5,000	2,150	-57%
Jumeirah Lake Towers	1,200	1,800	720	-60%

Source: JLL

Abu Dhabi had an increase in prices of real estate during 2003-08 that peaked in 2008. Increased demand from expats prompted the launch of numerous projects. Again failure to deliver projects on time caused an unprecedented increase in rents and selling prices. Many projects, sold at rapidly increasing prices, came to a standstill.

The global financial crisis led to a correction in prices, which dropped 50% from its market peak in Q4 2008 to a market low by the end of 2011. Rental rates fell by nearly 60% since the peak in 2008.

Rentals in Abu Dhabi dropped by 44%, and the decline continued till 2011. Apartment sale prices also saw a huge decrease in sale price, post the crisis. Marina Square area's sale prices fell by 48%. Similar trends were witnessed in Al Muneera and Sun & Sky Towers. The average price for residential units in Abu Dhabi stood at USD 545 per sq. ft., at the end of Q2 2008. However, it declined to reach USD 340 per sq. ft., at the end of Q2 2010.

Government-related entities, such as Dubai World, engaged in real estate activities with other people's money. In no time, Dubai World accumulated USD 59bn in debt, as it had borrowed heavily to build showcase projects, such as a giant island shaped like a palm tree that attracted investments from many global celebrities. When the boom burst in 2009, Dubai was stuck with houses that did not have any investors.

When the government requested that Dubai World be allowed to skip six months of interest payments, it spooked markets globally and sparked fears of a crisis in real estate. Those fears were put to rest, as foreign banks' exposure to

UAE was a mere $130 billion. This amount was negligible, as its only 0.4% of the foreign banks' total cross-border exposure. It made investors wary of Dubai's status as a global financial hub and rattled the confidence of those in highly leveraged economies, like Greece, Britain, Spain, and Ireland.

Investors feared a sovereign default by Dubai World, which could lead to subsequent crashes in Dubai and Abu Dhabi equity markets. In a bid to rescue its neighbour, Abu Dhabi stepped in with a $20Bn loan. The debt deal finalized by Dubai World in 2010 with its lenders, helped improve the prevailing market situation.

Other GCC real estate markets were no better. Kuwait and Saudi Arabia's markets slowed down after 2008. Kuwait witnessed huge volatility. Prices in Riyadh markets declined in 2008 and remained stagnant until 2010. Apartment prices, rentals, both office and residential, started slowing down.

How the GCC fought back

The economy started showing signs of resilience.

The government adopted various measures, such as fiscal stimulus, deposit guarantees, liquidity support, capital injections, bank asset purchases, stock market purchases and monetary easing to fight back.

Different countries responded differently, although mostly the measures were the same.

Saudi Arabia provided fiscal stimulus to increase credit to non-oil sectors through state-owned credit institutions. This stimulus helped mitigate the risk of slow down, due to lower credit from banking institutions.

To encourage people to save their money in banks, Kuwait, Saudi Arabia, and UAE introduced deposit guarantees. Investors were insured of their deposits in case of default. The governments increased their short-term deposits with the banks and provided long-term support and liquidity adjustments through their respective central banks. All this helped banks overcome a tight money squeeze of the kind faced by US and European banks.

In 2008, in the wake of the crisis, the GCC banks' capital adequacy ratios

Capital adequacy ratios in GCC banks

	2007	2008	2009
Kuwait	19.3	15.6	16.7
Qatar	N/A	N/A	15
KSA	20.7	16	16.5
UAE	16.6	13.3	19.5

Source: IMF

suffered. The government injected capital to provide stimulus to weak banks and to improve the availability of capital.

The Qatar government purchased 20% of all banks and real estate companies' assets, investing more than USD 30bn in the bargain. This purchase helped the banking sector stay resilient during 2008-10.

That was very much like Kuwait, which adopted a somewhat similar strategy. The Kuwait Investment Authority (KIA) launched a fund worth KD 1.5Bn (USD 4.95Bn) for investments in the domestic stock market. However, its impact on the market was minimal, as only 1/3rd (500Mn) of the planned investments were implemented.

All GCC central banks, except Qatar, lowered interest rates and reduced capital requirements to move from the tight credit approach they had followed before the crisis. It was a much-required move to tackle the effects of a credit crunch in GCC economies, as banks suddenly became risk-averse after defaults in Kuwait and Saudi Arabia.

These were a few of the strategies to recover from the global financial meltdown.

Lessons learnt from the crisis

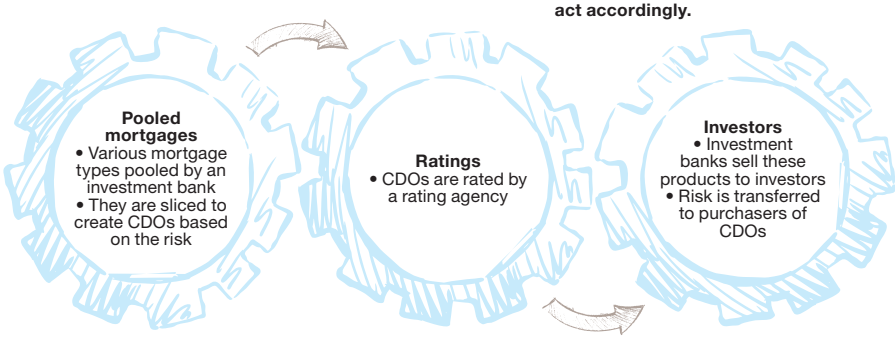
1 Supervision and maintenance of standards in banking and financial systems by the central banks would be a requisite, to prevent a similar crisis in future.

2 Very few analysts foresaw the crisis before its onset. Even international agencies did not predict the occurrences of such crisis in 2006 and 2007 when the markets and economies were thriving.

3 Investors are more risk averse than expected. Institutional, as well as individual investors, withdrew their investments even from fixed income assets.

4 Compliance and regulatory mechanisms must be strengthened. Regulators could be consulted before new products enter the market. They must look deep into the implications of changes in the market, and act accordingly.

5 Lenders must be incentivized to lend to high-quality borrowers after proper due diligence. The crisis led to increase in non-performing loans in GCC banks.



Source: Economists, Marmore Analysis

3

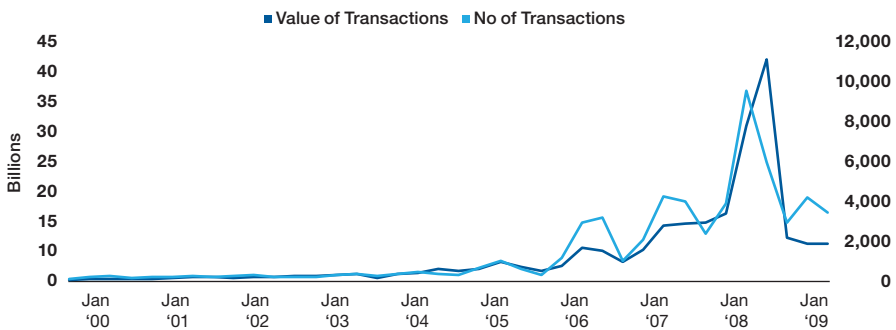
Dubai Real Estate Meltdown, 2009

Dubai, the jewel in the UAE crown, changed with times. In 1966, the discovery of oil changed the landscape of the country. Those were early periods of success, as the UAE slowly came to be known for its wealth and grandeur. It was oil that catalysed the country's economic boom. Of course, the presence of a forward-thinking government helped in channelling the oil revenue into developing non-oil sectors, attracting foreign investment, and financing infrastructure projects, which further contributed to the growth story.

The mid-1990s was the initial phase of the real estate industry. Within a few years, the government realised the potential of real estate and showered the sector with some initiatives. The market prospered, rocketing between 2002 and 2008, and at one point, UAE contributed 60 percent to the property boom in the GCC region.

It was the best of times, as the numbers showed. Average office rentals grew by 86% Y-o-Y in 2006, and by 55% in 2007. Average residential rents increased by 25% and 18% during the same period. Ongoing projects crossed USD 1 trillion by 2008; almost two-thirds of these were in the UAE, and of those, a majority were in Dubai. And then the fall happened.

Dubai value of land transactions (in AED)



Source: Dubai Land Department

A tale of two reasons

The days of success had people questioning the reason behind the growing prosperity.

The first reason was that the Dubai rulers were pragmatic to know that one-day, not very far away, oil would dry up. An economy that depended solely on oil would invite danger. So the government decided to reduce its reliance on oil revenue and diversify the economy to non-hydrocarbon income areas.

This push was spectacular as it resulted in an increase in the non- oil sector from representing 46% of Dubai's GDP in 2000 to 95% of Dubai's GDP by 2008. Simultaneously, the government turned its attention towards areas such as trade, transportation and storage logistics, professional services, tourism, construction and financial services. In what was rightly analysed as 'push for diversification', these efforts had a positive spill over on to UAE's real estate sector.

The second reason was that it opened up the housing market.

Dubai had enticed the wealthy from all over the world to invest in the city. It began the process by issuing the Foreign Property Ownership Law in March 2006 and legalizing foreign ownership of properties in designated areas of Dubai. This legalization resulted in high demand from the resident expatriate population, and foreign investors looking for attractive investment. Additional factors, such as low taxation levels, stable political economy further complemented Dubai as an investment haven in the Middle East. Major Dubai real estate developers had amongst themselves done close to USD 625Bn business in 2008.

The increase in demand led to a big spurt in housing supply, predominantly delivered by the Government-related real estate companies. These entities enjoyed the twin benefits of (i) access to newly serviced land and (ii) easy access to finance from regional and global lenders. Some of the prominent real estate government-related enterprises (GREs) were Nakheel, Dubai Properties, and Emaar Properties. These companies, along with some more large developers, were fiercely competing for landmark projects. Nuaimi Real Estate Global LLC was one of them.

The push towards diversification and the opening up to foreign investment in housing helped the real estate market to grow boundlessly. But things changed.

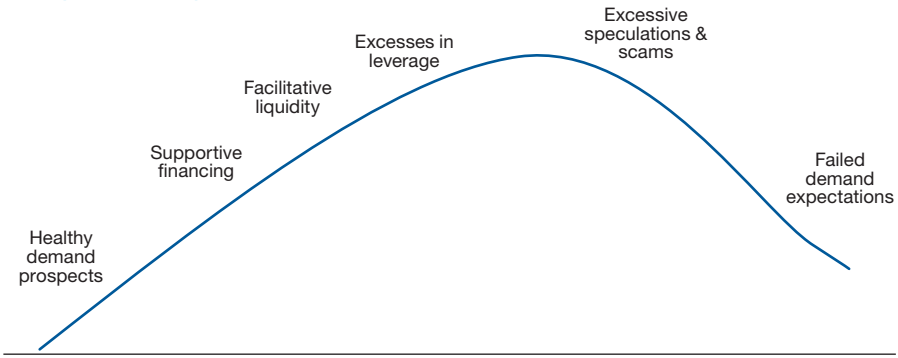
They ignored the tell-tale signs

Key inputs about the prospective negative state of the economy were not taken into consideration at the time.

In the last quarter of 2008, the economy turned chaotic. Dubai's property values nosedived, and created a property bubble, due to unsustainable price dynamics. The Land Department's statistics showed residential prices drop by over 50 percent between Sep 2008 and Sep 2009. By now, all the critical sectors of Dubai's economy, such as logistics, tourism, retail, finance, real estate and trade bore the brunt of the global financial crisis. It was the worst market tragedy since the Great Depression of 1929.

The world's top monetary body, the International Monetary Fund, named the region as among the significant three economies with the worst decline in property values.

Asset price bubble path



What lead to Dubai's real estate bust? Price of presales contracts

In this context, let us evaluate 'Presales' or 'Off-Plan' contracts. Under these contracts, the developer would 'pre-sell' the yet-to-be-built property to a buyer, who will then pay the developer according to a promised construction schedule. The initial payment was 10% of the property value. The smart buyer would resell these contracts, as the property prices would have now started rising.

Let us say, a property is assessed at 2Mn AED. The initial presale payment would be 0.2Mn. AED. As parts of the assets get constructed, the value of the asset rises. In this case, let's say it raises to 2.1Mn. AED. The original buyer will now sell off his presale contract to a new buyer with a premium of 0.1Mn.

AED. (2.1Mn less 2.0Mn.) This premium would mean a profit of 50%, on an initial investment of 0.2Mn.

These contracts were repeatedly traded, as the prices increased during the construction of the property, and there was never any intention of taking delivery. The widespread use of these contracts encouraged both the housing price boom through 'property flipping' and an oversupply of new units, above what long-term market fundamentals would support.

Excesses of money supply and inflation

There were some indications that credit extensions were excessive.

One, the UAE's mortgage market had expanded too rapidly for comfort during the years preceding the crisis. For example, total real estate mortgage loans grew from 4.1% of GDP in 2001 to 15.2% of GDP in 2008. In September 2008, total outstanding mortgage loans rose by nearly 100% from December 2007, to touch AED 115.7 (USD 31.5) billion.

Two, during the peaks of activity, Dubai banks were lending anywhere from 80% to 95% of the asset's market value. The lower end of the ratio was for the expatriates, while the upper end was for the Nationals. A debt-equity ratio of 19:1 predicted a clear failure.

Three, in 2007, the UAE witnessed massive financial inflows in the form of foreign banks deposits. The speculation that the UAE currency would appreciate against the dollar propelled these inflows. The UAE Central Bank reported that the money supply increased by 36.7 percent in 2007. This dramatic increase fuelled the fires of inflation. The IMF estimated Dubai's 2007 inflation rate at 11 percent, compared to the U.S. inflation rate of below 3 percent.

Thanks to the AED-USD peg, domestic inflation rose above 12% for the UAE, and negative real interest rate facilitated the growth of credit and quest for yields in real estate and other investments. There was an extraordinary momentum in price rise in Dubai from Oct-06 to Jul-08, and the average value increased almost three-fold. (Figure-2)

Excessive economic activity and employment

The real estate sector's contribution to Dubai's GDP experienced a steep surge from its six-year average of 10% to 15% in 2006 (Figure-3). The sector's share of the total GDP was 18% in 2007. This proportion was in divergence to

the rest of the region, where the percentage of real estate-to-total GDP either stayed flat or even declined.

Another measure that threw light on the extensive reliance on the real estate sector is the proportion of the population working in that industry. As per the census data for the year 2005, in Dubai, 48% of the total workforce was working in the construction and real estate sector. This number excluded the 300,000 strong work-force who stayed in Sharjah and commuted to Dubai daily for work.

Workforce in construction & real estate sector (2007)

Sector	Dubai	UAE
Construction	43.52%	13.91%
Real Estate and Services	6.74%	2.03%
Total	**50.26%**	**15.94%**

Source: Statistics Authorities and Ministries

Dubai -world's debt standstill announcement

The damaged economy faced a second round of disruption when the government of Dubai announced in late November 2009 that Dubai World would seek a six-month standstill on repayments. The news sent shockwaves across the world. A USD 20bn lifeline from the oil-rich neighbour, Abu Dhabi, was a timely help.

Dubai World is part of Dubai, Inc., which is the informal name used for the complex network of government-related enterprises (GRE) that dominate the Dubai economy.

Dubai Inc. is a web of commercial corporations, financial institutions, and investment arms owned directly by the Government of Dubai under the umbrella of three major holding companies (Dubai Holding, Dubai World and the Investment Corporation of Dubai). Each holding company includes several property developers and is involved in different property ventures in Dubai and around the world.

Amongst the DW subsidiaries, Nakheel (developer of palm-shaped islands and The World islands) and Limitless (planned 75-kilometer Arabian Canal project) were the most leveraged companies. Dubai Inc. entities leveraged themselves extensively during 2004-08, to fund their foothold in the large-scale commercial and residential property development segment.

These entities were always exposed to the maturity mismatch risk, as much of the borrowing had short maturities, and cash flows from property development would be realized over a longer duration. With the collapse of local property markets and the global crisis, the severity of these risks accentuated.

On November 25, 2009, the government-owned conglomerate, Dubai World, announced that it was seeking a 'standstill' on debt repayments while it restructured some of the borrowings. The standstill and restructuring were to affect USD 26 billion worth of bilateral bank loans, syndicated loans, and bonds, including a Nakheel Sukuk, due to mature on December 14 and was guaranteed by Dubai World. Approximately USD 6bn of the USD 26bn in debt of Dubai world was related to Nakheel.

As of January 2010, the debt of the GRE of Dubai Inc. accounted for 78% of the total public debt of Dubai. The Government of Dubai (GD) debt of 22% was significantly lower than the debt of Dubai World. Out of the aggregate USD 26bn outstanding debt of Dubai World, the standstill debt accounted for USD 14.4bn.

Dubai's publicly held debt (as of January 2010)

Debt Holders			Total (USD Mn)	Share of "Dubai Inc."
Total Dubai World (DW)			26,043	24%
a.	Dubai World stand stilled debt	Sub-total	14,350	13%%
b.	Other Dubai World subsidiaries	Sub-total	11,693	11%
Total Dubai Holding (DH)		Total	14,794	14%
Total Inv. Corp. of Dubai (ICD) (including ICD-owned banks)		Total	20,404	24%
Total Other Dubai Inc.		**Total**	**24,352**	**22%**
A.	Total for "Dubai Inc."		85,593	78%
B.	Government of Dubai (GD) (Assuming direct and indirect Abu Dhabi support is 100% drawn)		23,700	22%
C.	**Total "Dubai Inc." and GD DEBT**		**109,293**	**100%**

Source: IMF [2010], 2009 UAE Article IV Review, Annex Table 1, p.49

The global recession coupled with financial market crisis and Dubai's real estate bubble burst raised concerns amongst investors with regards to Dubai's ability to service its debt, particularly in the case of highly levered real estate enterprises. With the 'standstill' announcement, market participants could no longer assume an implicit sovereign guarantee for Dubai GREs, which were downgraded by several notches, most to non-investment grade.

The announcement had a sharply adverse effect on the stock markets of UAE. It also had a contagion effect on other GCC countries, resulting in higher volatility in the equity markets, and marginal widening of CDS spreads, in the week after the announcement.

On 14, December 2009, Sheikh Ahmad Bin Saeed Al Maktoum, Chairman of the Dubai Supreme Fiscal Committee, announced that the Abu Dhabi Government was supporting the Government of Dubai with a USD 10bn facility, to limit the contagion to other parts of the U.A.E.'s economy. USD 5 billion was provided through two Abu Dhabi banks, and the remainder was to be included in Abu Dhabi's 2010 budget.

The Government of Dubai used part of these resources for the timely redemption of the Islamic bond issued by Nakheel, the subsidiary of Dubai World. The remainder was to be used to cover payments to contractors, working capital, and interest expenses through to April 2010, conditional on a standstill agreement being reached between Dubai World and its creditors.

Aftermath of Dubai real estate bubble burst

UAE was hard hit due to the global recession, a subsequent bursting of the Dubai property bubble, and plummeting oil revenue. This resulted in a halt in property development, and a plunge in property prices. Once the global financial crisis of 2007 spread to Dubai a year later, lending declined; many foreign investors left, and confidence in the Emirate's overinflated real estate market lay shattered.

The overall implications of the housing turmoil remained erratic and were mostly restricted to the financial companies in Dubai and Abu Dhabi that fell victim to the crisis. The magnitude of the impact can be envisaged from the contraction in corporate revenue of the leaders.

Emaar properties lost 35% in revenue from property sales during 2009, compared to 2008. The following year, the Emaar Group had to reduce its USD 480mn investment in WL Homes, the Group's US subsidiary.

The revenue for Aldar Properties declined 60% in 2009. The crisis impacted the developments under construction for Aldar, which dropped from USD 6.2bn at the end of 2008 to USD 4.8bn at the end of 2009. Arabtec Holding, primarily engaged in the construction of high-rise towers, residential villas, and related activities, witnessed a YoY 22% decline in revenue in 2009.

Could they have done something?

Questions were raised about Government's role in limiting the extent of the crisis. For instance, could the Dubai Land Department not have jacked up the real estate registration fees earlier to curb flipping by speculators? They had now doubled the property registration fees from 2% to 4%.

Could the developer not have been mandated to own the land fully and keep money in an escrow account, which is mandatory now?

For instance, today a developer will have to own the ground fully and hold 20% of the construction cost in a particular escrow account if units are to be sold before completion of 20% of the building of the project. Some developers now went to another extreme, by banning the resale of unfinished properties before 40% of the asset's value is paid!

Could registration of real estate transactions not have been made mandatory before, as the Dubai Land Department has now done?

Why hadn't the Central Bank of the United Arab Emirates (CBU) acted earlier, as they have acted now? Today, the loan-to-value (LTV) ratios for mortgages are limited to between 60% to 80%, depending on the value of the property and nationality; and 50% for off-plan properties.

The borrowers' debt-service-to-income (DTI) ratios are limited to 50 percent. Banks can now lend to Emirate governments and Government-Related Entities (GREs) to a maximum of 100% of their capital, and not more than 25% of their money to a non-commercial GRE.

A few points merit attention.

One that Dubai's real estate meltdown had its roots in critical gaps in the UAE's regulatory infrastructure. It included the lack of prudent regulations to check building of speculative asset bubbles, backed by excessive leverage. He realized that while limitations on leverage set for the GREs is a positive step, this has to be followed up with strengthened corporate governance practices and increased transparency for State Owned and Government-Related Enterprises.

Two, though the mortgage market of the UAE is small and a majority of purchases during the boom were with cash, the UAE banks have attempted to prevent the mistake of poor underwriting of commercial and residential estate loans. The banks target to achieve this through better banking regulation, supervision, and stronger internal risk management. Cash flows, pre-sales, and leverage are the areas of real estate lending under focus for regulation and oversight.

4

Al-Gosaibi: A Debt Default that Rocked the Middle East

It was a high-profile corporate collapse that occurred in Saudi Arabia. It involved the Bahrain-based The International Banking Corporation (TIBC) as the owners, AHAB (Ahmad Hamad Al Gosaibi & Brothers Company) Group clashed with the Al-Saad Group into which they had married. It garnered interest across financial world as they were amongst the biggest business names in the country.

The allegation

Hamad Al Gosaibi (Gosaibi Family) is one of Saudi Arabia's top business magnates, with interests in multiple sectors, spanning countries, and continents.

Maan Al Sanea is a Saudi billionaire with roots in Kuwait. The big boss at the Al-Saad Group, primarily an investment company, he was the second largest shareholder in the HSBC Bank.

In the early 1970s, while oil was transforming the Middle East into an economic powerhouse, Al-Sanea married into the Gosaibi family. Sanea was put in-charge of AHAB's financial services businesses, and quickly rose in stature and influence within the company.

AHAB had a Money Exchange Division, which borrowed large sums from global banks. One estimate points out that about USD 120Bn was raised as loans, during 2000-09. The number alone is hard to digest, given the nature of the Money Exchange's business. What is certain, however, is that most of these loans were routed through TIBC in Bahrain, which in turn had raised funds from intermediate markets.

In May 2009, TIBC defaulted on its instalment obligation. As a direct fallout, the Money Exchange Division of AHAB too defaulted. In the ensuing legal battle, the Gosaibis declared that they weren't the fraudster but were victims of a USD 9bn fraud, orchestrated by Al-Sanea, who, they claimed, had complete control of the finance businesses.

More about the warring groups

Al Gosaibi Group

Ahmad Hamad Al Gosaibi and Bros (aka AHAB) is a highly respected private company in Saudi Arabia. Its founder, Ahmad Hamad, was initially involved in the production of silver coins for Saudi Aramco. In the 1950s, Hamad strengthened those ties by supporting Saudi Aramco's operations in catering, warehousing, oil pipes, and equipment. Later, he began supplying tires and boats and then expanded into fuel vending and automobile spare parts.

When his children grew up, they helped develop the business, leading to the establishment of Ahmad Hamad Al Gosaibi and Bros (AHAB). Later, the group opened the 1st Pepsi bottling factory in the eastern province of Saudi Arabia. Over time, it set up a diversified portfolio that covered manufacturing, construction, consumer products, energy, tourism, and hospitality.

Al-Saad Group

Maan Al-Sanea, a Kuwaiti fighter pilot who repatriated to Saudi Arabia in the 1970s, promoted the Al-Saad group. It was an equally respected name.

Al-Sanea started construction and contracting venture that became a business conglomerate, comprising 37 firms in such diverse fields as manufacturing, construction, engineering, real estate, financial services, hospitality, and healthcare, with investments cutting across countries and continents.

TIBC: what went wrong

When Al-Sanea married into the Al-Gosaibi group, he was asked to run AHAB's Money Exchange Division in Khobar. The Exchange was an excellent idea. It gave expatriate workers a convenient way to send remittance home and offered a few essential financial services. It also functioned as Al-Gosaibi family's in-house bank. The money exchange grew under Sanea and he has considerable influence over the banks.

Over time, Al-Sanea came into contact with Glenn Stewart who would eventually work as TIBC's CEO. Stewart was an Oxford graduate, with interest in Middle East affairs. He leveraged his knowledge of Arabic and Islamic finance to forge business relationships and create Islamic finance products. In 1989, after brief stints in Bahrain, Stewart moved to Saudi Arabia to join Al-Gosaibi.

Stewart began advising Sanea on various short-term finance mechanisms, including Sharia-compliant arrangements. In 2001, with AHAB's Money Exchange facing legal restrictions, Stewart suggested opening a bank in Bahrain. It was a masterstroke for two reasons. One, international bankers were comfortable with Bahrain, as it was ranked 11th in the Economic Freedom Index. Two, they would be lending to a bank instead of a corporation.

In 2003, The International Banking Corporation (aka TIBC) came into existence, with Al-Sanea, as managing director and Glen Stewart, as the chief executive officer. AHAB owned TIBC, and this prompted bankers to believe that AHAB would make good on any business loss that TIBC might make. TIBC lent to SME businesses in Saudi Arabia and routed the transactions through the Money Exchange.

In 2004, Sanea established Awal Bank, in Bahrain. Following that he left the office of the Board of Directors in TIBC, but remained engaged in its affairs.

By 2008, TIBC had the third highest capital to risk ratio among Arab banks. From 2004 to 2009, it had loaned USD 6.3bn to over one hundred customers. Some of these loans were as big as USD 67mn, and several customers renewed the loan multiple times. There were a few bizarre loans, like the USD 7.5mn to a textile merchant, USD 12mn to a man who traded in 'decor items,' and USD 35mn to support an auto-parts dealer.

After the onset of the global financial crisis, TIBC defaulted on its borrowing. The creditors expected AHAB to repay, but the Gosaibis weren't willing. They claimed that they were victims of a multi-billion dollar fraud and that they were ignorant of the siphoning of funds that took place in the company. These claims were undermined, when documents showed that an AHAB partner was aware of some of the transactions. Taking cognizance of this, an English court rejected AHAB's claim.

A series of suing and counter-suing ensued.

Who sued who

Party	Counter - Party	Claim ($mn)	Jurisdiction
Mashreq Bank	Al Gosaibis	225	New York
Deutsche Bank	A subsidiary of AHAB	-	New York
Commerz Bank	Al Gosaibis		London
Abu Dhabi Commercial Bank	Unit of Al-Saad group	30	-
Société Générale	Al-Saad Group	50	London

Source: The Gulf AHAB/Al-Saad cover story

The financial crisis that began in Wall Street had unintended consequences across the globe. The fall of Lehmann Brothers led to banks demanding repayment from TIBC. Since it was impossible to pay up, Stewart made an interim arrangement through a split-value' foreign- exchange deal.

A 'split-value' deal takes advantage of the fact that banks exchanging currency operate in different time zones and different holiday periods. Suppose a New York bank paid TIBC a hundred dollars on a Thursday afternoon in exchange for equivalent Saudi riyals. TIBC would not make the return payment until Sunday because banks in Bahrain are closed on Friday and Saturday. But on Sunday the banks in New York are closed so such a deal would be settled only on Monday!

This arrangement delayed an immediate disaster. However, in the last week of April 2009, Stewart, in a final effort to keep TIBC afloat, requested the Dubai-based Mashreq Bank to loan USD 150mn to AHAB. Stewart promised to return it a week later. When the loan fell due on May 5th, instead of repaying, Stewart sought an additional USD 75mn, for which Mashreq Bank agreed. He assured the lenders the full support of Al-Gosaibis in repaying the loan.

The Gosaibis, in turn, echoed these assurances to Mashreq.

Then, on May 11th, 2009, TIBC defaulted. AHAB now owed Mashreq $250Mn. There were also dues to an incredible 62 other banks, which it could not service.

In Feb 2010, the Bahraini government hired Kroll, a private investigation firm, which was paid by the Al-Gosaibis. Kroll's report had it that Al-Sanea provided most of the names and their relevant documents to Stewart. It also revealed that there were names of real businesses in TIBC loan books and that these were carried out without the company's consent.

In the aftermath of the collapse of TIBC, a travel ban was imposed on Stewart in connection with an ongoing investigation into TIBC conducted by audit major, Ernst & Young (now EY).

Saud-Al Gosaibi, the brother in law of Maan Al-Sanea, upped the ante against Al-Sanea by bringing in lawyers to investigate what had transpired in TIBC. Eric Lewis, a US-based attorney, spearheaded a lawsuit in California against Stewart, naming him a co-conspirator, along with Maan Al-Sanea in defrauding the Gosaibi family of $9Bn.

In 2011, five banks collectively went to trial against the Gosaibis in the U.K. over the AHAB debt. The banks argued that the Gosaibis, as the owners of TIBC and the Money Exchange, were obliged to cover their obligations. The Gosaibis denied any responsibility, stating that they did not know about the extent of Al-Sanea's activities or even of the existence of TIBC. The banks won the case as documents emerged suggesting the Gosaibi family members' knowledge of the transaction.

In 2013, the Gosaibis agreed to drop the charges on Stewart to focus on reclaiming billions from Sanea. Four years (2009-13) since the crisis the ramifications of the fraud are still felt by the Gosaibis. They were forced to sell their Pepsi facility, and the Saudi government banned them from traveling abroad.

Stitching a settlement

Saudi-based or Saudi-owned banks hold one-third of the debt. Banks from abroad, including BNP Paribas and Standard Chartered, hold another one-third. Rest of the debt is with non-bank investors, who bought them in secondary markets.

In a bid to resolve these claims, AHAB met the foreign creditors in the summer of 2014 and offered to pay 20 cents on the dollar, plus at least half of any recoveries from litigation against Al-Sanea.

Meanwhile, the Al-Saad Group came out with a statement on June 2nd, 2009 saying that their business accounts were unimpaired, but creditors made a quick exit. On the same day, the Group's credit rating was cut and later suspended. Five days since, on June 7th, 2009 banks in the UAE were instructed not to lend any more to Al-Sanea. In an emergency move to raise cash for its operations, the Al-Saad Group sold its holdings all over the world, including shares in HSBC, in which it was the second-biggest shareholder; Berkeley, a British homebuilder; and 3i, the private-equity firm.

Nine years on, the creditors are yet to reach an agreement on how they should recover their money.

An S&P survey of 30 commercial banks showed that, while total exposure net of collateral to the Al-Saad and Al Gosaibi groups is significant and will put additional pressure on ratings, banks, in general, should be able to manage any fallout.

Banks from Saudi Arabia, home to the two troubled groups, and the UAE, the region's financial centre, have been the most exposed to these groups.

While an agreement that does not involve Saudi banks is unlikely to be approved by the regulators, some of the creditors feel that the government has been little more willing to nudge the local banks to accept the agreement, as that would send positive signals to global investors. Al-Gosaibi Group signed a 'Settlement support agreement' with its creditors. AHAB said that 90 percent of creditors by number and 56 percent by value had agreed to the terms, which potentially allow then to recover around 50 percent of their loans, albeit at below par rates. If the required level of support from either creditors or the government proves unattainable, the saga's future could turn out to be a lot longer than it's past.

The Al-Gosaibi Scandal had comparatively lesser ramifications as Saudi Arabia had enormous cash reserves to stave off the crisis. And two, the government's decision to freeze the assets of Al-Sanea, bolstered Saudi Arabia's position as an uncompromising country that clamps down on the wrongdoers.

At one point, people had wondered if TIBC's default may have led to questions about the sustainability of Bahrain's banking sector. This was quickly put to rest, as Fitch Ratings reaffirmed Bahrain's "A/Stable" outlook.

Post script

In June 2018, the Chief Justice of Cayman Islands dismissed rival claims made by Al-Gosaibis and Al-Sanea, finding both groups to have defrauded scores of banks over decades. The ruling follows a decade-long dispute played out in international courts between the warring families over who was instrumental in the fall of each other's empires. The court found that AHAB knew of and authorized the fraud carried out by Al-Sanea. It also dismissed a $5.9 billion counterclaim by Saad.

Key-event timeline

On May 12, 2009, Bahrain based TIBC, wholly owned by Ahmad Hamad Al-Gosaibi and Brothers Co. (AHAB), of which Al-Sanea is the managing director, defaulted on some of its bank debt. This default fuelled rumours that the bank would start a company-wide restructuring. S&P lowered the bank's

rating to 'Selective Default' that alleged that the company was unwilling to honour its debts, despite having USD 400mn in its equity.

On May 22, 2009, the situation worsened for Al-Sanea, as S&P revised its outlook for Al-Saad group from stable to negative. Reasons cited by S&P included the high concentration of securities holdings in the global financial services sector, the volatility of Al-Saad Group's portfolio, the active use of debt to expand the Group's asset base and the company's high level of exposure in the real estate industry. Real estate was one of the most affected sectors in the region following the crisis.

On May 28, 2009, the Saudi Arabian Monetary Agency (SAMA) ordered to freeze the accounts, including credit cards, of Al-Sanea, his wife, and four other family members. Public knowledge of the development raised alarms about the unprecedented move by the Saudi government against one of its most influential business houses.

On June 2, 2009, Moody's downgraded the ratings of major Al-Saad group of companies by six levels: from Baa1 to B1 (Junk Bond) status. Moody's also added that the group's ratings could be downgraded further as it was at a heightened risk of default.

On June 24, 2009, Al- Gosaibis held a creditors' meeting in Bahrain. In the meeting, it was revealed that the group owes $9.2 billion to over 120 banks all over the world. The group's representatives claimed "substantial financial irregularities" in the group's financial-services arm.

On June 2018, the Chief Justice of Cayman Islands dismissed rival claims made by Al-Gosaibis and Al-Sanea.

5

Riding on Oil, Slipping on Oil

In 1973, the world witnessed an oil-price shock which took origin in the October War. As a result, supplies to the United States, and its allies in Western Europe were stopped. By the time the embargo was lifted in 1974, OPEC had quadrupled the price of oil in the West from $3 per barrel to $12.

The consumers faced a 300 percent rise in one year. Six years later, in 1979, the second oil crisis engulfed the world. This time too, it had its genesis in geopolitical tension in the Middle East. The Iranian Revolution that ran for a year beginning 1978 saw the country's oil production decline by 4.8 million barrels per day. At that time, this fall was the equivalent of seven percent of the world production, and the disruption pushed the oil price up from $14.02 per barrel to $31.61, marking a 125% flare up in just one year.

While the oil importers suffered, it was boom times for the exporters. The GCC experienced an impressive increase in GDP (at 1986 prices), from USD 53bn in 1974 to a peak of USD 190bn in 1980.

In 1986, oil- producing countries faced an unprecedented situation. Oil prices crashed: down from $28 per barrel, a year earlier, to $14.43 per barrel, the rate that prevailed seven years ago in 1979. The accusing finger was pointed at the Kingdom of Saudi Arabia (KSA), and it was faulted for increasing oil production.

KSA was only trying to correct what it perceived was wrong responses to the first two crises. At that point, they had cut down production to manage price.

During the first two crises, crude prices rose ten-fold in ten years to touch $35 per barrel in Jan 81, before stabilizing. There were unintended consequences. Some importing countries opted for fuel-efficient vehicles as a means to reduce oil consumption. Others looked to coal, gas and nuclear power for electricity generation. It resulted in fall of global oil consumption by 20%.

Although the demand for oil was falling, the producers outside OPEC, excited by high prices, initiated expensive projects. From 1980 to 1986, non-OPEC production increased by 6 million barrels per day (BPD). The high cost of crude oil stimulated exploration and production operations in non-OPEC countries and made Enhanced Oil Recovery (EOR) production techniques profitable.

OPEC had dominated the global oil supply in 1973- 1974. But by 1985, its market share was reduced to a fourth of the total market share. Faced with lower demand and higher supply, OPEC set production quotas low enough to stabilize prices during 1982 to 1985 periods.

But these failed as other members of OPEC refused to cooperate, and produced beyond their quotas. The rapid increase in non-OPEC production caused OPEC, led by Saudi Arabia, to defend its official price of $34 per barrel by cutting output further. Between 1978 and 1985, OPEC production halved from 29.9 million BPD to 16.6 million BPD. Saudi Arabia produced 10.3mn BPD in 1980, but by 1985 it was down to 3.6mn BPD.

By then, non-OPEC production comprised 70 percent of total world production. OPEC's share of U.S crude oil imports crashed from 82 percent to 41 percent. So, in Sep 1985, KSA increased its production. The objective was to cause a price crash that would hurt KSA's OPEC rivals forcing them to curb output.

Oil daily production (million barrels)

Region	1979	1980	1981	1982	1983	1984	1985	1986
Soviet Union	11.8	12.1	12.3	12.3	12.4	12.3	12.0	12.4
US	10.1	10.2	10.2	10.2	10.2	10.5	10.6	10.2
Saudi Arabia	9.8	10.3	10.3	7.0	5.0	4.5	3.6	5.2
Mexico	1.6	2.1	2.6	3.0	2.9	2.9	2.9	2.8
UK	1.6	1.7	1.9	2.2	2.4	2.7	2.7	2.7
China	2.1	2.1	2.0	2.1	2.1	2.3	2.5	2.6
Iran	3.2	1.5	1.3	2.4	2.5	2.0	2.2	2.1
Canada	1.8	1.8	1.6	1.6	1.7	1.8	1.8	1.8
Venezuela	2.4	2.2	2.2	2.0	1.9	1.9	1.7	1.9
Nigeria	2.3	2.1	1.4	1.3	1.2	1.4	1.5	1.5
Iraq	3.5	2.7	0.9	1.0	1.1	1.2	1.4	1.9
UAE	1.8	1.7	1.5	1.4	1.3	1.3	1.3	1.6
Algeria	1.3	1.1	1.0	1.1	1.0	1.1	1.2	1.2
Kuwait	2.6	1.8	1.2	0.9	1.1	1.2	1.1	1.2
Libya	2.1	1.9	1.3	1.2	1.2	1.0	1.0	1.1

Source: BP Statistical Review

The strategy to flood the global markets with oil worked. Prices fell from USD 30 a barrel in Nov 1985 to USD 10 by July 1986.

The drop in oil prices lead to a decline in real GDP growth rate for all the GCC countries during 1986 and 1987. Bahrain and Oman even ran into current

account deficits during 1986, and other GCC nations saw their surplus fall. The oil price fell 66%, due to increased supply from non-OPEC countries. This time, OPEC tried to protect its market share, instead of fixing the target price.

In 1998, the Asian Tigers came unstuck. It was the year oil prices began declining, causing concern amongst oil exporters. The global oil price fell from a $25 a barrel in early 1997 to below $10 a barrel.

Shrinking demand

The demand for oil from North America and East Asia was rising, and OPEC decided to increase production. But they had not accounted for the severity of the financial crisis that began in July 1997 with the devaluation of the Thai Baht. Other Asian currencies too tumbled.

As oil prices were fixed in dollars and as the dollar appreciated dramatically in value, the cost of oil for these countries skyrocketed in local currency terms. This led to fall in Asia's demand for oil by 350,000 BPD.

While the Asian recession was a primary factor, several other incidents that coincided, exerted more downward pressure.

Increased supply

Historically, oil-exporting countries produced oil in excessive quantity. Saudi Arabia, Kuwait, and the UAE were the only three OPEC members that had voluntarily restricted their production to the quotas agreed within OPEC in 1993. Consequently, Saudi Arabia had high levels of idle capacity. In December 1997, OPEC increased its quota by 2.5 million BPD effective January 1, 1998.

In 1991, in the immediate aftermath of the Gulf War, the United Nations had imposed sanctions on Iraq and forbidden it from exporting oil. However, in the late 1990s, it relaxed and allowed it to export oil up to limits set in dollar terms. This increased the supply in the global markets. As the limit was set in dollar value, Iraq could increase its export quantity, as the oil price fell.

In Aug 1998, Russia defaulted on its debt leading to the devaluation of the Rouble. The recession resulted in lower demand for fuel in the domestic market. The currency was devalued, and this incentivized the producers to flood the global market with the fuel, resulting in increased supply.

As oil prices declined, production levels were cut to avoid a further downward spiral of prices. This hurt the economy and led to lower GDP growth in

1999, for oil-producing countries. Qatar was the sole exception since it was a gas, not oil, exporter.

Saudi was running a fiscal deficit between 1996 and 1999, due to its policy of lower oil production to support the oil prices in the global market. However, post the change in its strategy to increase output, the deficit gap reduced in 1999. Kuwait reported a deficit of USD 0.33bn. UAE's surplus contracted in 1998 to USD 8.28bn, as against an excess of USD 12.60bn in 1997.

The market index of Gulf nations, except Qatar, saw sharp falls with Oman's 52% drop leading the pack.

The high reliance on the regional economy on oil revenue and dependence of non-oil sectors on government spending saw market capitalization for Kuwait, Oman, and Saudi Arabia erode by 36%, 32%, and 28%, respectively.

It is not surprising that states except Kuwait, had to scale down their spending.

The four crises

The oil price reaction to the first two recessions was not immediate, as the oil price declined gradually. However, during the subsequent two recessions (1991-93, and 1998), the sharp oil price decline was quick.

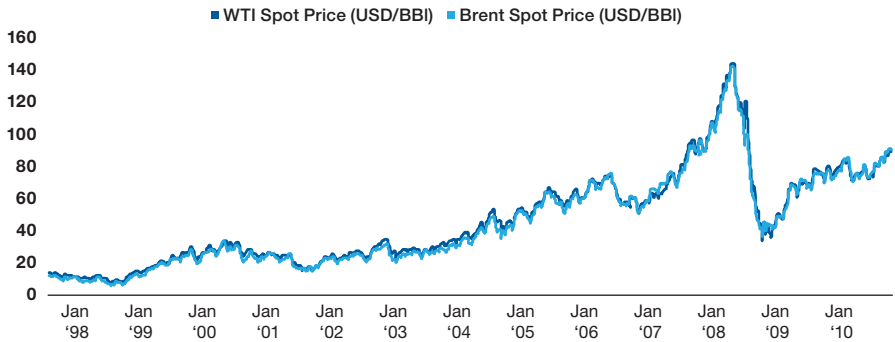
There were three reasons. First, was the shift from contract pricing in the 1970s to spot selling in 1990s. The contract, locking the higher prices for the respective duration, reduced the phase of responsiveness.

Two, the significant market share of OPEC during the 1970s and 1980s complimented their ability to manipulate supply to control the prices fall. However, as OPEC lost its market share, it also lost its ability to control the price.

Three, the well-developed futures markets in the 1990s meant one could take speculative positions on the future oil prices. As the speculative long positions were closed due to expected bear run, oil prices spiralled more rapidly.

Oil price steadily increased from mid-2003 until end-2007, and sharply until mid-2008. The demand came from emerging markets, in particular, China and India. The global oil consumption rose by 1.9% per annum, which is almost twice the CAGR of 1.1% clocked between 1980 and 2007. This increased demand, and later a series of events that occurred during the first half of 2008 led to a sharp increase in oil price.

Historic oil price



Source: E/A

There were many fortuitous events. Individually they didn't mean much. But collectively they led to ballooning up of the oil price.

First, Venezuela stopped selling crude to Exxon Mobil. Then saboteurs blew up a major oil pipeline in Iraq leading to drop in oil flow from 1.2 million BPD to 300,000 BDP. At the same time, Scottish oil workers walked off their jobs, which meant a loss of 50% of United Kingdom's the North Sea oil production.

In the same month, Exxon Mobil stopped its oil production in Nigeria due to union workers strike, giving the average output of 800,000 BDP in 2007. Later, close to 1.36mn BPD of oil was shut, due to militant attacks, sabotage, and workers' strike. Next, armed attacks in Nigeria caused Shell to lock in an additional 225,000 BPD. Finally, Nigerian protesters blew up a pipeline that forced Chevron to shut down production, a loss of a further 125,000 BPD.

Arriving in quick succession, these events lowered supply of oil and contributed heavily to the rapid acceleration of the oil spot price.

The phase 2003 to 2008 saw an unprecedented surge in global demand. However, OPEC did not have sufficient capacity, as for many years they were busy lowering production, and hadn't made the necessary investment to ramp up when the time called for it.

The world crude oil production had mostly kept pace with world consumption throughout the 1980-2005 period but fell short by about 1.5mn barrels between 2005 and 2007. The extraordinary increases in the price of crude oil continued through to the first half of 2008.

When the global financial crisis was unfolding in 2008, the demand for the oil plummeted. To keep the market in balance, OPEC, which controlled 40 percent of world oil output, cut the quotas to 4.2m BPD. But the free fall in prices continued, in part due to global economy falling deeper into recession, and partly due to uncertainty over OPEC members complying with the production cuts.

The 2008 financial crisis, which originated with the housing bubble in the US, had a contagion effect across the globe. The crash in oil prices, due to subdued demand and the subsequent impact on the oil exporting countries, lead to fall in GDP growth levels in the Gulf. KSA lost 38.6% export revenues in 2009, while for Kuwait and the UAE it dropped by 37.4% and 19.7%, respectively.

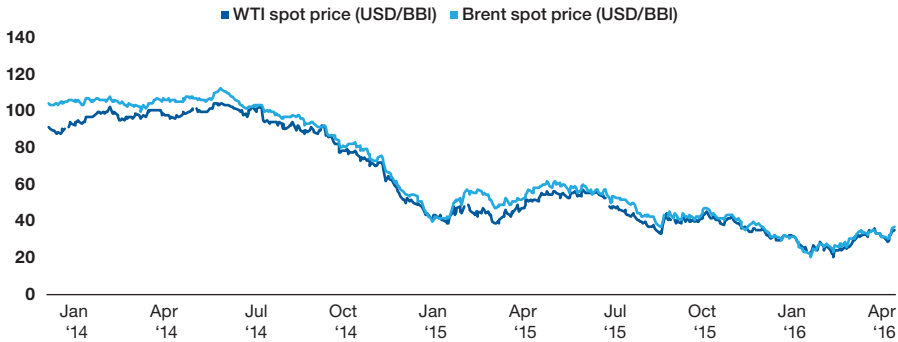
So, what was the impact on the market?

After reporting a surplus of USD 157bn in 2008, Saudi Arabia reported a deficit of USD 23.4bn in 2009. Kuwait had an excess of USD 29.3bn that was significantly lower compared to its surplus of USD 44.6bn in 2007. Meanwhile, UAE reported a fiscal deficit of USD 10.75bn in 2009.

The equity indices of all GCC countries declined as a consequence of the global financial crisis. However, the subsequent drop in oil price, due to lower demand in the aftermath of the crisis, didn't impact the performance of the equity indices in the GCC region. Export and fiscal revenues dropped sharply in 2009 for the GCC countries, but government spending mostly continued, as a countercyclical measure, to restrain the impact of the lower oil price and financial crisis on their respective economies. While credit and money growth slowed down, and fiscal and external balances declined substantially, the GCC had had a strong starting financial position, which aided in maintaining spending levels.

Ever since Jun 2014, oil prices have been on a free fall. They have lost 70% of their value, and the Bull Run that began in 2010, is now over. Several years of production of unconventional oil, weak global demand, and a strong dollar, have taken the toll. As the fall began in June 2014 and ran till 2016, it should be one of the most extended periods of continuous decline.

Oil price performance



This is what happened

First, the global oil demand was downgraded ever since 2012, due to disappointing global economic growth. As if that wasn't bad enough the US shale revolution turned out to be transformational. The scale of the revolution was unexpected and sensational.

It caused the pendulum to swing, from fears of energy scarcity and high prices in the U.S. to abundance and talks of energy independence. In hindsight, pricing oil high was a self-inflicted harm. Consequently, the advantage of going for shale gas became immense.

Here's a background on the supply of shale. The total shale reserves (tight oil) stood at 13.4 billion barrels at the end of 2014, almost twice the consumption of 5.5 billion barrels in 2013.

With the advent of the shale age in the U.S. in 2005, American net oil imports fell every year after that, from 12.4 million barrels a day in 2005 to 9.4 Mb/d in 2010. The drop was mainly due to the policy of driving down oil imports, by boosting domestic production.

Also, OPEC's policy played a crucial role in this.

In the previous oil slumps, OPEC had cut down on supply to support oil prices. For instance, in 2008 it cut down 4.2 million barrels a day from their overall production quota.

OPEC's preferred crude oil price range slowly increased from USD 25- 35 per barrel in early 2000 to USD 100-110 per barrel in 2010. That resulted in a fall in OPEC's market share. Consequently, several OPEC members began

offering discounts to Asian oil importers from the third quarter of 2014. Finally, OPEC in Nov 2014, decided to maintain the production level of 30mn barrels per day, as agreed in December 2011. This change in policy implied that OPEC was not willing to change its supply to control the price decline.

The geopolitical tension had tremendous impact in the market.

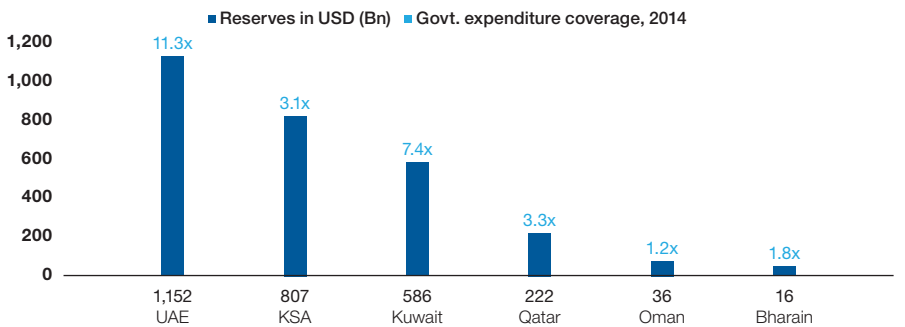
The rivalries amongst major oil producers, such as Russia and Iran, whose budgets require oil prices at over USD 100 per barrel to break-even, increased the woes. KSA can weather lower prices for a sustained time frame, due to its high fiscal reserves.

Despite diversification efforts, the GCC states were excessively reliant on hydrocarbon revenues to fund their expenditures on infrastructure and social programs. On an average, hydrocarbon revenues contributed 80% of budget receipts, during 2010 and 2013.

As a consequence of lower oil prices, the income for all the GCC countries contracted during 2014 and 2015, with declines of 41%, 44%, and 33%, respectively, for KSA, Kuwait, and UAE during 2013- 15.

With GCC reserves totalling over USD 2.8trillion, the key economies commanded an expenditure coverage ratio of over 3x, based on 2014-estimated expenditure figures. These provided sufficient cover for future government spending programs and curb investor fears about regional prospects, which were predominantly fuelled by government spending programs.

Reserves (USD bn) & government expenditure coverage, 2014

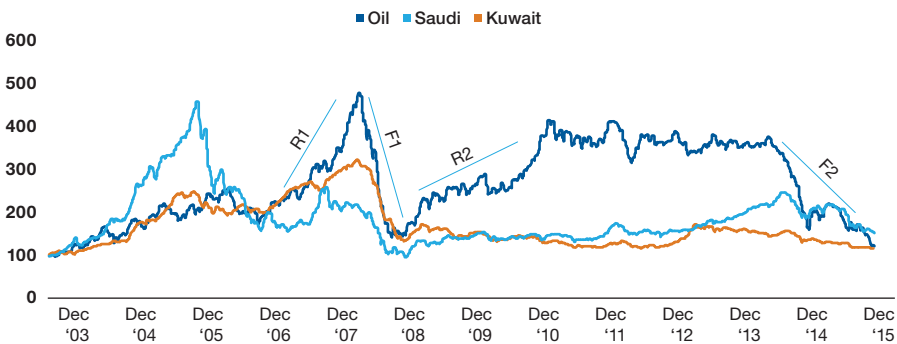


Source: MF, SWF Institute, Markaz Research
Note: Reserves include SWF assets, gold and officially declared reserves.

In addition to the significant reserves, the low debt levels and stable credit profiles offered plenty of support to the GCC government during the weakness in oil markets.

Lower oil prices, however, drove the markets, with GCC equities shedding USD 200bn in 2015. Oil prices and GCC equities have moved mostly in tandem since oil prices started retreating in the second half of 2014, implying the direct correlation between the GCC equities and the oil price. However, the correlation and volatility have increased in the recent times, with GCC equities responding forcefully to fluctuations in the oil price.

A figure that captures Brent Oil price with both TASI and Kuwait Price Index for the period 2003-14 sings a tale of its own.



Source: Reuters

The above graph discusses the rebased index values of Saudi's TASI index, Kuwait's Price index, and the Brent crude values from 2003 till Nov 2014. Looking at the movement of the prices, it can be seen that prior to 2008, the index values approximately followed the movement in oil prices.

The dramatic fall in oil price (F1, -68%) was due to an easing of tensions between the US and Iran, and the US lifting a ban on offshore drilling. Buoyant economic activity, rising consumer and investor confidence, and abundant liquidity during the oil boom spurred excessive credit growth, inflation, and asset price increases. The GCC economies were affected by both corporate and sovereign leverage, which were directly hit by the fall in oil prices. All this led to a tightening of liquidity in the markets, which was amplified by the onset of the global financial crisis. The effect of the subprime crisis was also felt both

in the oil and equity markets, as Brent crude price declined by USD 100 per barrel during the period to USD 46 per barrel.

After 2008, the relationship changed slightly. The gradual increase in oil price (R2, 168%) had little effect on the index values. Supply concerns, due to geopolitical issues, and a rise in demand, with the emergence of the primary consumers in China and India, were the main reasons for the increase in oil price. Political turmoil in Egypt, Libya, Yemen, and Bahrain drove up oil prices in February 2011. The crisis soon spread across the MENA region, driving up oil prices to record highs. The Arab Spring uprising affected investor confidence in the area, and also increased volatility in the stock markets. Saudi improved its infrastructure to assist in the growth of non-hydrocarbon sectors.

Finally, the sharp fall in prices in the second half of 2014 (F2, -39%) affected both the indices after a lag. The reasons for the drop in oil prices have been addressed in previous sections, while the markets were wary of medium to the long-term effect of lower oil prices in government spending.

The change in the relationship, post-2008, between oil price movements and the Saudi index movement could be attributed to the government's increasing efforts to diversify the economy away from the hydrocarbon sector. With the growth in the number of companies in the non-oil sectors, corporate profits determined the movement of the markets. In the case of Kuwait, higher oil prices gave the government the necessary cushion for increasing investments. However, the stakes had little effect on corporate profits, and this resulted in a change in the relationship between oil price and Kuwaiti index.

In the case of Saudi and other GCC countries, oil surpluses were accumulated and invested, mostly in foreign markets, either directly by central banks or through Sovereign Wealth Funds. Hence, there was little to no effect on oil prices climbing on index values.

But lower oil prices affect investor sentiments, as fears of government curtailing spending, impact the markets. While countries such as Saudi Arabia and Kuwait had surpluses to fall back on, sustained low oil prices over the long term would hurt the markets due to slowing down of economic expansion. This would impact corporate profits, which in turn affected the stock markets.

The low oil prices do raise concerns about fiscal sustainability and growth in regional economies. However, GCC governments have mostly stuck to their development spending plans, maintaining massive deficits in the medium term.

The issuance of USD 28bn in bonds by the Saudi government in 2015, to finance the fiscal deficit, substantiates the GCC states stand to raise debt, to plug the gap. However, a prolonged period of low oil prices could force governments to reduce capital spending and benefits and could put pressure on liquidity.

The following are some of the lessons learnt from the crises:

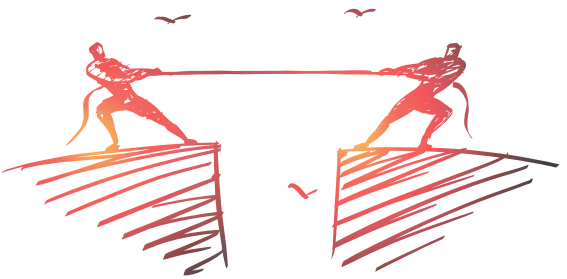
First is the demand-supply sensitivity. The most impressive fact of the oil rout is how a little amount of excess capacity and supply can tip this market. All the oil routs can be attributed to an imbalance in supply and demand. The 2014 oil price rout was set in motion by about 4 million barrels per day of new capacity, mostly from North America, and mainly from an unconventional source. And OPEC refused to correct this oversupply by reducing its production, to preserve high oil prices.

The second point to note is that oil price is no longer under OPEC's control. Non-conventional oil, such as shale, has reduced OPEC's ability to control the price. During the 2014 crisis, even if OPEC had frozen production and induced a rebound in prices, there were plenty of producers that the OPEC coalition couldn't control.

Finally, there is the concept of the commodity super cycle. The 2014 fall in oil prices, signals a potential downward phase of the super cycle, similar to the oil price crash that took place from 1981 to 1986. Both these crashes share uncanny similarities, such as both occurred within the context of a recession that weakened oil demand. And both took place after nearly a decade of high, fast-growing energy prices that led to aggressive investments in upstream exploration and development. Today, the trends point to oil heading for a low-price phase of the commodity super-cycle, with hydrocarbon prices remaining flat for several years to come.

6

The Diplomatic Standoff: Qatar



On June 05, 2017 The Kingdom of Saudi Arabia (KSA), the United Arab Emirates (UAE), and Bahrain, along with Egypt (a member of the Arab League), cut diplomatic ties with Qatar, on charges of promoting terrorism and instability. They closed air and sea connections with the peninsular country and also prohibited their nationals from traveling to Qatar.

Given the close trade and deep geographical links with the rest of the GCC, the severance of diplomatic relationships did have economic repercussions for Qatar. Let's look at it from five viewpoints: Broader economy; Trade (export and import); Investments (FDI's); Currency; and Capital Markets.

Broader economy

First up, if sanctions remain in force for long, many things were predicted to happen.

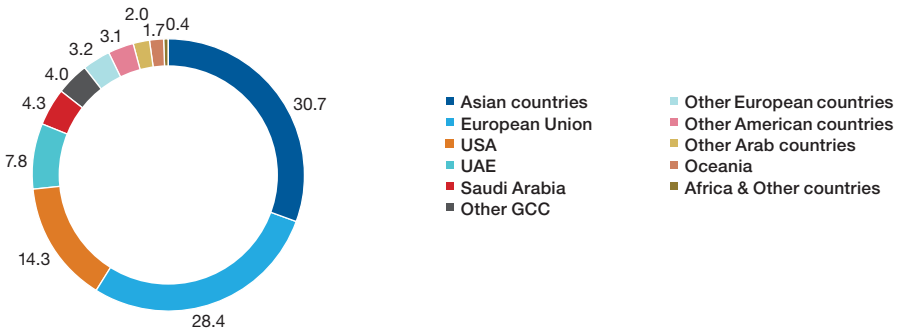
For one, GDP was expected to nosedive. The Institute of International Finance (IIF) estimated that Qatar's GDP growth could decline from 2.3% in 2016 to 1.2% in 2017 as a result of lower non-hydrocarbon growth. However, the GDP remained resilient resulting in an overall real GDP growth of 2.1% in 2017. Following the diplomatic standoff, foreign financing (nonresident deposits and inter-bank placements) and resident private sector deposits fell by about US$40 billion; but this decline has been offset by liquidity injections by the central bank and private sector deposits. In fact, the diplomatic rift has probably acted as a catalyst to speed up the structural reform agenda to improve the business environment.

Trade exposure

Import

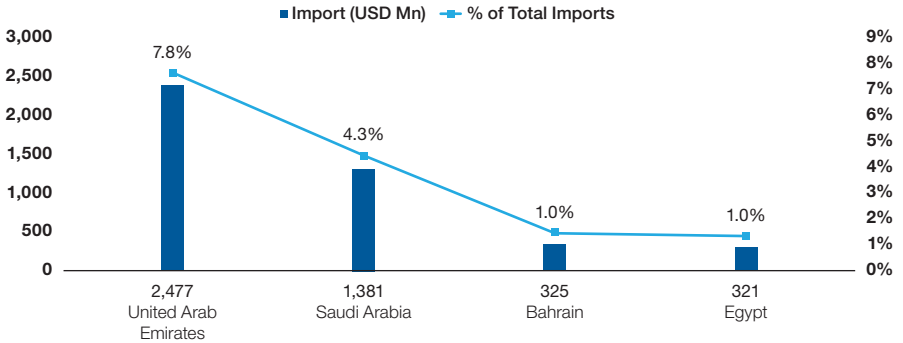
A majority of imports (73.4%) consisting of machinery and manufactured items arrive from Asia, Europe, and the USA. Qatar receives most of the essentials from its neighbours. About 80% of food supplies are from UAE and Saudi Arabia. All this is now going to take a hit.

Import by origin (% of Total Imports) - 2016



Source: Ministry of Development Planning and Statistics

Import from diplomatic conflict countries - 2016



Source: Ministry of Development Planning and Statistics

In the short term, other import countries will see challenges related to logistics and banking. It may be noted that shipping operators use Dubai's Jebel Ali hub to discharge Qatari-destined cargo and then forward it to smaller vessels into the Doha port. Now, the Jebel Ali hub has banned all ship destined or arriving from Qatar. The ban means a rerouting of traffic leading to increased cost and time. If the current blockade of essential goods from the neighbours continues, Qatar will be forced to align with new partners like Turkey, Iran, and India. It is not clear how the trade with these potential partners would pan out in the long run.

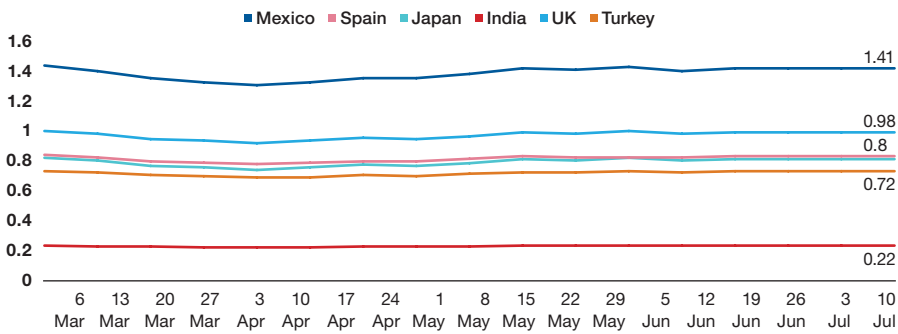
Export

Qatar is the world's biggest seller of liquefied natural gas and exported 30% of global supply in 2016. A majority of the gas export is to the Asian countries, and only 8% is to GCC of which exports to UAE were 5.8%. Qatar's exports to UAE are mostly gas (LNG), and UAE has so far avoided shutting down the pipeline supplying gas from Qatar. Abu Dhabi-based Dolphin Energy Ltd., which operates the gas pipeline, pumps around 2 billion cubic feet of gas daily to the UAE. Moreover, though the diplomatic dispute could close the gas pipeline to the UAE, Qatar has decided against it.

Qatar's exports of oil and gas are unlikely to be affected, as its main sea routes through Omani and Iranian waters are still accessible. Further, its biggest trading partners Japan, India, China, and South Korea (JICS), which buy more than 70% of natural gas from it are outside the politically volatile Middle East. So, it is unlikely that O&G exports from Qatar will take a hit.

The International Energy Agency (IEA) has warned increasing diplomatic tension between Qatar and its Arab neighbours is leading to operational problems in the region. While there have been some logistical issues, Marmore data suggest that this hasn't increased the transportation cost of LNG to crucial trade partners yet.

Qatar freight (USD/MMBTU) 2017



Source: Marmore Research

FDI, currency, and rating

What are the implications on FDI inflows, which are so central to the growth of the economy? Has the embargo hurt the Qatari Riyal (QAR)? What has been the cumulative impact on the sovereign rating?

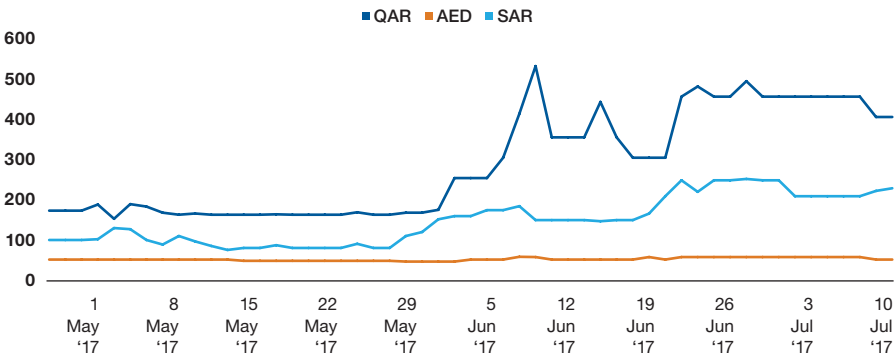
Foreign direct investment

Although a range of large capital projects related to construction and transport are being lined up, FDI inflows in Qatar has been meagre. Besides, historically, more than 90% of the FDI in Qatar has been from USA (20%), European Union (30%), other American Countries (35%) and Asia-excluding GCC (5%). The impact of the ongoing crisis on the FDI inflow will be insignificant.

Currency

On 12th June 2017, 12-month forward contracts for the Qatari Riyal (QAR) jumped to a record 525 basis points. This jump is an indication of increased bets on Qatar devaluing its currency, currently pegged at 3.64 per dollar.

USD-QAR 1Yr forward swap



Source: Reuters, Marmore Research

However, the possibility of Qatar abandoning the peg is remote as the Qatar Central Bank has USD 34.5bn of net foreign reserves. While the sanctions imposed on Qatar is exerting pressure on the QAR, the drop in oil prices is having a similar impact on the Saudi Riyal.

Credit rating

The severed diplomatic ties have adversely affected Qatar's credit rating. Standard & Poor lowered its long-term rating on Qatar by one notch to AA-minus. There can be further downgrading if the crisis deepens. These have had a contagion effect on Qatari companies, resulting in a subsequent decline of corporate ratings of biggies like Industries Qatar and Qatar National Bank. We are likely to witness similar trends in other banks and companies as well.

S&P credit rating

S&P Rating Scale	Qatar	Industries Qatar	Qatar National Bank	Qatar Insurance	Doha Insurance	Doha Bank	Qatar Islamic Bank
AAA							
AA+							
AA	Pre-crisis						
AA-	Post-crisis	Pre-crisis					
A+		Post-crisis	Pre-crisis				
A			Post-crisis	No-change			
A-					No-change	No-change	No-change
BBB+							
BBB							
BBB-							
BB+							
BB							
BB-							

Source: Reuters, Marmore Research

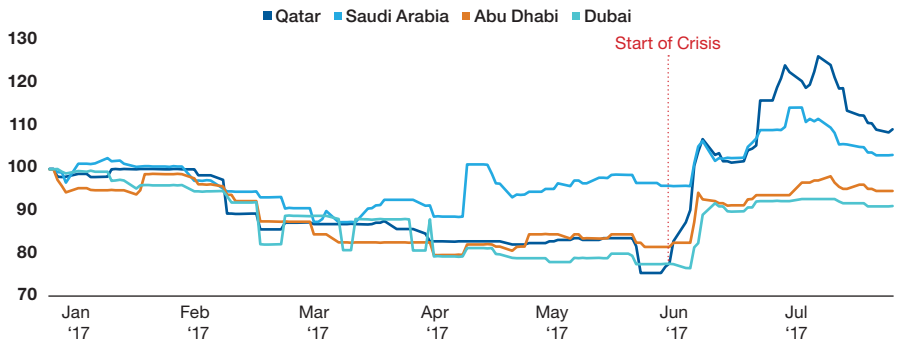
Capital market impact

Debt market

Qatar's external debt is 114% of its GDP, marking it as the second amongst GCC nations. The external debt saw a sharp increase in 2016, primarily on account of a sharp rise in commercial banks' foreign liabilities to $123 billion (81% of GDP) from $85 billion the year before. Qatar Government has an outstanding external sovereign debt of USD 35.8bn as of July-2017; a majority of this got issued in 2016. Consequently, the external vulnerabilities for Qatar are more substantial than for highly rated regional peers. As the chances of the ongoing dispute being resolved appear bleak, the cost of debt is expected to increase, and the balance sheet would deteriorate further. The rising global interest rates will accentuate the crisis.

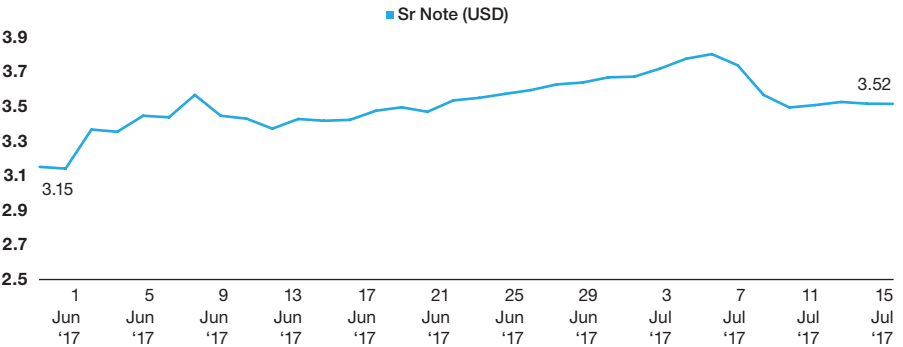
The diplomatic crisis has affected investor sentiment. For proof, look to the 5-year CDS or the cost of insuring risk, which increased from 57 bps in May-17 to 121bps in Jul-17. Similarly, the yield for the 10-year USD denominated bond issued by Qatar has increased 37bps. Investor sentiment is also gauged using the Equity Risk premium (ERP), which has risen.

CDS rebased to 100



Source: Reuters, Marmore Research

Yield on 10Yr USD bond issued by Qatar

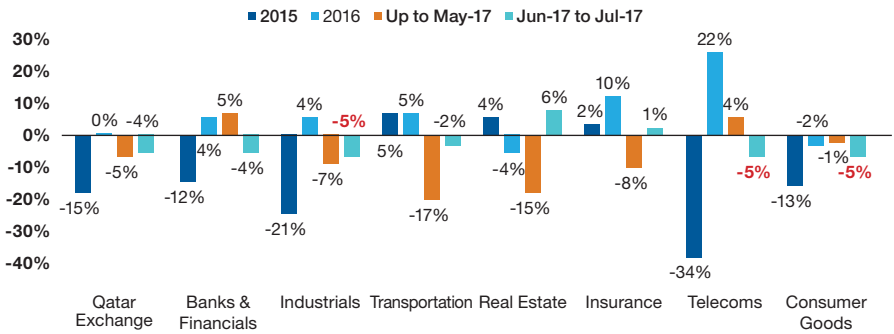


Source: Reuters, Marmore Research

The bottom line: Qatar's reputation as a financially sound, commodity-oriented economy, which could maintain high credit ratings is tarnished as a result of the ongoing crisis.

Equity market

Qatar's stock index tumbled 8.8% in June 2017, wiping out market capitalization equivalent to USD 11bn. As of July 20, 2017, the Qatar index declined by 4%. Except for real estate and insurance, all other sectors' indices have declined, with telecom, consumer goods, and industrials being the worst hit. However, it is not our case that Qatar's indices have been underperforming only due to the ongoing rift. The chart shows that most of them have underperformed during the 2015 and YTD May-17. The under-performance implies that most of Qatar's sectors were under-stress even before the rift and the current crisis acted as a double disadvantage.



Source: Reuters, Marmore Research

Some anomalies have been spotted with a few stocks rising unexpectedly.

The notable ones were Ezdan Holding (up 13%) and Qatar Insurance (spiked 4%) during the period. Ezdan's positive performance since the dawn of the crisis can be attributed to the base effect, as the stock closed at the lowest level since 2015. Both these stocks, being heavyweights in their respective sector indices, contributed to the rise. The sharp decline of Industrials Index can be attributed to the decrease of the index constituents such as Industries Qatar and Qatar Electricity at 4% and 6% respectively, as these two stocks account for 67% of the index market cap.

The Qatar stock exchange witnessed a 25% increase in turnover in June 2017 as against the previous month. The increase in the volume of trading was due to institutional investors from the GCC bailing out of the country. Before the

crisis, GCC and international investors held 9% of Qatar's stock market. Since then the GCC institutional investors have reduced their position in Qatari shares by USD 200mn. The Qatar Stock Exchange index was witnessing selling pressure since valuations based on which the investors had taken their respective positions no longer held right given the high level of uncertainty. Qatar is in the MSCI EM index, and a lower market cap and associated risks resulted in a reduction in weight. The decrease in weight might lead the passive fund managers to sell their holdings thereby exacerbating the issue.

Marmore estimates the revenue at risk (USD 1.3bn) for listed companies. The estimate amounts to only 3% of the total earnings of those companies in 2016. Out of the USD 1.3bn of revenue that is exposed to the conflict countries, 90% is expected to be from UAE. Financial Services and Construction are the two major sectors that are likely to face challenges as an outcome of the ongoing blockade. For Qatari listed companies, a majority of the revenue comes from domestic business.

Blue chip performance

The performance of the blue-chip stocks has also been in sync with the performance of the indices. The five blue chips discussed below account for 56% of Qatar's listed company's market cap: and so turn to be the movers and shakers of their respective indices.

QNB and Qatar Industries declined by 1% and 13% respectively, up to May-17, and further decreased since the start of the crisis. Since SOEs own QNB and Qatar Industries, any event impacting the Qatari Government would trickle down to these companies. Factors such as rating downgrade of Qatar, followed by a decline of Qatar Industries to A1 from Aa3 by Moody's impacted the performance of these companies. Ooredoo performed negatively on the account that domestic operations, which account for 25% to 30% of the group's revenues, would suffer from the departure of residents of the countries severing ties with Qatar. Additionally, Ooredoo's Maldives-based subsidiary, which accounts for 1% to 2% of the revenue, would also suffer as a result of severed diplomatic ties with Qatar.

Name	Sector	Mcap (USD Bn)	2015	2016	Up to May-17	Jun-17 to Jul-17	Trend
Qatar National Bank	Financials	36	-18%	12%	-1%	-3%	
Industries Qatar	Industrials	17	-34%	6%	-13%	-4%	
Ezdan Holding	Financials	10	7%	-5%	-28%	13%	
Ooredoo	Telecom Services	9	-39%	36%	2%	-6%	
Masraf Al Rayan	Financials	9	-15%	0%	18%	-6%	

Source: Reuters, Marmore Research

Qatar's banking system has in recent years become more dependent on loans and deposits from Gulf and international banks. Because of the crisis, the Gulf banks have refused to extend matured deposits. It is not surprising that non-resident deposits declined from USD 40bn in August-2017 compared to USD 45.97bn in June-2017. The withdrawals could lead to liquidity issues and a consequential increase in the cost of funding. So, as a precautionary measure, Qatar's sovereign wealth fund has been pumping U.S. dollar deposits in local banks. Qatar Government infused deposit of close to 25bn into its banking system to cushion it from withdrawals by financial institutions. Factors such as a decline in the operating environment, loss of business confidence of the non-oil private sector, and external exposure of Qatari banks, could result in a spike in non-performing assets (NPAs). Despite the ongoing rift, according to the Qatar Central Bank, the Government and public sector deposits in Qatar's banking system have increased by around USD 11.5bn during June 2017, compared to the previous month, and reached USD 66bn.

The outlook for Qatar's insurance sector is positive as large-scale government investments in infrastructure and private sector construction projects are presenting substantial insurable assets for the Qatari insurance companies. The lower insurance penetration level also offers opportunities for the sector to grow. The ongoing conflict is not likely to impact the domestic telecommunications sector as it is envisaged to play a crucial role in helping Qatar progress towards its vision of becoming a knowledge-based economy. The short-term outlook is positive, supported by the resilience of the Qatari economy and the defensive nature of the telecommunications sector in Qatar given the non-discretionary characteristics of expenditure on telecommunication services. The tourism sector is one of the worst impacted sectors due to the ongoing conflict.

The hotels, which are usually full during the Eid Al Fitr holiday, witnessed low occupancy levels of 57%. The arrivals at Hamad International Airport dropped by 27,000 passengers a day compared to the same period last year. The drop in visitor arrivals is likely to force hospitality and real estate developers to re-evaluate their strategies, potentially causing delays to some of the ongoing tourism projects.

Conclusion

Given the close trade and deep geographical links that Qatar has had with the GCC, the ongoing blockade will hurt its economy in the short term. Also, if the embargo continues longer, it is possible to substitute the trade relationships with other countries. However, the sentiments and attractiveness of the country as a haven may deteriorate. Increase in food prices, erosion of Qatari fiscal balances, and a rise in borrowing costs are some of the real risks that Qatar will continue to face if the situation is not settled amicably soon.