The Rule of Regional Arab Banks in Promoting Arab Capital Markets

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Abstract

دور البنوك العربية الإقليمية فى تنشيط الأسواق المالية العربية

تتطلب المتغيرات التى تشهدها التسعينات النهوض بأسواق المال العربية، فى مواجهة طلب محلى متزايد على رأس المال، ومنافسة طلب المناطق الأخرى مع تراجع المتاح من البنوك الدولية، بينما يتزايد الإعتماد على قوى السوق وعلى القطاع الخاص بدلاً من التدخل الحكومى فى دفع قوى التنمية. ويرى الباحث أن على البنوك العربية أن تستأثر بنصيب كبير من هذه الأسواق، ثم يعدد عوامل النهوض بها. ويعدد الأساليب التى اتبعتها المؤسسة العربية المصرفية (ABC) والتى يمكن أن تسهم بها فى تنمية الأسواق المالية العربية. من جهة أخرى فرغم العوائق السياسية واللغوية، تتجه المؤسسات المالية نحو الإندماج العالمى. وبسبب خفض تكاليف الإقتراض عن طريق الأوراق المالية بدلاً من المصارف، زاد الإعتماد عليه بدرجة كبيرة، مما يتطلب وعياً أكبر بتلك الأوراق. ويلاحظ تراجع أهمية القروض المشتركة التى يعتمد عليها مقترضون من الدرجة الثانية، ويعدد الباحث عوامل تراجع الأنشطة المشتركة بين المصارف. وعلى البنوك العربية أن تعزز استراتيجية تواجدها فى السوق الإقليمية حتى لاتجد نفسها فى مواجهة منافسة البنوك العالمية. وانتهى الباحث إلى عدد من التوصيات التى يجب على المصارف والمؤسسات المالية الأخرى العربية تنفيذها فى مواجهة تحديات التسعينات، بعد أن نجحت فى اجتياز الصعوبات التى أثارتها أزمة الخلية، والتى أعقبتها.

(*) The late Dr. Nashashibi was then Senior Advisor, Arab Banking Corporation. This paper was received early 1992, and is being published in his memory.

In the wake of the post Gulf War era, Arab fund raisers are likely to experience a challenging period reflecting:

(1) The substantial demand for domestic capital

(2) The growing international competition for finance from **other** regions of the world.

(3) Reduced lending capacity of international banks to non-OECD countries and institutions.

All Arab countries are non-OECD risks with the exception of Saudi Arabia, and as borrowers require 100 % risk weighting according to BIS guidelines which come into effect end of 1992.

In the light of these development it has become most essential for Arab financial institutions, to strengthen local capital markets in order that they can attract efficiently, expeditiously and competitively local and foreign savings and also repatriate private sector foreign assets. This will be achieved primarily through offering a broad range of asset classes and products-equity, debt or hybrid financial instruments, including Islamic instruments.

In talking about equity finance it will be most appropriate to talk a little bit about the so called "emerging stock markets" in other parts of the world. The remarkable growth of emerging stock markets in the develop-ing world recently has to be seen **in the context of a wider change** - a general change **away** from **government control and direction to** policies that allow the forces of the market to work and that encourage the private sector to be a driving force of economic growth. A move to market-based economy must involve the **financial sector at an early stage**. Market forces cannot determine the price and volume of output properly if one of the most crucial factors of production - capital- is priced artificially and arbitrarily. Free market-driven financial markets are essential to determine the price of capital realistically on the basis of return expectation of inves-tors and to ensure that such capital is used efficiently. **Competitive fina-ncial markets** transmit efficiency to the real sectors of the economy; **con-trolled markets** spread inefficiency

Stock markets play a critical role in the process, as a source of equity finance **as well as** a pricing mechanism. Economic growth requires that new and growing companies expand their capital bases. Many are initially closely held firms, often family owned, which need to open up if they are to grow. A large, liquid stock market facilitates the process, giving the owners a chance to realize capital gains and new investors a chance to share in future growth and profitability.

The new importance of stock markets for developing economies can be seen by looking at the decade of 1980s when the total capitalization of the 20 largest markets increased seven fold and the number of listed companies doubled. More remarkable, the value traded on these exchanges by 1991 had increased to (40) times the level of 1980. As a percentage of GDP, capitalization increased from 6 % to 32 % at the end of the decade. This ratio is 90 % in the U.K., 105 % in the U.S. and 120 % in Japan. I doubt if this ratio is over 5 % in the Arab countries as a whole. Regional capital market-places have a lot of catching-up to do.

Looking into the 1990s more changes are underway that will continue to transform emerging capital markets, including Arab markets.

First: Privatization by itself will increase the size and liquidity of many emerging markets. **Such programs could form the core stock markets that have begun operating only recently or do not yet exist.**

Second: The opening of economies to market forces will lead closely held companies to raise capital from beyond their traditional family owners. Open markets lead to competition, forcing investments in new facilities and in mergers and acquisitions at home and abroad.

Third: The pace of initiatives to improve the environment for foreign portfolio investment will accelerate in 1990s. This obviously calls for relaxing among emerging and developed markets will be reinforced. Companies in developing countries are raising funds not just in their national markets but in foreign markets as well. The search for new sources of finance has led companies in developing countries to issue securities through private and public listings on the major developed markets. Such a trend will undoubtedly rise significantly in the 1990s.

Fourth: Emerging markets are rapidly gaining in sophistication. Numerous markets, including Arab markets, are in the process of implementing more effective regulatory environment, better information and disclosure systems, advanced trading systems and centralized streamlined clearing and settlement procedures.

Fifth: Emerging markets, like all stock markets, they go up and down, sometimes with dramatic speed. Over the long-run, however, they will provide substantial benefits to local economies and to foreign investors. But only recently have many of them begun to demonstrate their potential. The 1990s will see them play an increasing role as a tool for economic growth.

Sixth: To put the emerging world stock markets in their proper perspective I would like to leave with you the **Following piece of statistics**:

Each year the rich world's savers invest something like $1 trillion of **new** money in equities. Together the emerging stock markets represent 5 % of world stock market capitalization. As the **bench mark** for global portfolio managers is to allocate money according to capitalization of world stock markets, this would imply an **annual transfer** of **$ 50** billion to these emerging market-places. If world saving institutions **also** begin to shift **existing** funds to reflect that proportion perhaps the **transfer** could be even bigger, amounting to **$ 100 billion**. That would dwarf the **$ 14 billion** that these emerging countries received in 1990 by way of direct investment, and **even more than match** the annual **$ 80 billion** or so the international banks were lending to these countries on the eve of the debt crisis in 1982.

How could Arab banking promote a regional market-place ?

In addition to being important conventional lender to governments and corporate entities, Arab banks should consider the emerging capital markets in the region as an important niche for themselves. These markets though currently underdeveloped, are gradually building up and also integrating, offering profitable opportunities for creative investment banking and capital market activities. The recent declared objective of governments to retreat from a direct centralized role in some productive and service activities has resulted in greater reliance on market forces as engines for growth. This drive towards liberalizing Arab market-places and privatizing enterprises will assist in the reduction of the budgetary deficits of Arab countries, encourage the mobilization of private savings and complement other market-oriented reforms that have been introduced. As a result of structural, as well as policy changes, responsibility for economic growth within the Arab region will become, in time, more evenly distributed between the private and public sectors. In this regard, financial development stands at the very center of increasing the productive capacity and economic growth. I always to refer to this overall process as "financialisation" of the Arab economy.

It involves liberalizing interest rates policies, relaxing restrictions on foreign ownerships and exchange control, changing investment habits, stepping up financial sophistication, updating capital markets and expanding the supply of financial services and their efficient pricing. In fact, the improved overall efficiencies of Arab capital market-places, financial institutions, legislation's and instruments in both primary activities, as well as secondary trading, are among the more appropriate responses to the challenges of the 1990s for the Arab countries.

Throughout the last ten years Arab Banking Corporation (ABC), as the largest capitalized regional banking institution, has contributed to the development of Arab capital markets **in many ways**, particularly by being an issuer itself of many fixed and floating-rate international bond issues denominated in many currencies, and more importantly a major international share offering in June 1990 which was an unprecedented event in the history of Arab capital formation. It represented the first time that one of Arab enterprises had managed to increase its capital ($ 350 million) through a public share issue launched simultaneously in both Arab and international markets. For the first time also international investors, institutions and individuals alike, were seen to participate in an offering of new shares in an established Arab company. the shares have been listed in Paris bourse and Bahrain simultaneously and ABC Securities W.L.L. has been set-up to do brokerage business in ABC shares and others listed on the Bahrain stock market. Other ways in which ABC can contribute to the development of Arab capital markets are:

(1) Invest directly in the local financial services industry - ABC has the required capital resources to achieve this objective.

(2) Place its **international experience** at the service of the banking and fiancial industry in the Arab world.

(3) Use its international network to support this Arab industry.

(4) Upgrade the overall local business practices and efficiencies in this industry to international standards, such as credit rating disclosure requirements, etc.

Global integration of finance is a force nowadays for revolutionary change in the market structure exemplified by the great increase of banks and other financial institutions outside their home markets. Politics and language may still separate countries, but the financial markets are doing their best to fuse national markets into one system.

Thanks to the cost savings and liquidity benefits of securitisation, borrowers have drastically cut their reliance on bank financing. In the international credit markets, securitised lending now accounts for the bulk of gross new credit arranged yearly. All market participants nowadays, therefore, have to adjust not only to thinking globally but also to becoming "security conscious".

Latest statistics produced by the Organization for Economic Co-operation and Development highlight the continued strong growth of the international securities market, particularly Eurobonds. The annual total is expected to reach $ 400 billion by end of 1991. The syndicated credits market, on other hand, continues to show signs of sluggishness and the annual total is **not** projected to go above $ 100 billion. The dichotomy between the strong performance of the securities market and the depressed state of the syndicated loans market will continue unless an improving financial environment encourages banks to resume lending to second-tier borrowers, which is not likely to happen. Among the factors which adversely affected the syndicated loans market were poor economic conditions, the contraction in merger and acquisition transactions, the cautious approach to lending adopted by many banks and the stricter capital adequacy requirements imposed by banking regulators everywhere. A recent study by Euromoney also indicates that in the two years, 1991 and 1992, the estimated volume of Eurobonds maturing will reach $ 360 billion. As these are normally refinanced in the same market, they will represent a further major **addition** to the volume projected of Eurobond new issues activity in the forthcoming period.

Another important factor, that contributed to the poor performance of the syndicated loans market relative to securities market is the squeeze in the interbank loans market. Such a squeeze could both increase the vulnerability of smaller banks and in the longer term reduce the capacity of the Eurobanking system to provide credits to outside customers. It was the Bank For International Settlements which noted a marked deceleration in lending between banks during the Autumn of last year. This year the situation has become markedly worse. The Bank of England in its latest quarterly bulletin pointed to an 'unprecedented contraction" in cross-border interbank business during the first quarter of this year. Second quarter figures are likely to show further contraction. The interbank credit squeeze is more than just a technical problem for banks. A squeeze in interbank loans is restricting banks' capacity to Euroloans extension to corporate and sovereign sectors. Furthermore, strains in interbank relationships is leading to the **eventual narrowing of the intermediation capacity of the international banking market**. It appears also, that the slow-down in interbank lending and the credit crunch facing companies are directly related. Two main causes are cited by bankers leading to the contraction in interbank activity:

(1) Banks' desire to shrink assets to maintain capital adequacy ratios and to free capital for other purposes. Banks looking to shrink their assets quickly can do so by cutting overnight interbank lending.

(2) The declining credit quality of some banks against a background of loan losses.

Finally, the interbank market's **potential** for transmitting **destabilising influences** across the entire Euroloans market **should not be underestimated**.

In addition to being global in outlook and "security conscious", Arab banks have an advantage in pursuing a regional niche strategy. In the years ahead, Arab banking industry has to adopt effective and expeditious financial regional niche strategies or else see global banking developments overtaking the region. Arab banking has a lot of weight to add to the determined Arab efforts to strengthen institutions, instruments and legislative financial infrastructures.

Now, that the dust has settled in the Gulf, Arab banks have successfully weathered several major crises during the last few years, the decline of oil revenues, heavy provisioning for non-performing loans, the

1990 military confrontation and most recently the BCCI scandal. These crises took their toll on Arab banks' profitability. But overall banks in the region have coped well with the crises and particularly the turmoil which followed Iraq's invasion of Kuwait. Not only did some Arab banks suffer huge losses, inability to operate and loss of confidence, but also acute funding problems. Some of them, however, have restored their funding deposit base to pre-crisis levels, and have even emerged healthier, both financially and administratively. In the 1990s Arab banks along with other Arab financial institutions have numerous challenges ahead. **Among them are the following**:

(1) Assist in the integration of the region's financial services industry. So far Arab banking cannot be categorized as a single entity but rather as a series of a parallel bank markets which spring from a similar environment but have differing characteristics and priorities. In this drive to integration the Arab central banking and monetary authorities have a big role to play.

(2) Confirm to the new capital adequacy standards according to the Basle Accord. This is important for Arab banks engaged in international finance. As to the purely domestic Arab banks there is the vital need to become more capitalized and to complement that with extending the maturity of their deposit base by issuing longer term paper, including certificates of deposit.

(3) Integrate into the domestic economies and make available to the regional development endeavours, longer-term credit and a wider spectrum of finance, ranging from venture capital, equity finance, fixed and floating rate debt resources in international, as well as, in Arab currencies.

(4) Cooperate closely with the development institutions of the region in a variety of ways such as co-financing.

(5) Contribute to enhancing the spread and depth of the region's emerging **government debt markets**.

(6) Expand their roles in securities underwriting and off-balances sheet businesses. This means a gradual shift from spread lending credit risk focus, to fee based market related risk focus.

(7) Contribute to the strengthening of Islamic banking as a complement to traditional banking

(8) In addition to enhancing capital and sources of revenues as pointed out, there is the need for Arab banks to become more cost-efficient and competitive, either through internal restructuring or through mergers.

(9) To adapt to a constantly changing world-wide banking industry. This is reflected among other things in keeping up-to-date their **information technology** and attracting skillful personnel. The banking industry, after all, is basically a " people's industry", where the capital goes home at the end of the working day.

In concluding, the time has come for Arab banks to become major participants in their own emerging capital markets. In doing so they will act as vital catalysts to economic growth by contributing to a healthier Arab finance and banking industry.