Finance in the GCC: Policy & Developments

Featuring

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Governor
Qatar Central Bank

Trevor Butcher & Maher Ghanma
DLA Piper

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Foreword by
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*The Financial Markets of the Arab Gulf*
Foreword

by Adel Altoraifi

The finance sector in the GCC region is about to pass a significant threshold which holds the potential to revolutionise many aspects of citizens’ lives. Just as the arrival of the mobile phone in the late 1990s allowed GCC states to leapfrog many developed countries already wedded to the infrastructure of the landline, financial technology (Fintech) could once again catapult them ahead of the pack: the combination of a conducive policy environment, desire among leaders to steal a globally competitive edge and a rich, but poorly penetrated market looks very promising.

GCC states have set in place a series of forward-leaning policies to support Fintech development and have adopted some of the most globally recognized regulation standards to help enable its penetration. The executive style of governance within the region has supported the introduction of essential changes to the regulatory environment. Moreover, its pragmatic approach to cherry picking international standards stands to serve the sector well. For example, sandbox regulations have been fast-tracked to help set a legal framework for the live testing of small-scale innovations in a controlled environment. As such, the GCC region provides an attractive environment given both its light touch regulations and leaders’ ability to introduce and implement speedy reform.

Government-sponsored sandboxes and incubators have surged since 2017. In January 2017, the Dubai International Financial Centre (DIFC) started FinTech Hive, while Abu Dhabi launched, in March 2019, Hub71 endowed with significant financial backing ($272 million). Notably, Hub71 has sought to leverage its status by partnering with global tech giants, such as Microsoft and Softbank, to facilitate cooperation between venture capitalists, start-ups and regulators in Abu Dhabi. Similarly, Bahrain has placed itself at the forefront of regulatory reform: in 2017, its central bank was the first to permit Fintech businesses to test products and services with clients. At present, it remains the only GCC state to approve a law allowing SMEs to raise financing through crowdfunding (either conventional or sharia-compliant).

Blockchain is of particular interest to the GCC states, especially the UAE. The Emirati government published its Blockchain Strategy 2021 in April 2018, and it aims to process at least 50% of all government transactions using blockchain technology by 2021. If this were achieved, then it would save the federal government an estimated $3 billion per annum by cutting down 77 million hours of work and reducing the size of government to the tune of $389 million. It would further save $1.6 billion by shaving kilometres off driving distances.

In spite of GCC governments actively promoting Fintech and even trying to get ahead of the curve, the sector is likely to remain marginal, at least in the short term. For instance, traditional banks in GCC countries are either unfamiliar with Fintech or simply sceptical about its promise. In a survey of 22,000 digitally active consumers carried out by EY, which examined Fintech adoption across the world, less than half (46%) of respondents were aware of Fintech services in emerging markets. Moreover, over 93% of those surveyed doubted that Fintech players would disrupt the banking sector.

One of the most promising aspects of Fintech in the region is financial inclusion. The IMF’s report Gulf Cooperation Council: How Developed and Inclusive are Financial Systems in the GCC? published in December 2018 found that women, youth and SMEs remain largely excluded from banking systems. It noted that around a fifth of the GCC population lacks access to a formal financial institution (in Saudi Arabia unbanked adults amount to 6.4 million); and around 25 million foreign nationals are sending remittances
back home (worth $102 billion in 2016). Furthermore, among the GCC states, 70% of female adults hold a bank account (only 42% in Oman) compared to 86% of male adults; only around 63% of those aged 15-24 hold an account; and SMEs only represent 4.5% of total loans in the GCC, which is much lower than the average of the MENA region at 9.3%. By lowering bank onboarding costs by 90%—a move facilitated by digital identification—Fintech has the potential to become an important tool for reaching the unbanked in the Gulf.

The authors of the IMF report argue that Fintech can support the wider and critical goal of financial inclusion by reducing information asymmetry, improving competition and lowering lending costs. The power of big data analytics, the ease and access of crowdfunding and lower costs of know-your-customer (KYC) procedures will, in fact, help Fintech become an important financial service option for SMEs. However, it remains to be seen whether GCC customers will become more open to digital and impersonal approaches, away from the traditional relationships-based lending process.

The states of the GCC are poised at a threshold: there is a discernible trend among leaders and entrepreneurs to enable and embrace Fintech, respectively, and this holds the potential to revolutionise the lives of ordinary citizens. There is evidence of increasing awareness of Fintech among citizens in the Gulf—84% of customers are aware of Fintech services in 2019, compared to 62% in 2015. This bodes well for the financial services sector, investment and development and, most importantly, financial inclusion. However, GCC states account for only 1% of the $90 billion already invested in the sector globally. Therefore, for Fintech to be successful, regulators need to develop an ecosystem that encompasses a raft of supplementary legislation, such as new investment laws and incentives to encourage not only investors but a broader base of customers which includes all segments of society.

Dr Adel Altoraifi is Chairman of Castlereagh Associates. He is a former Minister of Information for the Kingdom of Saudi Arabia and served as a member of the Kingdom’s Political and Security Affairs Council (2015-17). Dr Altoraifi is a prominent author and recognised authority on international relations and, for the past 20 years, has specialised in foreign policy decision-making in the Gulf.
I. Overview

Finance in the GCC: Policy and Developments
Overview
by Rachel Ziemba, Theme Editor

Broadening and deepening local financial markets is a precondition and facilitator of the economic diversification plans underway in the Gulf Cooperation Council (GCC) countries. Deepening and broadening access to capital markets, debt, equity, bank and non-bank finance are a critical part of employment plans and local economic diversification, which are the top political and economic priorities across the GCC. Not only are financial institutions an important source of potential employment as part of service sector development, but they can provide important capital to new projects, either by channeling foreign funds or considerable local savings to new platforms. There are important challenges ahead: ensuring adequate access to capital (especially to underrepresented groups), regional competition, gaps in the assessment of credit and other risks and governance issues. This issue of Gulf Affairs highlights the experience to date, lessons learned from practitioners, academics and policymakers involved in analyzing and shaping regional capital markets to meet these critical political economy goals.

The financial development of regional capital markets, bank and non-bank financial institutions, Islamic and conventional, public and private sources of finance has been underway for many decades. After all, the region is home to the world’s oldest sovereign wealth fund (Kuwait’s Investment office was launched in 1953), some of the world’s largest pools of capital (ADIA, KIA, and QIA regularly rank in the top 5 of global sovereign funds), and the locus of significant financial hubs (UAE).

However, in 2019, financial development seems to be switching gears to different extents across the region—either speeding up or recalibrating. Policy is kicking up a notch across some markets, notably Saudi Arabia, with its existential focus on job creation, is now open for portfolio investment. Policies seem to be shifting to a new, lower, but steadier gear in some of the well-developed and perhaps overbanked regions such as the UAE and Qatar—here focus is shifting to leveraging new markets, while trying to absorb past oversupplies. In others, including Bahrain and Oman, the financial sector is trying to avoid the risk of government-led borrowing which could crowd out local developments. Across the GCC, economic policy changes have sped up their entrance into global equity and debt markets. Saudi Arabia has followed the UAE and Qatar into the EM equity indices.

This edition of Gulf Affairs thus comes at a critical time to assess these new gears and the interconnections between the financial sectors of the GCC nations and those outside of the region. Our contributors survey the changes in the GCC financial markets, their links with the macro and social goals and their ability to foster new sectors including renewable energy or provide capital to underrepresented groups including women and migrants. Opportunities in Islamic finance, for example, provide an opportunity for differentiation across the GCC and allow institutions to take advantage of a growing interest in environmental, social and governance (ESG) investment around the globe. Investing with burden and risk sharing, with interests aligned has been shown to outperform (and especially minimize losses). With global returns in public markets set to be lower over the next few years, assessing these risks and avoiding principle-agent problems will be key to financial and economic goals.

The last few years have brought a shift in the direction and focus of GCC finance especially regarding portfolio inflows. Rather than just being a major supplier of capital abroad (over $3 trillion in government-owned assets abroad in central banks and sovereign wealth funds), now GCC sovereigns are all major borrowers. This shift partly reflects lower savings due to lower oil prices and higher domestic demand.
But it also reflects a policy shift to better target these revenues. The shift has been most extensive in Saudi Arabia or in countries that produce relatively little oil revenue per person like Oman or Bahrain.

The focus on attracting more local and foreign private capital to support economic goals brings challenges and opportunities, including new investors who are less familiar with the region. In 2018, the GCC accounted for over 25% of global USD denominated EM/ Frontier sovereign bond issues (Egypt and other MENA countries take the tally to 40%). Several GCC countries recently entered global bond indices, while Saudi Arabia has followed some of its neighbors into the global equity indices. These trends can increase the region’s exposure to global financial catalysts through channels other than oil prices and raises political and governance questions. For now the bulk of inflows have come from portfolio investors. Attracting more than just index-weighted flows will require a clear and compelling macro story, more transparency and governance.

Even some of the region’s global investors are becoming more focused on local development goals. The largest sovereign wealth funds in the region—those of Abu Dhabi, Kuwait and Qatar continue to be sizeable players abroad, and have now been joined by a large activist fund from Saudi Arabia, the Public Investment Fund (PIF), which takes a more extensive role in investing for development at home and abroad. While development funds are not new—Abu Dhabi’s Mubadala has been around for more than a decade, and most GCC countries had some local development investment vehicle—the shift in capital allocation has been geared towards local development projects, including investment in regional and international projects which are aligned with domestic economic development goals. Examples include Saudi Arabia’s PIF whose global investments in technology and infrastructure are consistent with domestic economic development goals. Past efforts can provide cautionary tales.

With some of these funds taking on debt in order to finance these projects—either because it is routine for the sector (property, project finance, private equity) or because investment and development plans are so extensive that debt is preferred to drawing down sovereign assets—there are new questions of accountability and access, many of which have yet to be clarified: Will the governments alone be responsible for repaying the debt? What will be the return on capital? Who decides on what projects are to be funded?

The region has long been an active market for project finance and funding for state-led and public private partnerships, helping finance extensive property development and infrastructure. However local needs and global focus on private markets are creating new opportunities. Meanwhile concerns about governance (after some corporate governance scandals including the Saad-Gosaibi and Abraaj cases) have created a greater push for transparency and alignment among local investors, asset managers and other stakeholders.

One challenge that emerges from the region is increased competition—a plethora of banks, international financial centers and local capital markets. While competition is not the only factor limiting local liquidity and trading volume, it is unlikely to help. Greater coordination and expanding access will be key to future development, not just of capital markets, but also to make progress towards economic and political goals.

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II. Analysis
II. Analysis

Boosting Employment of Nationals in the Financial Sector: A Comparative Analysis of the GCC

by Sophie Olver-Ellis

Towards the post-oil development agenda

Oil has been the elixir of life for many in the Gulf region because over the last five decades the rentier social contract has enabled the ruling elites to offer their citizenry free education, healthcare and lifelong public sector employment. Indeed, despite getting used to high energy revenues that fill the coffers of the state, as the global oil market has become increasingly volatile with more boom and bust cycles, the Gulf Cooperation Council (GCC) states have had to finally act upon the fact that they can no longer depend on oil rents to be their predominant source of government revenue.1 Reinforcing the urgency to diversify their economic base is the fact that of the 56 million total population including migrants, half of the region’s estimated 26 million GCC national population comprise youth aged between 15 and 24.2 With a youth unemployment rate of approximately 27 percent and more than 2.8 million people entering the labour market on an annual basis,3 there is an alarming youth bulge that needs to be absorbed.

In response, across the GCC, new economic ‘visions’ have been adopted, seeking to transform the role of the private sector and certain industries such as the financial sector. They are also looking to increase the employment rate of the national citizenry, alongside reducing their extensive dependence on migrant labour. To achieve this ambition, in many cases by 2030, policymakers are launching initiatives that will restructure the regional economies towards being led by the private sector and a relevantly skilled and
capable national workforce. Therefore, the implementation of manpower replacement strategies such as the nationalisation policy has never been more relevant, especially as the integration of GCC nationals in the private sector labour market is one of the most critical socio-economic challenges that policy makers must address if they are to diversify towards a post-oil dependent economy. The article analyses the various 'nationalisation' policies adopted throughout the GCC and highlights the progress they have made in boosting the employment of nationals in the financial sector.

The path to nationalisation of the financial sector

Over the decades of oil-fuelled development and ample revenues, the national citizenry of the GCC were guaranteed public sector employment as part of the largesse social contract which subsequently led to the private sector drawing upon a migrant workforce. These trends permanently distorted the structure of the labour market between both the public and private sectors and national and migrant workforce. Indeed, as the GCC member states seek to diversify their economic base and encourage the private sector to spearhead the socio-economic transformations, the financial sector will have to play a central role. According to the World Bank, a thriving financial sector will lead to the creation of more enterprises that attract investment and in doing so, will generate employment opportunities and contribute to the economic diversification process.4 This perspective is even shared by the GCC governments—the development of the financial sector has been at the forefront of the policy agenda for the last two decades and with new Visions in place, this has given the governments greater impetus in regulating the sector’s activity.5 This is evident in the case of the nationalisation policy, with each of the six GCC states embarking on a tailored path.

The overarching objective of the nationalisation policy is to increase the number and share of nationals in the labour market, especially the private sector, whilst reducing the socio-economic presence of the migrant workforce and reducing the public sector wage bill. As shown in Table 1, the migrant population is the dominant demographic across most of the GCC states.

Table 1: Demographic Distribution in the GCC: Nationals Vs Non-Nationals6

<table>
<thead>
<tr>
<th>GCC State</th>
<th>National Population (%)</th>
<th>Non-National Population (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Saudi Arabia</td>
<td>62.2</td>
<td>37.8</td>
</tr>
<tr>
<td>Kuwait</td>
<td>30.1</td>
<td>69.8</td>
</tr>
<tr>
<td>Qatar</td>
<td>12.7</td>
<td>87.3</td>
</tr>
<tr>
<td>UAE</td>
<td>12.6</td>
<td>87.4</td>
</tr>
<tr>
<td>Bahrain</td>
<td>45.1</td>
<td>54.9</td>
</tr>
<tr>
<td>Oman</td>
<td>56.0</td>
<td>44.0</td>
</tr>
</tbody>
</table>

To meet this objective, the quota system has been adopted as a central regulatory mechanism and is aimed at incentivizing private sector companies to hire more workers from the national labour pool.7 Indeed, as each state has a different socio-economic profile, this is reflected in the specific nationalisation quotas they have set for their financial sector. For example, as shown in Table 2, the quota applied significantly varies from 4% in the UAE to 94% for platinum companies in Saudi Arabia. In the case of the UAE, which has a small national labour pool to draw upon, the government have only applied a small quota to the financial sector to realistically reflect their demographic profile. While in Kuwait and Qatar, although their quota...
is higher, they both have a blanket country-wide (non-industry-specific) quota, and therefore have been to date pursued on an ad hoc basis. But in the case of Bahrain and Saudi Arabia, there have been attempts to pursue the nationalisation policy with more rigour, by designing financial sector specific quotas as part of their range-based system which is determined by the size of the private sector company. Moreover, the Saudi Arabian nationalisation strategy, *Nitaqat*, goes further by situating financial sector companies in a specific band of nationalisation. The size of the company determines their quota target and is placed within one of four *Nitaqat* bands which comprises of platinum, green, yellow and red.

**Table 2: Nationalisation Quotas of the Financial Sector**

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<tr>
<th>GCC State</th>
<th>Financial Sector Nationalisation Quota (%)</th>
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<tr>
<td>Kuwait⁸</td>
<td>40</td>
</tr>
<tr>
<td>Qatar⁹</td>
<td>50</td>
</tr>
<tr>
<td>Oman¹⁰</td>
<td>45</td>
</tr>
<tr>
<td>UAE¹¹</td>
<td>4</td>
</tr>
<tr>
<td>Bahrain¹²</td>
<td>Company Size (number of employees) Quota</td>
</tr>
<tr>
<td></td>
<td>6-9</td>
</tr>
<tr>
<td></td>
<td>10-19</td>
</tr>
<tr>
<td></td>
<td>20-99</td>
</tr>
<tr>
<td></td>
<td>100-499</td>
</tr>
<tr>
<td></td>
<td>500+</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Saudi Arabia¹³</th>
<th>Platinum Band</th>
<th>Green Band</th>
<th>Yellow Band</th>
<th>Red Band</th>
<th>Company Size</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Max</td>
<td>Min</td>
<td>Max</td>
<td>Min</td>
<td>Max</td>
</tr>
<tr>
<td>100</td>
<td>88</td>
<td>87</td>
<td>51</td>
<td>50</td>
<td>34</td>
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<tr>
<td>100</td>
<td>91</td>
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<td>56</td>
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<td>100</td>
<td>94</td>
<td>93</td>
<td>71</td>
<td>70</td>
<td>51</td>
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To encourage financial sector companies to meet their set quota, each GCC state has adopted incentives and punitive measures. For example, if companies succeed in implementing the nationalisation policy, they are able to apply for government contracts, economic grants and continue to recruit migrant workers. If they fail to meet their quota, they face punitive measures such as economic penalties (fines) and restrictions on recruiting migrant workers.

**Aiding the nationalisation process: the human capital and manpower requirements of the financial sector**

In order for the GCC states to diversify their economic base and successfully nationalise the workforce in industries such as the financial sector, it is imperative that each government proactively address the structural barriers that have and continue to impede their socio-economic transformation efforts. One such area, critical to the success of the policy, is developing a highly skilled national workforce which can compete and meet the needs of businesses in the private sector.¹⁴ This has been a longstanding issue, because due to the rapid growth of the oil economy in the mid-20th century and the boom in the early 21st century, GCC governments relied on recruiting migrant workers to help develop their economies. Through the so-
cial contract guaranteeing the national citizenry a lifelong public sector job, education was not prioritized, while recent catch-up efforts have failed to keep up. As a result, there is now an alarming skill and education mismatch between GCC jobseekers and the requirements of private sector employers—the majority of students throughout the region undertake higher education in the social sciences, humanities and arts rather than in technological, scientific and economic disciplines, the latter of which are in great demand by the financial sector. Therefore, for migrant workers to be genuinely and productively replaced by the national workforce, the governments need to drastically improve the quality of their national human capital by investing in relevant education and skill development and training programmes that are geared towards the needs of the job market. As for the financial sector, there needs to be particular focus on providing education and skill development training in areas such as financial and debt management, risk, accounting, banking and microfinancing.

Indeed, if a well-educated and appropriately skilled national human capital is to be utilised in the post-oil dependent economies of the GCC, there also needs to be a change in perspective of private sector employment, both from the employer and national worker. According to human resource managers, they continue to fail to hire workers from the national labour pool because they view nationals as lacking the necessary qualifications, skills or experience to meet the demanding workload of the industry. On the other hand, nationals have been reluctant to work in private sector industries such as the financial sector due to a lower salary, less flexible working conditions and lower social status in comparison to that of similar roles in the public sector. Further exacerbating these issues is the wage differential between the public and private sector, whereby nationals can expect to receive a 50% higher salary in the public sector than they would if they worked for a private company.

**Conclusion**

Although GCC states are attempting to diversify their economies and create genuine employment opportunities for the national workforce in the private sector, the rentier constructed labour markets continue to be extremely distorted with the overwhelming majority of nationals working in the public sector and the majority of migrant labour working in the private sector. Despite increased effort from the region’s governments to make financial sector companies increase their employment rate of nationals through the quota system, the nationalisation agenda has a long way to go until it can be deemed a success in altering the dynamics of the six labour markets. Indeed, despite its limited success to date, with new development ‘Visions’ in place, nationalisation strategies look set to continue to dominate the policy agenda of the GCC. This will inevitably put pressure on private sector companies, because despite not having a sufficient and appropriately-skilled national labour pool to draw from, they will need to adhere to their nationalisation quota or face punitive measures. However, until the legacy of rentierism is addressed in the national political economies of the GCC, it remains to be seen as to whether the nationalisation strategies can make real structural changes to the national labour markets and boost employment of nationals in financial based industries and indeed, across the whole private sector.

*Dr Sophie Olver-Ellis is a political economist with eleven years’ experience researching and consulting on the transforming political economies of the Arabian Gulf and has recently completed a research project for the Kuwait Programme at the London School of Economics Middle East Centre.*

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II. Analysis

5 Ibid.
Till Debt Do Us Part:
Bahrain’s Fiscal Position and Regional Lifelines

by Muizz Alaradi

In June 2018, Saudi Arabia, Kuwait and the United Arab Emirates announced that they were in talks with authorities in Bahrain to provide financial support which would “enable the kingdom of Bahrain to support its economic reforms and fiscal stability.” This announcement was prompted by a selloff of Bahraini government bonds by international hedge funds and investors and pressure on its dinar currency due to concerns about the country’s rising public debt levels and weakened fiscal position. This situation has been at least a decade in the making, first exposed by the 2008 global financial crisis and recession.

Looking back

Like its GCC peers, Bahrain’s public revenues are primarily generated from hydrocarbons. Based on the Final Accounts between 2007-2017, oil and gas made up, on average, 82.9% of total government revenues. However, unlike its peers, oil production is relatively small. During that same period, Bahrain’s oil output mainly ranged between 180,000 - 200,000 barrels per day (bpd), meaning that any fluctuation in international oil prices directly corresponded to movements in public income. It is also worth noting that approximately one quarter of the country’s oil output (23% in 2017) is generated from its onshore
II. Analysis

Without tangible fiscal reform, Bahrain will continue being substantially exposed to market forces outside of its control. Bahrain field; the remaining 77% was from the Saudi Aramco-operated offshore Abu Saafa field, via an equal production-sharing agreement between Bahrain and Saudi Arabia.

Prior to the Global recession, oil prices had steadily risen to reach an all-time peak of $147 per barrel in July 2008, boosting Bahrain’s revenues and expenditures to new highs. However, within six months, oil prices plummeted, pulling revenues sharply down with them, as shown in Figure 1. Yet rather than adjust expenditures to this new low-revenue environment, spending continued to rise, now financed by public sector borrowing. The situation was further exacerbated by the protests that began in 2011, which, in part, fuelled even higher spending on security and social services. Despite gradually rising oil prices over the next several years and some financing from other GCC countries, Bahrain’s debt-to-GDP ratio rose from 8% in 2008 to 41% in 2013.

Figure 1: Bahrain Government Revenues and Expenditures (US Dollars)

![Graph showing Bahrain government revenues and expenditures over time.]

Data Sources: Kingdom of Bahrain Ministry of Finance; U.S. Energy Information Administration. Note: 1 USD = 0.376 BD.

In 2014, oil prices collapsed once again. This time around, however, expenditures were almost double their 2007 levels in Bahraini Dinar, meaning that the revenue collapse widened the deficit gap substantially. The country began enacting budgetary reforms, such as by removing or redirecting subsidies on fuel, meat and poultry, raising the fees for public services and imposing excise taxes on soft drinks, energy drinks and tobacco. It has recently implemented a value-added tax (VAT) of 5 percent, similar to those implemented in Saudi Arabia and the UAE.

Despite these reforms, revenues still fell far short of expenditures. The International Monetary Fund (IMF) estimates that, since 2014, Bahrain has consistently needed an average oil price of well-above $100 simply to break-even on the national budget, compared to an actual average price of $59. That gap is likely to remain large through 2019. The resulting deficits were financed with debt, translating to rising debt levels—debt-to-GDP is expected to top 100% by the end of 2019 (see Figure 2). These increases have also
prompted an increase in bond yields and thus debt service. As of April 2018, the majority (58%) of the debt was US Dollar denominated and the remainder was in Bahraini Dinars, which is pegged to the US dollar at 0.376 Bahraini Dinars. Between 2019-2024, Bahrain will have approximately $3 billion in annual bond principal and interest due.

**Figure 2: Bahrain’s Public Debt**

![Figure 2: Bahrain's Public Debt](image)

**Data Sources:** Central Bank of Bahrain, International Monetary Fund. Note: 1 USD = 0.376 BD.

**Looking ahead: regional support**

Following the 2011 “Arab Spring” protests, the Gulf Cooperation Council (GCC) countries had announced a $10 billion GCC Development Fund aid package to Bahrain (as well as Oman), which has helped support GDP growth over the past several years, despite leaving underlying core fiscal issues unresolved. The IMF’s 2018 Mission to Bahrain noted that “notwithstanding notable measures implemented since 2015, a credibly large fiscal adjustment is a priority” and that “additional revenue measures—including consideration of a corporate income tax—would be welcome.” The latter advice is similar to that proffered to other GCC countries, though somewhat more acute.

In October 2018, the UAE, Saudi Arabia and Kuwait announced another $10 billion in financial support to Bahrain through “a long-term, interest-free loan.” This was soon followed by a new “Fiscal Balance Program” by the Bahraini government, which seeks to balance the public budget by 2022 through several initiatives, including cutting cash subsidies and improving efficiencies. Although the upcoming aid package is expected to relieve immediate pressures, the moment presents an opportunity for long-term fiscal reform. Bahrain has already diversified its economy away from hydrocarbons—the “non-oil economy” made up 81.6% of the Kingdom’s GDP in 2017, though the fiscal income is somewhat less diversified. Moreover, to-date, diversification efforts have been largely reliant on government funds, with growth in the private sector still driven by government spending and transfers. For instance, over a third of the local workforce is employed in the public sector, placing a sizeable wage burden on the state. Streamlining the state budget through the redistribution of subsidies and implementation of progressive
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corporate and personal income taxes would raise non-oil public revenues without placing a cost burden on lower-income earners. Shifting local employment towards the private sector could improve productivity levels and reduce the sizeable public wage bill.

Without tangible fiscal reform, Bahrain will continue being substantially exposed to market forces outside of its control. In the medium-term, as the expansion in the United States matures, the Federal Reserve is likely to return to its rate hiking path. Given its pegged exchange rate, Bahrain’s central bank will likely follow suit, which could stifle its own growth. Conversely, if the global economy slows and oil prices were to substantially fall again, the Kingdom may be forced to borrow even further, which can become prohibitively expensive. In the 2018 and 2019 budgets, interest on debt alone was equal to more than 23% of public revenues,18 a dangerous level and the highest in the GCC. Furthermore, over the next five years, the Kingdom has almost $6 billion of dollar-denominated bonds and sukuk maturing,19 which will most likely need to be refinanced at higher costs than when they were issued.

In April 2018, the Kingdom did announce the discovery of large quantities of hydrocarbon deposits “amounting to at least 80 billion barrels, and deep gas reserves in the region of 10-20 trillion cubic feet.”20 However, the viability and recoverability of these reserves is yet to be determined, and production is likely to take at least five years—details on any royalties and distribution payments remain uncertain. Nonetheless, if realisable, these reserves could provide a boost to output and revenues, alleviating the pressure on public finances.

Bahrain’s trajectory towards ever-higher levels of debt is clearly unsustainable. Although recent fiscal reforms have been in the right direction, more needs to be done at the structural level, and sooner rather than later. Continuing to move away from blanket subsidies to more targeted support to those who need it would reduce deadweight losses and improve efficiency, although care must be taken to avoid negative impacts on energy-intensive productive industries. Developing the private sector through workforce and enterprise development initiatives can also foster a more vibrant, self-sustaining non-oil economy. Increased transparency and public awareness are also necessary, as policies that raise the cost of living tend to be understandably unpopular. In the short term, the Kingdom’s small size allows for continued support from its neighbours, but these may begin to come with increased conditions and stipulations. Implementing effective, sustainable reforms with broad-based equitable policies may prove difficult, but it is the only way forward.

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5 "Annual Report" 2017, National Oil and Gas Authority, Kingdom of Bahrain.
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9 Ibid.


11 Ibid.


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In 2018 Saudi Arabia took its first serious steps in what is set to be a new era of renewable energy development. The Renewable Energy Project Development Office (REPDO), part of the Saudi Ministry of Energy and Mineral Resources (MoEMR) awarded the 300MWp Sakaka Solar project—the first of its kind in the Kingdom—for a record low price. A similarly striking price was also achieved at the tender of a 400MWp wind project at Dumat Al Jandal.

At the utility scale, there are few structural obstacles standing in the way of the Kingdom’s aims of reaching its ambitious target of 27.3 GWp of installed renewables capacity by 2023, equivalent to a third of overall projected generation capacity in the mid-2020s. ¹ If a truly sustainable, localized renewables industry is to take off in Saudi Arabia, distributed generation (solar on the rooftops of homes and businesses) must do a lot of the heavy lifting. The ability of the state to build a healthy and vibrant private sector renewables ecosystem will be a litmus test for some of the broader economic reforms it is attempting to undertake. Clever and flexible green finance will determine whether a local distributed industry can get off the ground. More-

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Distributed rooftop solar installation in Jeddah, Saudi Arabia, part of Haala Energy’s portfolio.

The Green Finance Gap in the Kingdom
by Faris Al Sulayman & Rowan Jandu

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¹ Distributed rooftop solar installation in Jeddah, Saudi Arabia, part of Haala Energy’s portfolio.

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over, the state can be a catalyst in allowing the industry to leapfrog challenges faced elsewhere and make up for lost time.

**Why distributed energy resources are valuable**

With the rise of renewables, distributed energy resources (DER) are becoming an increasingly important segment of the global energy mix. According to Navigant Research’s *Global DER Deployment Database* report, DER installations are estimated to increase at a double digit compound annual growth rate between 2019 and 2025, with solar installations representing half of the anticipated growth. These generation assets produce energy at a smaller scale and closer to the point of use than conventional centralized plants. Although distributed generation is generally more expensive to install on a unit of capacity basis ($/kWp), the proximity to the point of consumption means that power does not have to be run long distance through expensive transmission and distribution networks, avoiding the associated losses and costs. As a result, distributed generation can be cost-competitive on a unit of energy consumed ($/kWh) basis, often referred to as the levelized cost of energy (LCOE). In addition, a more granular and dispersed energy generation network is more resilient, with outages in any one part having a lesser impact on the whole. Finally, DER can be quicker to deploy at scale because large centralized power projects depend on the effective sponsorship, planning and project management of governments, without which significant delays and setbacks are likely.

Creating a favorable environment for private-sector development of DER is therefore a relatively appealing and straightforward way for governments to accelerate progress towards their renewables targets and energy transition, complementing the public-sector development of centralized power plants. This is doubly true in Saudi Arabia as it attempts to undertake a series of economic reforms, typified by Vision 2030 and the National Transformation Program, that aim to shift the onus of growth from the bloated public sector to the private sector.

A further benefit of developing a healthy DER ecosystem would be increasing the local content of the renewable energy elements of the Saudi mega-projects announced over the past 24 months (REPDO, NEOM, Softbank etc). If a well-established local DER market existed, local companies would be more likely to be able to contribute to large projects, and foreign companies might also consider establishing a more permanent presence on the ground, producing inputs, creating jobs and driving economic growth. The number of solar firms, both local and foreign, based in the UAE, with its well-established local DER market, is a good example of this.

The development of DER projects is driven by the price of electricity from the grid, and the cost of the alternatives, both of which are determined by a combination of market forces and government manipulation through subsidies and regulation. In Saudi Arabia today, the LCOE for solar is lower than the cost of electricity from the grid for many large energy consumers, and the consensus is that this gap will only get larger as energy subsidies continue to be lifted over the coming years and the cost of solar components continues to decline. As an example, the tariff paid by large commercial consumers, like a shopping mall or warehouse, is 0.30 SAR/kWh, and the LCOE of rooftop solar could easily be below 0.20 SAR/kWh. This presents an opportunity for energy consumers to make long-term savings by developing DER today.

*The ability of the state to build a healthy and vibrant private sector renewables ecosystem will be a litmus test for some of the broader economic reforms it is attempting to undertake.*
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The green finance gap

Despite the fact that developing distributed solar photovoltaic (PV) systems is already economically viable for many energy consumers in the Kingdom, the size of the savings is subject to some uncertainty, being dependent on the rate of subsidy reform pursued by the state (see Figure 1). This means energy consumers are faced with investment decisions characterized by large potential savings over a 30-year period with relatively low risk of outright losses, but a high upfront capital commitment to an unfamiliar technology, with uncertain project payback periods of around 7-10 years. For many heavy energy users in the commercial and industrial sectors, this is not yet a convincing investment case. Diverting significant capital away from their core businesses is unappealing, even if internal rates of return (IRRs) are likely to be 10-15% or higher over the full project lifetime.

Figure 1: Cost of a typical commercial scale solar PV system under different tariff scenarios:

Source: SEC, DEWA, Haala Energy

Note on scenarios: A) tariffs increase by inflation only, averaging 2% per annum; B) tariffs increase to 46hl (Dubai’s current price) by 2025, and then with inflation thereafter; and C) tariffs increase to 63hl by 2025, with inflation thereafter. The distance between the Solar PV line and each scenario line is indicative of the return on investment (ROI).

For another category of investors however, these metrics make for a very interesting proposition. The prospect of relatively low-risk, double-digit IRRs over long-time horizons of 25-30 years is very appealing to asset managers and large institutional investors, particularly those comfortable with the underlying technology (solar PV being reliable and well established) and the local macro-economic outlook.

This presents an opportunity already familiar to many working with DER worldwide, namely the possibility of bridging the finance gap by offering power purchase agreements (PPAs) or leases of distributed generation assets to energy off-takers, financed by larger institutional investors. Under such models off-takers stand to benefit from lower cost energy with little to no price risk over time and no upfront capital commitments, while specialist investors can lock-in above average rates of return over long time horizons. The investment risks can be relatively low, particularly with the right approach to evaluating off-taker credit risk and the aggregation of large numbers of projects spanning different locations and sectors.
Why the gap persists

At present in Saudi Arabia, the economic case for such solutions is strong and there are plenty of interested players on either side of the gap, both off-takers and investors. The finance gap stubbornly persists and remains a major bottleneck holding back renewable energy development. In general, the Saudi finance sector is relatively conservative, often waiting for the state to explicitly take the lead in opening up a new space for investment. In the case of green finance, unfamiliar project and technology risks and the challenges associated with the residual value of renewables assets, are cause for some hesitation.

The scale of DER project finance is also a major challenge. Although the underlying project structures and cash flows are similar in nature to more conventional non-recourse lending models, DER project debt requirements are typically less than $10 million, which does not justify the considerable legal and due diligence costs that are normal with ticket sizes in the hundreds of millions. Lending at this scale could benefit from a more wholesale approach with pre-defined eligibility criteria and the aggregation of numerous projects (ideally across different sectors) to reduce risk—principles that are already well established in the mortgage and car leasing markets.

In addition to these sector specific challenges, the general liquidity situation in Saudi has tightened considerably over the last two years as interest rates have risen in line with the US Federal Reserve, and outstanding domestic sovereign debt has risen to over SAR 500 billion ($150 billion) as of the end of 2018, with a plan to reach $181 billion in outstanding debt by the end of 2019. The combination of these factors means that limited-recourse debt is not generally available for DER project developers.

Bridging the gap

In lieu of a more rapid removal of energy subsidies which may be politically sensitive and further slow down an already sluggish economy, the state can play a role in bridging this gap and stimulating DER project development by assuming some of the risk on behalf of the private sector. Once a history of local commercial operation is established, private sector finance should be more forthcoming. This could be done in a number of ways, both directly and indirectly.

As a relatively straightforward and low-cost option, the state could offer a loan guarantee program to local banks and establish a set of standards that can be used to assess the bankability of projects. The Ministry of Finance already has a similar program to support start-ups and small business called Kafalah, and the same framework can be expanded to include project finance. The US Department of Energy, through its Title XVII program, and India’s Renewable Energy Development Agency, are two large programs that could be emulated.

In anticipation of the growth of a secondary market for solar assets, the state can also provide debt directly to businesses choosing to invest in their own solar projects. The Saudi Industrial Development Fund (SIDF) has a number of similar debt products for industrial clients and is set to roll out a more tailored product aimed specifically at energy efficiency improvements soon. Such a program could be expanded to include commercial entities, who in fact pay the highest electricity tariffs and therefore have the strongest investment case for solar. Similar tried and tested debt programs have been developed by the EBRD, various governments, as well as local and international clean energy funds. A step in between a loan guarantee program and direct lending would be an on-lending program through commercial banks, similar to the Green Initiative developed by the European Investment Bank.
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Ultimately, the state has a number of ways to bridge the finance gap and depending on its fiscal capabilities and appetite for exposure it can use one or more of these tools to provide a boost to the industry. More broadly, the emergence of smart and flexible finance options for the distributed solar market is typically the kind of development that trails the birth of the industry by a few years. Given the prolonged low energy cost environment in the Kingdom however, the state playing a role in bridging the finance gap would allow the industry to leapfrog some of these traditional hurdles, and in doing so, make up for lost time.

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1 Note: the capacity factor of renewables is lower than that of conventional generation assets, meaning that this capacity figure would translate into less generated energy when compared with the latter (TWh/year).


III. Commentary
GCC Equity Trends: Economic Reforms Support Growth and IPO Activity

by Mahmood Abdulla

In 2018, GCC equity markets had their best performance in five years, rising by 12% compared to losses in indices in emerging and global markets. This growth took place during a year of volatility in the global oil market, with Brent moving between a low of $55 per barrel and a high of $86. This came on a regional backdrop of continued fiscal reforms, with GCC state budgets taking on initiatives to increase non-oil revenue. The positive trend in GCC equity markets continued in 2019, with most indices showing persistence during the first few months of the year.

Oil prices experienced a steady upward trajectory throughout most of 2018, up until October where they dropped by almost 40%, before rebounding to around $70/barrel (Brent) by Q2 2019. Nonetheless, GCC governments continued their fiscal consolidation initiatives, including diversifying sources of revenue away from oil via new taxes. Such steps, varying across countries, were reflected in growth levels of different GCC stock indices.

Equity indices helped by new global flows

Overall, the MSCI GCC index grew by 12% during 2018, outperforming global and emerging market stocks which declined by 11% and 17% respectively. Saudi Arabia’s Tadawul remains the largest of the Gulf’s equity markets with market capitalization of $495 billion by the end of 2018 and witnessing $232 billion worth of trading during the year. The first few months of 2019 saw Muscat’s stock exchange continue the losses it experienced last year while Dubai slightly picked up its performance in February 2019, slightly bouncing back from its declining trend of 2018. The remaining GCC markets experienced...
an uptick in March, with Kuwait showing the strongest growth in that month.

The positive trend in the GCC during 2019 so far, which echoed and outperformed global markets, was driven by strong inflows of foreign funds, strengthening oil prices and expansionary state budgets across the Gulf, the latter two of which helped support regional growth and earnings. Saudi Arabia’s inclusion in the MSCI Emerging Market (EM) Index, finalized in June 2019, will bring in an initial batch of passive investors who track this index. These investors will automatically allocate a percentage of their overall EM equity investment to Saudi Arabia’s equity market. Moreover, the inclusion will garner more global attention to Saudi stocks and may eventually attract active investors. Based on past experiences, the inclusion into an index, also brings some speculative flows ahead of formal inclusion.

In addition, Kuwait is currently being considered for reclassification from Frontier Market to Emerging Market status by MSCI’s annual market review for 2019, with an announcement expected in May 2020. This decision is anticipated to bring in an inflow of foreign funds to the Kuwaiti market. For the rest of the GCC markets, these upcoming few years will allow them to observe the opportunities and challenges that Saudi Arabia and Kuwait experience as their classification changes.

**New instruments may boost liquidity**

In addition to index inclusions, initiatives to develop GCC stock markets will start yielding results during 2019 and beyond. In January 2019, Nasdaq Dubai launched futures trading on the MSCI UAE equity index, a move that could pave the way for sophisticated hedging products that attract a new wave of investors. During the same month, Nasdaq Dubai also launched single stock futures trading on 12 Saudi companies, and in February it launched futures trading on FTSE Russell’s Saudi Arabia index which comprises 46 Saudi companies. These steps expand the range of the region’s capital markets product offerings, allowing investors to make use of leverage to magnify the outcome of their trades. They also allow some investors to hedge their risks, though implementation remains a question.

A key element to observe during the rest of 2019 is the volume of trading activity. Despite the positive performance of GCC stocks during 2018, trading activity declined for the fourth consecutive year. More initiatives to introduce sophisticated trading products could encourage higher levels of activity in the future, especially if they are married with more investor education and strong macro policies.

On a larger scale, macro-level challenges in the horizon that could impact equity markets include rising political tensions in the Middle East region as well as the current trade war between the US and China. While these two developments could slow down global fund flows, it is expected that internal factors will continue to be a more impactful driver behind the performance of GCC equity markets. The performance of listed companies as well as initiatives to introduce more sophisticated trading products are examples of these drivers.

**Watch for more IPOs**

On the IPO front, a key driver of interest and flows, the GCC followed the global trend of muted activity during Q1 2019. During that period, there was only one IPO in the GCC while globally, the number of IPOs was half that of Q1 2018. This could be due to increased international uncertainties including the US-China trade war, Brexit and geopolitical tension between the US and Iran. Despite this general theme, some blockbuster offerings took place in the US, such as Airbnb, Lyft, Pinterest, Uber and WeWork.
2018 saw some slowing down in IPO activity in the GCC, with the number of offerings dipping to 17 down from 28 in the year before with the value of IPOs decreasing by a third to reach $2.2 billion. Nonetheless, both the volume and value of IPOs in 2018 was stronger when compared to 2016 or 2015. Moreover, what could be the largest IPO in history is set to take place by 2021 if Aramco lists 5% of its shares to raise up to $100 billion according to the company’s valuation. Depending on the stock exchange chosen for this listing, it could bring a large share of investment and attention to Saudi Arabia and the GCC or at least unlock new funds for investment elsewhere by the Saudi government. The positive sentiment surrounding this IPO continues to grow, especially after Aramco’s financials showed record income of $111 billion, more than the combined profits of Apple, Google and ExxonMobil.

Looking forward, continuing privatization efforts could help boost IPO activity this year. In addition, historical data shows that the number of public offerings tends to pick up in the second half of the year. IPOs that are expected to take place in 2019 include Abu Dhabi National Oil Company (ADNOC). Another catalyst of growth in equity markets could come from family businesses as they test public offerings which are considered by some to support succession planning and processes.

Performance in GCC equity markets during the rest of 2019 and beyond is expected to be driven internally by the size of fund inflows as a result of the inclusion in global indices and externally by geo-political tension as well as the direction of oil prices. With these drivers, and with most indices coming off of a decent 2018, a continuation of growth in GCC markets should continue to outperform global equity markets.

Mahmood Abdulla is an economics researcher who worked on geo-economics at the International Institute for Strategic Studies (IISS) and developed forecasting models at the Bahrain Economic Development Board.
The Gulf’s Diligence Deficiency

by Ali Al-Salim

The Gulf's oil producing countries command significant wealth, held in both state and private hands. In addition to over $2 trillion of sovereign assets, the Boston Consulting Group estimates Middle East personal wealth alone is currently at least $3.8 trillion and poised to grow 8-10% annually for several years. Less known is whether that wealth is in the hands of prudent principals and fiduciaries.

Judging by last year’s Abraaj Group fiasco, the region may be further behind than thought in key areas of governance. The Gulf is home to a spectrum of investor types, including sovereign and pension funds, foundations, family offices and banks. It is clear that not enough Gulf investors conduct adequate due diligence as part of their investment process. As the importance of fiscal responsibility grows, sustainable economic growth will increasingly rely upon effective due diligence. Such measures will also be required to attract and retain local and global capital.

The last crisis

Approximately a decade ago the Global Financial Crisis left the US and came crashing onto the shores of the Gulf. Some of its highest-profile victims included Saudi Arabia’s Saad Group, Kuwait’s Investment Dar and Global Investment House, Dubai’s Shuaa Capital and Bahrain’s Gulf Financial House. Massive losses were delivered to both shareholders of these firms and the fiduciary clients whose assets they managed. During this period, dismal investment performance masked losses exacerbated by weak governance. Cases of front-running, insider trading, over-charging fees and related party transactions abounded but few, if any, were discovered by investors let alone investigated and successfully prosecuted by authorities.

Ten years on

A decade later and it is evident the Gulf’s investor community continues to suffer a dearth of diligence. It took organisations located over 10,000 kilometres from Abraaj’s head office to identify and flag governance issues afflicting the Dubai-based asset manager in early 2018. Throughout much of its 16-year existence, Gulf investors comprised the overwhelming majority of Abraaj’s client base. Yet none of Abraaj’s Gulf investors identified irregularities or raised meaningful red flags with local regulators, nor did the regulators themselves discover these issues, which included mixing of capital between different funds, and undercapitalization.

Gulf investors simply aren’t doing enough to evaluate fiduciaries through the lens of operational quality. Greater Operational Due Diligence (ODD) is needed in assessing the way an asset manager runs its business, both before and after entrusting them with capital.

Complexity

Asset management boils down to investing money—usually for a third party—in public and private markets to generate a financial return. Beneath this simple veneer lives an intricate system of administrators, auditors, banks, brokers, custodians and lawyers that each provide a service
to facilitate the buying, holding, selling and valuation of assets. Asset managers are typically responsible for more than one client, not to mention their own balance sheets. They’re also responsible for coordinating this orchestra of service providers, in serving the interests of their investors. It’s no surprise then that such complexity naturally gives rise to conflicts of interest that need to be disclosed and suitably managed.

‘Good’ asset management is not solely about investment returns. It entails operating in a manner that is both fair and transparent to investors; after all, it is the investor’s capital that is at risk.

Importance of operational due diligence

ODD is required to assess whether an asset manager has the required infrastructure to manage investor capital and sufficient alignment of interest with said investors. Without an adequate level of either infrastructure or alignment, investors expose themselves to a variety of risks that come with no reward.

A ‘trust but verify’ philosophy is commonly adopted by ODD practitioners. Key questions include: asking which individuals can make wire transfers, and how many signatures are required? How are assets accounted for and valued, and how transparent and independent is that process? What service providers are involved in the management of a fund? Are those parties also independent of the fund manager? What kind of compliance and governance culture does the asset manager have? These scratch the surface of vital questions that help build a holistic picture of the operational qualities of an asset manager.

At one end of the spectrum investors are exposed to the risk of negligence or oversight due to weak operations, at the other, governance failures can lead to outright fraud. Gulf investors must do more to develop policies that codify how they assess operational risk and what their tolerance is for accepting it in their portfolios. These will be important to attract local and global investors and for the success of the businesses and infrastructure they finance.

Local regulators

Recently members of the Gulf financial community have sought to lay blame on regulators for not effectively supervising the investment institutions under their watch. Local regulators have appeared to prioritise improving the operations of their local public equity markets to achieve the coveted status of global index inclusion, especially in Kuwait and in Saudi Arabia. Saudi Arabia has been particularly proactive in enforcing regulations by prosecuting unlicensed activity, insider trading and fraudulent IPOs. While it is notable that regulators throughout the Gulf have shown less explicit interest in the topic of ODD with regard to asset management, one cannot dispel the notion that ODD remains the responsibility of the end investor.

Why haven’t investors cared?

There are many reasons for investors’ cavalier attitudes towards ODD. The biggest culprit is a lack of awareness. Many investment mandates in the Gulf set by state bureaucrats or principals of family offices focus solely on the merits of an investment fund’s return potential, with less attention given to downside risks, specifically those of a ‘non-market’ variety. Operational risks are disregarded as less impactful on expected performance.

Too often Gulf investors succumb to the fallacy of thinking that large brand-named fund managers are inherently less risky. Such thinking didn’t help several Gulf sovereign wealth funds, banks and pensions in 2008 when it was revealed their investments with Bernard Madoff turned out to have financed the world’s largest Ponzi scheme. In 2015, another case saw London-based BlueCrest Capital, which managed $35 billion in assets at its peak, disclose that a $2 billion private fund for employees had drastically outperformed the funds managed for their investors, suggesting a different type of principal-agent problem. Also in 2015, Blackstone Group, the world’s largest private equity firm, revealed it would pay around $40 million in compensation and fines to settle the regulator’s investigation which cited “violations of law or material weaknesses in controls”. Earlier that year a rival firm, KKR, paid close to
Gulf investors must do more to develop policies that codify how they assess operational risk and what their tolerance is for accepting it in their portfolios.

When the tide goes out

Investors also tend to overlook ODD because outright frauds are frankly uncommon. Many investment professionals see it as unlikely that they will lose their job after investing with a large, illustrious fund manager that is well known and revered, even if they end up failing. The Abraaj situation echoes this sentiment.

ODD can be repetitive, tedious and requires specialist talent. Furthermore, it is concerned with preventing loss, more so than identifying drivers of return. As a result, it is often mistakenly regarded as an unnecessary cost, especially during boom times.

These factors lead to a lopsided allocation of resources. Both financial budgets and human capital are directed towards front-office fund selection roles at the expense of ODD. This can subsequently lead to greater losses when markets turn and governance issues can no longer be hidden.

Diligence needed for the economy

The bigger picture reveals the many benefits brought by greater operational diligence by Gulf investors. It not only lowers the chances of exposing oneself to operational failures but creates a virtuous circle whereby best-practices are shared and adopted, raising the bar for all in the industry. Over time only the most operationally-sound asset managers can attract assets and grow. This improves the quality and robustness of the Gulf’s investment industry. It ultimately creates an attractive investment environment not just for local but also foreign capital, something our region is desperately keen to do.

The responsibility for a better Gulf financial industry is shared by all participants. Although regulators have become increasingly active in capital markets’ issuance and trading activity, they have done far less to further best practices in asset management.

I would, however, argue that the onus is on the owners of capital to demand excellence from their fiduciaries—they are the direct beneficiaries.¹ There’s little room for excuses either. If investors lack internal resources to conduct effective operational due diligence they can outsource to specialists. Consultants such as Castle Hall, based in Canada, have recently opened offices in Abu Dhabi to support their regional clients evaluate both international and local asset managers and their funds. The costs associated with such evaluations generally come to fractions of a percent of the assets to be invested.

If the Gulf region wishes to be taken seriously as host to globally competitive financial centers and home to sophisticated deep-pocketed investors, then Gulf financial market participants must both perform greater Operational Due Diligence and ‘pass-the-test’ when subjected to it by foreign investors. It is only as champions of best practice and good governance, that regional actors stand a chance of protecting and growing their financial wealth, while attracting that of others.

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¹ We’ve seen progress with some large investors such as Abu Dhabi Investment Authority, who consistently report on investing in their Investment Services Department, a unit that manages various internal functions including operational diligence.
Finance Access that Works: Women, Millennials and Mortgages in Saudi Arabia

Karen E. Young

For all of the difficult challenges of Vision 2030—including the Saudi government’s efforts to attract foreign direct investment and spur private sector job growth—there is one policy that is achieving notable success. Vision 2030 has a direct target of increasing home ownership to 70 percent among citizens. The mortgage industry is growing in Saudi Arabia, and with it, more young people should be able to access loans to buy their first homes. The acceleration of women’s employment may be a key factor increasing first home purchases for young Saudis. Working women will expand the market size of potential mortgage borrowers, either on their own or as part of dual-income families. As more women are employed, they qualify to borrow and they create demand for new financial products like mortgages, which strengthen the position of local banks listed on the Saudi stock exchange, Tadawul. Bank stocks on the Tadawul are also strengthened by incoming foreign investment as a result of emerging market index inclusion. Social policy that targets women’s economic empowerment (employment and access to financial products) can also be a powerful growth multiplier.

Sometimes the “sweet spot” in economic development policy requires some simple policy adjustments to provide big impact. In a new research paper by World Bank economists Elena Ianchovichina and Danny Leipziger, they argue for combining gender-enhanced growth diagnostics to identify win-win solutions based on policies that target jointly the binding constraints to economic growth. Essentially, there are some policy adjustments that can be good for women’s economic empowerment while also creating overall positive growth effects in the economy.

Saudi home ownership at a glance

Saudi Arabia does not necessarily have a low percentage of home ownership. In fact, it rivals home ownership rates of the United States, and regional peer Turkey. Sixty percent of Saudis own their homes, the same as Turkish rates and just below that of Americans. Moreover, Saudi Arabia is not too different from more developed economies in the demographics of home ownership among its population. More older people own homes than younger people. Saudi millennials are similar to their peers in the United States where roughly 37 percent of young adults under age 35 own their own homes. In Saudi Arabia, about 39 percent of young adults under 35 own homes and 50 percent of those between the ages of 35 and 44 own homes. What is different is that this group of citizens under age 45 make up nearly half of the Saudi population—in comparison, millennials make up about a quarter of the American population.

So, while home ownership is not low in Saudi Arabia, access to mortgages and financial products is scarce. According to a report on financial inclusion by the King Khalid Foundation, nearly 7 million Saudis do not have bank accounts, and women make up 60 percent of the “unbanked” population. Therefore, the fact that home ownership in Saudi Arabia parallels rates within the United States with its expansive mortgage market tells a complex story about inequality in access to finance in the kingdom. For those Saudi citizens unable to afford a home, there has been very lit-
tle hope for the financial mobility to achieve what most of the adult population has achieved without a mortgage. The barriers to finance are more likely to span (and reinforce) urban-rural divides and more nuanced divisions of gender, class, tribe, sect, and religious practice within Saudi society.

**Persistent barriers to economic inclusion**

Across the Middle East and North Africa, the structural barriers to economic inclusion have not improved much since 2011. Joblessness and rising cost of living remain key grievances for young people across the Arab world. Hence, there is a policy imperative to improve financial mobility, employment opportunity and social signals of progression, including marriage. The Saudi government recently expanded funding for a new program to encourage marriage among young nationals, the Sanad Mohammed bin Salman Social Enterprise Program and its “marriage grants.” We need better data to understand financial access in the kingdom, but one data point has become crystal clear. Women’s economic participation is increasing and with it, more demand for new products to improve financial mobility. The social implications for young families and young single adults are immense.

**Banking, finance tools aligning with growth policy**

The implications for the banking sector are also very positive. New policy changes in bank regulation are encouraging banks to extend housing loans. SAMA, the Saudi central bank, regulates loan to value ratios and has twice extended limits to increase lending limits in the last two years. In the first quarter of 2017, maximum loan value ratios were extended from 70 percent to 85 percent and in January 2018 up to 90 percent. The government has also introduced support for low income and first-time buyers in its Real Estate Development Fund (REDF) as a subsidy for both debt service cost and principal payments. While subsidies have been a weight on the Saudi economy, these particular programs serve to boost access for some buyers, while also providing protection for the banking sector to extend its new lending practices.

For Saudi banks, this also presents an opportunity to grow. Investment into the banking sector and into real estate products, whether securities or Real Estate Investment Traded Funds (REITs), creates more access for financing to home buyers, and incentives for the market to cater to different kinds of housing needs, as well as creating new types of financial assets for investors in the kingdom. According to projections by HSBC, there is the potential for $150 billion of growth in mortgage loans in Saudi Arabia over the next five years, and as much as $78 billion could come from first time buyers, with women accounting for as much as 40 percent of new first-time buyers. Mortgage lending will be profitable for many banks willing to enter the business. Those banks that seize the mortgage market potential will also benefit from parallel status change of their Tadawul listings, as more emerging market index funds engage the Saudi equity market and search for value in the growing financial sector. Expanding their offerings of loan products will help the banks grow. While consumer credit expands quickly in the Saudi market, the ability to sustain that growth (and service the debt) will continue to depend on job growth.

When social policy and state development objectives align with market opportunity, there can be fast-changing results. The ripple effects of women’s economic inclusion and expanding financial access to mortgages also create incentives for the bank sector to expand, which, in turn, creates attractive growth stories for foreign investors eyeing banks listed on the local stock market. In this social policy, the government continues to underpin the structure, through loan subsidies and social programs like marriage grants. Job growth will be the independent factor that can sustain the growth of the mortgage market and the financial sector at large. That will be finance access that works.

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Managing Gulf Sovereign Wealth: Transition to the ‘Modernised Economic Era’

by Sara Bazoobandi

Since the term sovereign wealth fund (SWF) was coined in 2005, it has been used for various state-owned funds that are created from different sources of wealth, such as commodity exports revenue, which are prevalent in the Gulf. These funds have macroeconomic purposes including intergeneration saving, macro stabilization and domestic development. Some of the most globally well-known and largest SWFs, such as Kuwait Investment Authority (KIA) and Abu Dhabi Investment Authority (ADIA) are owned by the Gulf oil exporting countries. With oil revenues having fallen and domestic spending needs rising in recent years, the role of these investment funds is changing, with sponsor governments investing more heavily at home in some cases and some funds being drawn down rather than receiving new capital. Saudi Arabia is a critical test case, as its economic development plans involve the sales of local assets via privatization and greater reliance on external debt.

SWF varied functions

In addition to macroeconomic goals, the Gulf countries’ sovereign wealth, in its broader definition that captures wealth beyond the institutional investors like ADIA, KIA and other comparable government-owned institutional investors, has been used for various political and social purposes:

• State building: establishment of the Gulf states in the twentieth century was followed by the introduction of a new social contract across the region. The ruling families created mechanisms through which they provide security, justice and economic support for the local tribes in return for loyalty. As populations have grown, the expectations in this implicit and in some cases explicit social contract have grown, with demands for public wage bills and subsidies increasing.

• Longevity of the ruling families: distribution of oil wealth throughout the society, as a condition for political compliance, has allowed the Gulf ruling elite to maintain their political power for decades.

• Creation of national identity: new citizenship identities that are built upon the close link between citizenship and economic benefits have been facilitated by the sovereign wealth. These explicitly differentiated nationals from migrants and also between the Gulf and their poorer neighbors. There has been a conscious effort by the ruling families to associate the economic benefits with national identity in order to boost popular support. The privileges that accompany holding GCC passports are reflected in employment benefits, judicial protections, and government grants and payments.

• International recognition: sovereign wealth has been used by the governments across the Gulf to increase their financial status globally. Particularly in the post 2008 global financial system, various investment vehicles from the Gulf have been used for this purpose, investing...
in high profile global assets ranging from banks to retail institutions to sports and entertainment vehicles. These in turn were viewed as a form of soft power and in some cases a source of competition between GCC countries.

- Weathering the storm of change: more recently, sovereign wealth has been used by the Gulf governments to attempt to buy regional power and quiet social anxiety. The Gulf economies enjoyed a period of sharp increases in oil prices during the initial phase of the Arab Uprisings beginning in 2011. For that reason, the ruling elite reacted to the challenges of the Arab Uprisings mainly by channeling financial expenditures in two distinct ways: 1) by introducing new financial packages domestically, and 2) by providing financial assistance to countries going through political transitions.

**New challenges to reshape SWF mandates**

While sovereign wealth has served many of the national purposes in the Gulf, it has not contributed much in addressing economic diversification, one of the biggest challenges for all the oil-exporting countries of the region. The Gulf economies have been affected to differing extents by past oil price falls—the impact tends to reflect the size of the population, the availability of savings and associated economic needs. For example, smaller, richer nations like Qatar and the UAE have been more resilient to oil price swings and have been more able to use their wealth to seed new industries. Vulnerability of the existing growth model across the region, and especially the need to increase employment, has underlined the need to make substantive changes towards a more diversified economic growth model. Decreases in hydrocarbon export income may profoundly affect the growth prospects in the Gulf and it has prompted some of the Gulf economies to introduce new fiscal measures, such as: value-added tax (in Saudi Arabia and the UAE), in order to generate more non-oil revenues. Moreover, the policy makers have begun to address some of the challenges imposed due to unsustainable public spending through policies such as: public sector hiring freezes, pay cuts and subsidy reforms. However, these measures are not sufficient to address structural problems, as the main source of government finance has largely remained dependent on oil—and spending cuts/new revenue have not increased sufficiently. Moreover, some of these measures may have to be abandoned to avoid social discontent. Therefore, while economic diversification has affected public policy in the region, there has been very little done to implement necessary measures in a timely manner. Instead, there is a lot of effort amongst the regional ruling elite for rebranding the old economic structures by launching widely publicized modernization initiatives.

**Saudi Arabia sets the tone**

Saudi Arabia’s new economic reform program, Vision 2030, is the best example of such modernization initiatives and how SWF management is shifting. Saudi Crown Prince, Mohammad bin Salman, has associated himself closely with economic reforms that promised to reduce oil dependence and create more jobs by the private sector. In the case of Saudi Arabia, a new pattern for using sovereign wealth has been emerging. After years of saving the bulk of revenues and investing in a range of more liquid assets abroad, Saudi Arabia’s local spending needs have increased sharply since 2011. Since 2014, there has been a recognition that past economic policy is unsustainable. Under the leadership of Mohammad bin Salman, the government has promised to develop the country as a global hub for business, trade and tourism. There is a major difference between the traditional source of sovereign wealth (i.e. commodity export income) and what the Saudi Crown Prince calculated (i.e. through privatization and attracting private investment). Generating sovereign wealth from selling government’s assets seems necessary, as the oil price trends make it clear that states can no longer afford to keep spending open-endedly, especially as new spending demands proliferate. However,
attracting private investment as a diversification method is challenging for oil exporting economies of the Gulf since investors judge the growth prospects on the basis of the oil price. Moreover, there remain questions about the terms of the mega projects which have kept investors at bay.

All in all, the new economic strategies in the region, in particular in Saudi Arabia, are capturing a lot of attention both at the domestic and international level. However, efforts to reduce the level or at least the pace of growth of government spending combined with privatizing government assets would have serious social consequences. The current economic trends prove that 1) ultimately, the traditional use of sovereign wealth to maintaining longevity of the ruling elite via distribution wealth in exchange for political loyalty, and 2) the transition from the current structures to the ‘modernized economic era’ will be inevitably associated with risks of growing inequality and social exclusion.

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Sheikh Abdulla bin Saoud Al-Thani
Governor
Qatar Central Bank

Gulf Affairs: What role is the Qatar Central Bank (QCB) playing in Qatar’s national vision 2030?

Sheikh Abdulla bin Saoud Al-Thani: QCB is committed to achieving the goals of Qatar’s National Vision (QNV) 2030 by maintaining monetary and financial stability in Qatar. QCB, along with Qatar Financial Centre Regulatory Authority and Qatar Financial Markets Authority, launched the Second Strategic Plan in 2017, an extension of the First Strategic Plan 2013-2016, for financial sector development. In the Second Strategic Plan 2017-2022, QCB promotes financial market development which supports the QNV 2030 goals of modernisation, economic growth and social development that will help Qatar achieve the status of ‘developed nation’ by 2030.

A well-developed financial sector is a necessary condition for transforming Qatar into a developed country by the year 2030. Accordingly, in the second strategic plan, QCB aims to enhance financial sector regulation and to promote institutional cooperation for the development of financial markets. In terms of financial market development, QCB recognises the role of financial innovation and Fintech in meeting future challenges. As for human development, QCB is making efforts for enhancing financial inclusion and financial literacy in Qatar. Financial literacy and wider financial inclusion are also important for the
encouragement of young entrepreneurs, innovation and human development, and for economic diversification more generally. In sum, the developed financial market will create opportunities for lending and investment and help in economic diversification needed to attain the goals of QNV 2030.

Gulf Affairs: How do the QCB and the Qatar Investment Authority (QIA) strategies complement each other?

Al-Thani: Qatar Investment Authority (QIA) plays an important role of managing and investing a major portion of Qatar’s reserves with an objective to grow and create long-term value for the State and future generations. On the other hand, QCB as a central bank endeavours to maintain domestic monetary and financial stability. In this regard, QCB also manages a significant part of foreign exchange reserves to facilitate maintaining the currency peg. Since the government’s financial transactions through QIA has domestic liquidity implications, normally there is regular coordination and interaction between QIA and QCB. In the immediate aftermath of the blockade imposed by neighbouring Gulf countries in 2017, both QCB and QIA provided liquidity support to the banking sector to deal with the stress of capital outflows from Qatar, complementing each other through joint strategies.

Gulf Affairs: How has QCB regulation contributed to the development of Qatar’s financial sector in recent years?

Al-Thani: In the aftermath of the Global financial crisis of 2008, the regulatory measures taken by QCB were mostly proactive in nature and were in tune with the standards advocated by the Bank for International Settlement (BIS) and the IMF.

Basel III Capital and Liquidity standards were implemented back in 2014. QCB also implemented the Domestic Systemically Important Banks (DSIB) framework around the same time, requiring DSIBs to maintain high loss absorbency capital proportionate to the systemic importance of the bank. In 2016, QCB has completed the methodology for calculating the Countercyclical Capital Buffer (CCyCB) that banks should take into account when computing the minimum requirements of capital adequacy ratio in accordance with Basel III. Banks are also required to put in place an Internal Capital Adequacy Assessment Process (ICAAP) under Basel’s Pillar 2 framework. ICAAP seeks to capture the risks that are not fully assessed under the capital adequacy framework and other factors external to the bank. Banks have to maintain a floor of 1% of additional capital for the risks considered under the ICAAP.

Qatar Central Bank has also been playing a central role in the implementation of macroprudential policies to achieve financial stability. The framework is evolving continuously based on developments in the financial sector and the economy as a whole. More recently, QCB has implemented IFRS-9 standards to develop a regulatory framework that can assist QCB in its supervision and monitoring activities of the banking sector.

Strong credit risk assessment augmented by the high-class regulatory environment enhanced the resilience of Qatar’s banking sector even during the period of low oil prices. These proactive regulatory measures implemented by QCB also enabled the financial sector to weather the stressful conditions which stemmed from the economic blockade. Going forward, continuous upgrading of the regulatory framework will enable the banking sector to adequately manage unanticipated vulnerabilities and support sustainable asset growth.
Gulf Affairs: How do you envisage financial technology (Fintech) impacting the Qatari financial sector?

Al-Thani: Fintech can bring positive change to the sector but also brings additional risks. It can impact the financial sector at multiple levels such as:

- Streamline processes of financial institutions, hence increasing efficiency and facilitating faster delivery.
- Improve connecting financial institutions with their customers to further help understand and meet their needs.
- Enhance access to financial services.

On the economic level, the sector-wide transformation is also an opportunity to develop the market. With digitalization comes new entrants and new actors into financial services. This has the opportunity to increase the contribution of the financial sector to the GDP, diversify the economy and create new market dynamics.

On the technical aspect, the push for adoption of new technologies has been seen consistently across the banking sector can actually support demand for IT expertise, supporting other sectors. Fintech can create opportunities for local technological development as well as attract talents within various streams of activities. Future regulation will need to integrate Fintech as regulated financial service providers.

Gulf Affairs: Almost two years on, what has been the impact of the GCC rift on Qatari financial markets and the banking sector?

Al-Thani: The negative impacts of the economic blockade have completely disappeared. Qatar’s growth momentum is expected to pick up further going forward. Energy prices are likely to remain at an elevated level, which will further improve the external and fiscal balances, despite higher infrastructure spending by the government. The economic policies and structural reforms of the government to diversify the economy have already started showing results and enabled a reasonably high growth in the non-hydrocarbon sector and allowed the country to adjust its supply chains and sources of key goods.

Along with the economy gaining momentum, the banking sector also weathered through the adverse impact of the economic blockade, while recording sustainable growth including higher credit demand from the private sector in 2018. The banking sector has also improved its liquidity and funding structure. The sector witnessed a rebound of deposits from non-residents even though almost all the deposits from the blockading countries did not return to the system. Non-resident deposits were highly diversified, and a major part of these new non-resident deposits is from Asian and European countries, indicating the confidence of the investors from the rest of the world in our banking sector. Increased receipt of these stable funding sources reflect continued and strengthening investor confidence in the fundamentals of our economy.

The banking sector’s capitalization levels are significantly high and above the regulatory minimum. The ratio of non-performing loans is quite low and are adequately provisioned. Moreover, banking sector’s profitability indicators also remain stable. Overall, the sector remained sound and in good stead during 2018.
Gulf Affairs: In June 2017, Qatar and the US signed an agreement aimed at combating the financing of terrorism. What has been the impact of this agreement?

Al-Thani: An MOU was signed in Doha on 11/7/2017 between the government of the State of Qatar and the US in the field of combating terrorism. By virtue of this MOU, the two parties were engaged in the following:

1- Two strategic dialogues were conducted in the US for combating terrorism and the financing of terrorism, the first of which was completed in January 2018 and the second was in September 2018. A third dialogue is also due later in 2019 in Washington.
2- Two workshops were conducted in cooperation with the FBI in Doha on AML/CFT on September 2017 and April 2018 where different authorities took part in this event.
3- A number of suspected persons and entities were designated under the umbrella of the Combating Terrorism Financing Center in Riyadh.
4- US experts provided technical and legal assistance during the preparation of the newly proposed AML/CFT law amendment.
5- Cooperation and coordination between Qatar’s public prosecution and the US Ministry of Justice took place with a view to enhancing capacities of law enforcement officers in combating terrorism, financing of terrorism and anti-money laundering.
Gulf Affairs: How long has DLA Piper been operating in the GCC? What are some of your key achievements in the region?

DLA Piper: Having established our presence in the Middle East in 2005, DLA Piper has grown to become one of the largest international law firms in the region, with 27 partners and over 100 lawyers operating from nine offices across the GCC. Awarded International Law Firm of the Year in 2017 and 2018 by Legal Week at the Middle East Legal Awards, we are trusted by local, regional and international organisations, in addition to government bodies, across the full spectrum of legal services.

We bring particular strength in energy and infrastructure where our team has had a major role on most of the landmark and significant deals in these areas, helping to shape the region’s public-private partnership (PPP) landscape. We are also taking strides in new energy technologies, including renewables. These include having advised on the largest renewables programme in the world, including Saudi Arabia’s first commercial wind power plant; the first standalone water desalination projects in Saudi Arabia to be procured on an Independent Water Project (IWP) basis; Oman’s largest water project; Oman’s first utility-scale solar project; and the first International Sustainability and Carbon Certification (ISCC) project in Kuwait and only the second in the GCC (although unfortunately the project did not proceed).

DLA Piper is also unique for offering public policy advice and support to both private and public sector clients through our dedicated Middle East Government Affairs practice. We advise clients on policy issues in
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the context of legal and regulatory issues in both contentious and non-contentious environments across a number of sectors. On the project finance and PPP fronts, our government affairs advice typically involves articulating and helping clients navigate the political risks that impact the bankability of infrastructure projects. This is particularly critical in the context of public utilities, which typically involve large amounts of upfront investments and highly regulated sectors.

**Gulf Affairs: How does the GCC market differ from other markets in terms of finance opportunities?**

**DLA Piper:** The drivers in the GCC are quite different from those drivers in the Levant region, for example. There are different questions of resources and different questions of technical knowledge. In the Levant, it is more financially driven, and political risks are more pertinent as there are more such risks and greater volatility in policy implementation. Moreover, the security environment is a key differential, as the more uncertain picture in the Levant suppresses finance opportunities.

We are also beginning to see some of the International Finance Institutions (IFIs) assume a more active role in supporting PPP projects across the Gulf region. This is partly because, even in the Gulf, governments’ finances have become more constrained as a result of falling oil prices. The attractiveness of IFIs for a number of GCC governments is their ability to provide wider advice on structuring PPPs and assisting governments in deriving long-term and sustained value from PPP initiatives.

**Gulf Affairs: How is the outlook for project financing changing in the region in this time of economic reform and diversification? How is the GCC PPP market likely to develop?**

**DLA Piper:** A broad theme has been the revisiting of PPP regulatory frameworks following a realisation that governments in the region should fully utilise their purchasing power by actively investing as governments. This will ensure that investments ultimately deliver targeted economic change across a variety of industries—from technology to natural resources—and in specific geographic areas so there can be job creation and economic security for those communities.

The focus on electricity and water projects is likely to continue and the critical question is whether PPPs will take hold in other sectors such as transport, health, education and other social infrastructure. With the exception of social housing, where a number of smaller projects have been developed on a hybrid PPP model, there is no equivalent track record of governments using project finance to develop this infrastructure. Whilst this is partly due to legal and regulatory challenges, there is also a fundamental economic issue in play, which is that governments seem largely unwilling to retain the demand and usage risk implicit in investing in a new hospital or metro system. In the electricity and water sectors governments are entirely willing to hold the demand risk and to pay the private developer a capacity (or availability) charge to meet his fixed costs, regardless of whether the plants are actually required to supply electricity or water. In the transport and social infrastructure sectors, there appears to be a greater imperative to transfer the demand risk to the private sector and this has historically impacted project viability.

In many of the most active and successful PPP markets around the world, the recognition that these transport and social infrastructure schemes are unlikely to be economically self-sustaining, but are nevertheless a critical public service, has led to the development of models that are similar to the capacity change models seen in the GCC electricity and water sectors. The acceptance of these ‘availability’ based schemes or hybrids between demand transfer models and ‘availability’ based schemes is an essential next step if
the use of PPP is to expand. A number of major projects such as the Bahrain Light Rail Project, the new Saudi-Bahrain Causeway and the Saudi schools programme are currently exploring these issues.

**Gulf Affairs:** What regulatory changes are altering the outlook for project finance? What regulatory and other burdens are still meaningful obstacles?

**DLA Piper:** There is a long and successful history of the tendering and delivery of electricity and water projects in the GCC. These projects have typically been procured on the basis of a combination of existing procurement laws that don’t quite work for a PPP (necessitating the granting of exemptions); sector specific laws that establish a framework for the sector and override other laws that would otherwise create obstacles; and overriding Royal Decrees and Orders.

Whilst this somewhat piecemeal approach has worked well enough for the occasional procurement of major projects, it isn’t particularly conducive to the development of a pipeline of projects across a range of sectors, and it is this that has driven most of the GCC countries to look at implementing specific PPP laws that will work in different sectors. Progress has been mixed in this respect with Kuwait having been an early mover followed by Dubai. Oman, Qatar and Saudi Arabia have all prepared draft laws, but have delayed enacting them. We understand that Saudi Arabia’s Private Sector Participation Law is expected to come into effect in the near future, which could be critical for local and foreign investment. Early enactment of the PPP laws and the implementing regulations remain important in order to both facilitate implementation and to demonstrate political commitment.

The establishment of a central PPP unit is generally considered best practice, but it is not necessarily a guarantee of success. Kuwait, for example, has a long-established central unit (Kuwait Authority for Partnership Projects), but this has not avoided project delays and cancellations. In Saudi Arabia, although the PPP law is not yet in force, there has been a rapid development of the institutional framework around PPPs with a series of ministry specific Supervisory Committees supported by the Ministry of Finance (through the National Center for Privatization & PPPs and the Vision Realization Office) beginning to prove effective in driving projects forward.

It is now generally possible to close project financings in all of the GCC markets and, other than the enactment of PPP laws to facilitate growth in sectors other than electricity and water, it is really now a matter of making changes to improve the processes rather than a requirement for wholesale change. For example, in Saudi Arabia, although LLCs are now legally able to grant pledges, the registry in which they need to be recorded is not yet operational, so in practice banks will not finance projects unless the borrower is a joint stock company. There are numerous similar examples of this around the region and it is important that these refinements are completed and a stable state is achieved as soon as possible.

One significant recent trend is that of governments seeking to limit their exposure under government guarantees that are given on PPP projects and, in some instances, to avoid providing any such guarantees. The desire to reduce guarantee exposure is entirely understandable from the government perspective but, depending on the project fundamentals, may make it more difficult to raise funding or lead to an increase in financing costs.
Gulf Affairs: What are the current prospects for PPPs across the GCC? How has the regulatory landscape evolved to better accommodate this mode of financing?

DLA Piper: The PPP market across the GCC is busier now than it has perhaps ever been and there is a view amongst some market participants that it is in danger of overheating. Electricity (especially renewables) and water (both desalination and wastewater treatment) are by far the most active sectors, with major utility scale projects in procurement in every one of the GCC markets. Saudi Arabia alone is planning to procure 27 Giga Watts of renewable electricity over the next 5 years. Project developers are now having to look critically at the different markets to work out where they want to deploy the human and economic capital needed to tender and deliver these projects.

Although the use of PPPs has its roots in the regional governments’ need to identify alternative financing sources in the wake of the collapse of the oil price in 2014, it is being sustained by the growth of the renewables market and by photovoltaic solar projects in particular. As the price of solar power has reduced and the oil price has recovered, the solar resource rich countries of the GCC have reached the point where it makes economic sense to sell their oil and gas abroad while maximising the use of solar electricity in their home markets.

The economic and social reform agendas of the regional governments are also driving this trend with many regional PPPs now mandating high levels of local content (including workers and domestic inputs), encouraging tenders that will facilitate manufacturing in the local market and requiring that companies are subject to partial IPOs in the local markets once they are successfully operating.

We are also beginning to observe political risk issues feature more prominently for international investors supporting PPP projects in the Gulf region, where previously such considerations were muted in relation to other MENA countries. It is important that risks are fairly allocated and balanced in contractual arrangements to help protect the bankability and operational viability of projects (in particular where these are public utility projects) and to avoid a situation where the risk allocation in PPP contracts is not questioned over the lifetime of a concession.

Gulf Affairs: Which are the key institutions funding PPPs in the GCC?

DLA Piper: Smaller projects of up to $250 million (and perhaps higher in Saudi Arabia) are being financed by local banks (predominantly, in part or majority-owned by the state) lending in the local currency and this trend and deal value are increasing as liquidity improves in the local markets. The presence of these local banks strengthens the economic interest of the host governments in the commercial success and viability of these projects.

Larger deals are typically the preserve of a handful of European and Asian banks who are involved in the majority of deals in this market, often supporting multiple bidders: on one recent project with eight different developers bidding, the same group of four international banks (or some combination of them) supported all eight bids. On these deals, the local bank involvement is typically limited to the local currency tranche (if applicable) or the provision of equity bridge loans.
For major projects above $1 billion, it is common to see export credit agencies taking a central role, particularly those from Japan and Korea given the prevalence of major Engineering Procurement and Construction (EPC) contractors and equipment suppliers from those countries. Chinese EPC contractors and funders are beginning to play a larger role in the market.

The inclusion of a local state-owned bank, an IFI and/or an export credit agency in the composition of the lenders or investors consortium is generally helpful in mitigating political risks where they feature.

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Gulf Affairs: Why is Islamic finance so important in the GCC?

Khalid Howladar: Initially a niche market for orthodox Muslims, Islamic finance has become much more mainstream, now ranging from around 15-50% of total banking assets across the GCC. This is driven by strong retail interest for these products among consumers and the sector is growing faster than conventional banking. It is also a positive (and capitalist) expression of cultural identity.

Gulf Affairs: What role does Islamic finance play in economic development and diversification?

Howladar: Currently, most of Islamic finance actually replicates conventional, therefore its role is actually shared with that of a general regional move towards developing deeper and more sophisticated credit markets. These markets have a key role in helping to foster private sector growth and SMEs in a regional economy with an oversized public sector. Demand going forward is likely to be driven by several factors. Unusually compared to other sectors, drivers are both bottom-up (retail customer driven) and top-down (public policy driven).
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Gulf Affairs: What are the most important regional, national or global risks relevant to the sector?

Howladar: From a sector specific angle, Islamic Financial Institutions (IFIs) favor tangible assets, which in the GCC tends to be volatile real estate. As a result, they tended to have the worst asset quality metrics (and weaker than conventional). However, they are much better capitalized at around 14-15% of regulatory capital, higher than their conventional peers. On a global perspective, the Islamic interbank markets are fragmented and small, thus liquidity management is a more pronounced risk at IFIs.

Gulf Affairs: Tell us about the role your organization “Acreditus” plays in support of Islamic finance, GCC credit and associated trends.

Howladar: Since the onset of low/volatile oil prices and high deficits, many private sector corporations have looked to bonds and sukuk to break their correlated dependency on local bank funding. We at Acreditus provide strategic credit advisory to these firms, sometimes before they choose to seek formal credit ratings. In addition, we support investors and other stakeholders with independent regional risk assessments to help them better price their exposures and assess counterparties.

Gulf Affairs: You have spent time at a ratings agency and now run a credit analysis consultancy as well as supporting the next generation of experts? Could you talk about the positives and challenges of credit ratings? Is there a need for a different way of assessing credit and resilience?

Howladar: The credible and global benchmarking offered by the big three CRAs provides a valuable and credible second/third opinion to investors, but the cost structure is too high to apply beyond the larger issuances or to provide more timely credit risk assessments.

I think the use of AI and machine learning techniques involving big data is a massive threat to their business models. If a Google or IBM decide to move into this space it will prove massively disruptive and bring the market a much wider access to credit ratings that are probably more accurate and cheaper. They need to be careful they don’t go the way of Kodak.

Gulf Affairs: Some GCC countries have been considered overbanked. Do you agree?

Howladar: Absolutely. I would say Dubai is the most overbanked, but we are in the midst of an ongoing consolidation drive in the region. The external economic pressures, internal technology, regulatory and compliance pressures are too much for the smaller banks.

Gulf Affairs: Does this also apply to Islamic financial institutions or are they better poised to grow?

Howladar: There are definitely higher growth prospects for IFIs, but it is a marginal difference given the scale and confluence of pressures on the financial sector more generally. These include pressures on local property markets, lower liquidity and other macro trends.
Gulf Affairs: Being asset based, some Islamic finance instruments have been significantly exposed to regional and global real estate and commodity markets. Is this exposure a vulnerability?

**Howladar:** It is a bit of a misnomer as in substance, Islamic finance favors asset-backed and equity finance. ‘Asset-based’ is a misleading term that actually describes the unsecured bond-type instruments where the assets actual have no bearing on the risk/return profile. These instruments are anecdotally 95%+ of the market.

**Gulf Affairs:** Do Islamic financial instruments and investment options benefit from the increase in ESG screens?

**Howladar:** In theory, there is about a 95% overlap between ESG screening and Islamic finance, but one has to ensure that the principles are applied in substance and not just form for this premise to be valid. Governance in the sector should be improved.

**Gulf Affairs:** How does GCC Islamic finance vary from South East Asia, which has some of the longest running operations?

**Howladar:** Asia tends to be perceived as more liberal than the GCC, but in my mind when the final outcome replicates an identical credit product the distinction is arbitrary. Nonetheless this regional division (and divergence between some GCC countries) fractures the market and creates illiquidity.

_Khalid Howladar is the Managing Director and Founder of Acreditus, a Gulf focused credit, risk and Sukuk Advisory. He is also the Chief Strategy & Risk Officer for Blossom Finance, an Indonesian based startup focused on issuing digital Sukuk notes for social impact projects._
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The Financial Markets of the Arab Gulf:
Power, Politics and Money

Gulf Affairs: You’ve recently published a comprehensive book on financial markets across the GCC. What have been the main drivers of the GCC financial markets in the last few decades? What has changed most over the time period that the book covers?

Jean-François Seznec & Samer Mosis: The tempo of development in GCC financial markets over the last three decades, especially since 2000, has in many ways been exponential. It is important to remember that modern banking and finance in the region was largely nonexistent just 30 years ago. Since then, the early growth of some markets like in Bahrain stagnated, while other markets, such as those in Saudi Arabia, once resistant to change and modernization, rapidly expanded through the adoption of modern banking and financial practices. In fact, the region’s leading financial institutions, the likes of NBK, ADIA and SAMA, have developed in a manner in line with international standards. Of course, there is still a lot of room for further development, especially in the areas of regulatory alignment, privatization and financial transparency. Nonetheless, coming from zero, GCC countries have now developed sophisticated platforms for real estate, industrial activity and consumer finance, and are home to quickly growing stock markets.

The underlying attempt of the book is to evaluate how these markets have grown over the decades, what factors influenced the development of societies in the Gulf, and how the societies of the Gulf have, in return,
left their mark on the markets’ form and function. Looking towards the future, we detail how the state-led economic strategy which allowed for growth since the 1970s is now standing in the way of the next evolutionary step in the region’s financial market development.

**Gulf Affairs: What role do you see capital markets playing in economic development and diversification? Have GCC countries done a good enough job differentiating their capital markets from each other or are they destined to cannibalize each other?**

**Seznec & Mosis:** The banks and the stock markets have a great role to play in lending to the mid-size players, but they are yet to do enough to fully catalyze growth in this area. Indeed, this is where the main growth will take place for the financial players in the Gulf—essentially filling the space state-linked financial institutions have not been able to reach.

As discussed in our book, each of the GCC countries is trying to establish a credible market. Unfortunately, their markets are just too small to even think of competing at the regional level. Unless, as you mention, they can differentiate themselves from a large number of institutions. In fact, most likely, only the market with the largest base, Saudi Arabia, will truly thrive, while the others will merely exist.

**Gulf Affairs: You have spent a lot of time modelling potential capitalization strategies for Saudi Aramco. What do you think should be the next steps for the organization and the Saudi government? Do you still expect an IPO or do you think that the government will focus on debt issuance?**

**Seznec & Mosis:** Yes, glad you noticed! We thought it was important to put some numbers on paper regarding the IPO. We do still expect an eventual IPO, and the book discusses at length why it is a likely outcome. Saudi Aramco’s recent international debt issuance brought with it the release of extensive financial disclosures. In hindsight, our analysis of the potential value of Saudi Aramco at $2 trillion is very much supported by these disclosures. The purpose of an IPO would be to raise funds, and thus the merger with SABIC will delay any IPO for some time. Still, the more significant motivation behind the IPO is the attempt to make the economy more efficient, transparent and reactive. In this regard, delays in the IPO could rightly be seen as a byproduct of the difficulty that comes with this form of change.

If the IPO were never to happen, as many have speculated, it will overwhelmingly be because the country has been unable to progress through the aforementioned challenges. Listing requires transparency, and transparency brings with it additional scrutiny; scrutiny that has the tendency to disrupt sitting balances of power. The notion of transforming the economy from a lumbering state-controlled group of companies to a modern and efficient machine implies that the labor market will be liberalized, with hiring and firing easily arranged and regulations simplified or abandoned. These changes come with costs, and the current leadership is rethinking whether it is a good idea to incur these costs.

**Gulf Affairs: What challenges do you see for future capital market development?**

**Seznec & Mosis:** By far, it would be regulatory arbitrage. As we detailed in the book’s case studies, the Gulf region has seen repeated instances of unscrupulous business practices, abusing the overlapping or grey areas in regulatory jurisdictions across various financial markets. The events that transpired between Bahrain and Kuwait around Souk al Manakh, and then again a decade later between Bahrain and Saudi Arabia with the Gosaibi and al Sanea banking outfits all represent a form of arbitrage wherein weak
intrastate regulatory controls allowed the exploitation of financial markets. To say nothing of the countless investors affected, from a policy perspective the repeated instances of events like these highlight the inability, or unwillingness, of regulatory authorities in the region to establish stringent cross-border controls despite obvious signs and a history of malfeasance.

These issues are still a clear and present danger to the reputation, and thus growth, of regional markets. For the region’s markets to achieve their global aspirations, they must incorporate modern transparency and accountability norms. If for nothing else, these norms act as the cost to play in global markets.

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