

I am grateful for this opportunity to address this 31<sup>st</sup> Inter Arab Cambist Association Congress. I would like to offer some remarks on the capital markets situation in the GCC; in particular as it relates to corporate funding: what role can we hope that capital markets will play in meeting the financing needs of the GCC? I had the honour of speaking on a similar theme at the 29<sup>th</sup> ICA Congress two years ago which took place in Beirut and coincided with the ACI World Congress. I believe that some of my remarks then are just as relevant today.

First, that the GCC needs to nurture its domestic bond and equity markets to encourage the more efficient deployment of domestic and regional liquidity, and perhaps even encourage the repatriations of funds held outside the region. Capital market development will assist the process of capital formation by channelling savings into a broader range of instruments leading to a process of financial deepening.

Second, that there is potential for the region's local bond and equity markets to be less divergent and become more convergent in terms of market practices, legal documentation and clearing and settlement. The key building blocks for efficient domestic bond markets will be government sponsorship, expanded issuer and investor bases and an improved regulatory framework.

And third that a key success factor is healthy co-operation between government regulators and the region's market participants; the point being that exchanges can be opened and regulatory regimes established but it is market participants that breathe life into the process.

Since that 29<sup>th</sup> ICA Congress a great deal of interest has been aroused by the success of the Asian model in terms of capital market development.

The growth of Asian bond markets since the late 1990s Asian financial crisis has been by any measure a notable development in global capital market terms. We can now see with the benefit of hindsight that the scale of portfolio capital flow reversal that triggered the Asian financial crisis was in fact small compared with the amount of domestic savings in the crisis affected countries. Quite correctly Asia's policy makers have grasped that if these savings had been channelled into well functioning domestic capital markets, Asia's vulnerability to another financial crisis would have been reduced. Asia's local currency bond markets have since shown a dramatic growth in the annual volume of issuance; in every country except Indonesia the local currency bond market has grown in relation to GDP. In the case of Malaysia the local currency bond market has grown from 56% of GDP to 95% of GDP since the crisis.

If you look also at the corporate component of bond issuance, you find that it has grown in most Asian countries. In Hong Kong over three quarters of the market consists of corporate bonds. We all know that this is important because, no less than is the case in this region, banks are in the long run a less than perfect source of financing for long term large scale infrastructure investment. Since Asian governments recognised that corporate bonds will generally price off a government yield curve, the most far thinking governments in Asia issued their own bonds even if they lacked a strong fiscal incentive to borrow. In a country such as Thailand, leading corporation's tap the local bond market for all their funding needs. The level of new foreign currency borrowing has dried up completely, with a number of companies eliminating their overseas borrowing entirely.

I am old enough to remember the time when we had a dynamic KD bond market here in Kuwait in the 1970s and 1980s attracting a broad range of international issuers. In the current situation it is hard to see local currency bond markets in this region develop with the same vigour as in Asia. Obviously both regions are generating massive current account surpluses but the similarities largely end there. Asian capital market development has been driven by a unique situation where a pre-crisis pattern of budget surpluses and current account deficits has been replaced by a pattern of budget deficits and current account surpluses. Investor interest has been stimulated by attractive interest rate levels in real terms. The GCC interest rate situation is radically different.

The de facto link of each GCC currency to the US dollar anchors monetary policy. As there are no restrictions on capital movements, this requires GCC domestic interest rates to follow closely corresponding rates in the United States. Due to this region's abundant liquidity we now have a negative differential between GCC and US rates. Although the negative differential is not large it acts as a further dampener on local market development. But I would like to return to that later after a quick overview of the current situation in the GCC.

In general I would like to give more attention to the regional bond market situation than to the equity market. Why are bond markets more difficult to develop than equity markets? Successful bond markets need to combine a large number of different ingredients. An equity market can survive with a limited amount of new capital raising or trading taking place. By definition bonds mature and need to be replaced with new issues. Bond markets need quality issues because investors will not buy bonds unless they are satisfied with the issuer's credit standing.

So what are the main characteristics of today's GCC equity and debt markets? And what are the key issues and opportunities?

As this audience knows better than I, the GCC equity markets have been bolstered by high regional liquidity, low interest rates, a deep pipeline of new issuers and an absence of investment alternatives. A growing volume of institutionally managed money, perhaps most noticeably in Saudi Arabia, has contributed to upward pressure on equity prices. Upward credit re-ratings at the sovereign level have also encouraged more international bond issuance by GCC borrowers. This re-rating process reflects improved economic fundamentals and conservative fiscal policies which have produced burgeoning budget surpluses, most dramatically of all here in Kuwait. Middle Eastern borrowers are increasingly turning to the debt capital markets for liquidity and funding purposes. But it is financial institutions, not corporate borrowers, that are the most frequent issuers. The region's investment requirements are well known with project spending running at level of US\$150 billion per annum. A renewed focus on economic diversification has translated into an impressive programme of capacity additions in the downstream oil and gas sector and in infrastructure investment. The demand for capital is set to accelerate, bringing into focus the role of the capital market in catering to their demand.

I will argue that the commonality in economic structure and ambition, together with a need to broaden the range of local currency products, all argue for a unified GCC capital market.

We can see that bank credit remains the dominant source of funding for the region's economies. The regions credit to GDP ratio increased to 50.9% in 2004 from 36% in 2000 reflecting the larger intermediation role that banks are playing in the regions economies. Abundant liquidity and low interest rates are driving a particularly rapid increase in aggregate private sector credit, both corporate and personal.

The buoyancy of the region's equity markets is well know and requires no further elaboration by me. At the end of September the combined market capitalisation of the six GCC markets amounted to US\$814 billion with Saudi Arabia firmly established as the world's largest emerging market stock market. The level of average daily turnover in the GCC has doubled to US\$4billion, the bulk of that daily turnover being accounted for by the Saudi market.

Expressed another way the market capitalisation of the region's stock markets has enjoyed a staggering compound annual growth rate of 71% per annum over the past five years. Saudi Arabia again is the dominant factor in this equation with a 57% share of the total GCC market capitalisation.

GCC market indices have seen particularly significant gains over the past two years; with the most notable gains being seen in the UAE followed by Qatar and Saudi Arabia. These gains reflect the fact that the region has been enjoying a broad expansionary phase, but liquidity levels have also made a significant contribution to index movements. The region is clearly awash with liquidity. Because capital account data is opaque, it is hard to get a clear picture of the GCC's capacity to accumulate foreign assets above and beyond the current account surplus. The IIF in Washington estimates that the GCC countries accumulated foreign assets of US\$113 billion in 2004. More dramatic, the IIF estimates that accretions to the GCC's stock of foreign assets will top US\$360 billion in 2005 and 2006, a more rapid increase than that of China.

Firms throughout the GCC have exploited the demand for shares by raising capital through equity markets. IPO issues have picked up sharply with US\$9.9 billion raised since 2001; with a particularly sharp pick up over the past three years. The UAE has seen the largest number of IPOs (14 out of 38) coming to market 2001. But in terms of volume Saudi Arabia captured the largest share with US\$4.6 billion raised during the period. Nearly all issues have been significantly oversubscribed, with Abu Dhabi based Aabar Petrochemicals and Aldar Properties being the highest at 800 and 448 times respectively.

Activity has remained high in 2005. My next slide shows some of the largest offerings in the region since 2002. I might mention in passing that the offerings for Industries Qatar in 2003 and Al Marai and Dana Gas in 2005 were all led by HSBC or by our Saudi affiliate, Saudi British Bank. In terms of the forward calendar the largest single issue is likely to be for Showtime Arabia from Kuwait raising of the order of US\$1 billion.

Let me turn to the GCC debt market. The aggregate external debt of the GCC rose to US\$87.7 billion at the end of 2004. This was the result of increased borrowing from public and private sector corporates, mainly through syndicated loans for project financings but increasingly through the issuance of international bonds. HSBC estimates that the total volume of international loan and bond issuance over the last decade will be approximately US\$169 billion by the end of 2005.

My next slide shows that international syndicated loan issuance is well spread across the GCC with the largest share accounted for by Saudi Arabia at 31% of total loan borrowing. Consistent with that, 80% of loan borrowing is accounted for by corporate borrowers with government borrowing at a modest 6%.

The picture is somewhat different in the case of international bond issuance. Here we see a more important contribution from the UAE at 27% and from Bahrain at 20%. This largely reflects the growing volume of bond issuance by financial institutions. You can see that financial institutions at 39% account for the largest single percentage of bond issuance. They are by far the most frequent GCC issuers of international bonds. Floating rate notes have been the preferred form of issuance.

The region's banks are particularly keen to tap the bond market in order to secure funds that come closer to matching the longer terms of their lending. But the outlook for corporate bonds is also improving, particularly as the region's corporate borrowers secure debt ratings. Emirates Airlines recently became the first GCC corporate issuer to issue an unsecured international bond.

My next slide highlights some of the main international bond issues from the GCC in 2005. It is worth highlighting the two Ras Gas bond issues not only on account of their size, totalling more than US\$2 billion, but also the long maturities at 15 and 22 years. Both issues were very well received by US Institutional investors.

No discussion of the GCC bond market would be complete without a reference to the Sukuk market. The Islamic capital market is reaching a scale and depth that should command the attention of the regions borrowers. As the market deepens, Islamic finance sources are offering both longer terms and more competitive pricing. Sukuks are naturally targeted at specialist Islamic investors but, in the case of the larger issues, are also finding interest among conventional accounts. HSBC led both of the largest Sukuk issues shown on this slide, from the Islamic Development Bank and Emirates Airlines. Issuers such as these are attracted by pricing in line with conventional bond issuance and the opportunity to tap a new source of funding. With in the project finance sphere, we are also seeing an increase role for Sukuks as part of multi-tranche financing packages.

Let me return to the issues and opportunities facing the GCC capital market. The demand for capital has accelerated in the past four years and will continue to grow for the foreseeable future. This is reflected in the growth of total outstanding bank credit which has grown at a compound rate of 17.9% to a total level of US\$225 billion at the end of 2004. As I have already shown international bond issuance has also increased over the past three years and the number of IPOs has increased significantly in the past 18-24 months. But the demand for capital is set to gather further pace driven by a number of factors. First, project finance, both to infrastructure and both oil and non-oil sector related investment. Second the area of personal lending where favourable demographics point towards significant volume of untapped demand for retail finance. With most GCC states now allowing non-nationals to buy property, the demand for housing finance is also on the rise.

A last unknown is the potential for project re-financing; project sponsors may be tempted to take advantage of the low interest rate environments to refinance projects where construction risks have been removed. In addition many of these refinancings could also be candidates for debt capital markets because of the long term cash flows associated with them.

A major issue that will be in the mind of regional bank executives, and in the mind of their regulators, is whether the GCC banks will be able to cater to this burgeoning demand for capital. What are the bank's major concerns? First the area of asset liability mismatch. Regulatory attention in GCC countries is causing the region's banks to take a closer look at their widening asset liability mismatch issues. In 2002 the Central Bank of Oman became the first to issue explicit guidelines in this area.

Going forward we also suspect that the region's banks may be pushed to their leverage and single party exposure limits in attempting to meet the region's funding demands. Saudi banks already require SAMA permission to invest outside the Kingdom; and Omani banks cannot invest more than 30% of their equity outside the country.

The region's banks are operating at relatively high levels of leverage. GCC banking systems are averaging around the 80% mark with respect to their loan-to-deposit ratios. In respect to this the Kuwaiti central bank introduced its own measures in June 2004, the most significant of which was an 80% ceiling on banks loan-to-deposit ratio to be achieved by July 2005. Other countries have specifically targeted limits on lending for stock market IPOs. Pressure will remain on banks to secure long term funding from capital markets to cater to the rising demand. So what is the bottom line? It is that the region's capital market will have to play a bigger role in funding the region's borrowing needs. This will take the indirect form of providing capital to the region's banks; or, and this would be preferable, the more direct form whereby the region's project sponsors tap the capital markets directly.

As I indicated at the start I do believe that the GCC can draw some useful lessons from the steps taken in capital market development that we have seen in the Asian region.

I suggest that bond market development in order to seek access of longer term funds should be a target of initiatives by the GCC governments and by multilateral agencies with an interest in this region. The most far thinking governments in Asia have developed such markets even if they lacked a strong fiscal incentive to do so. The pioneer was Hong Kong which established its Exchange Fund Note programme at a time that it was in fiscal surplus. The Singapore government is issuing 10 – 15 year bonds in order to create a benchmark for bank and corporate issuance. If Kuwait is to energise its local bond market, a wider range of sovereign debt instruments in a broad range of maturities would be highly beneficial. Many Asian countries have also established primary dealer systems because they have recognised the value of engagement with banks and securities firms; creating a capital markets culture which fosters a range of committed participants.

Asian governments have also been open to securing technical assistance from a variety of sources in both the official and private sectors. A number of Asian countries have established local rating agencies to provide a boost to the local corporate bond market. Technical assistance has been readily available from the World Bank and the International Finance Corporation. The IFC, the World Bank and the Asian Development Bank are all making great efforts to issue bonds in the region's local bond markets and to provide guarantees for private sector issuers in those markets.

Something that is also highly impressive in the Asian context has been the level of co-operation and information sharing within the region. One example is Asian BondOnline: this is a website launched by the Asian Development Bank and several Asian countries which offers information on market infrastructures, rules and regulations, data and market commentary. Another example of regional co-operation is the initiative of eleven central banks to establish an Asian Bond Fund: ABF2 is a US\$2 billion fund for investment exclusively in Asian local currency bonds. The central banks expect to open up the fund to private sector investors. This process will require the central banks to work together to identify and eliminate any regulatory or tax obstacles to such private sector investment.

In a number of Asian countries, just as in the GCC, the local bond market is still not sufficiently developed to allow the issuance of long term bonds. Recognising this market gap, the Asian Development Bank is seeking to develop an innovative local currency swap mechanism. The initiative involves the ADB undertaking a fixed rate local currency swap with an individual Asian central bank, and using the local currency proceeds to provide long term lending to private sector financial intermediaries for on-lending to local borrowers. The ADB secures long term local currency funding in a maturity that it would not otherwise be able to access and passes the benefit to local borrowers which may be a local company or the subsidiary of a multinational corporation. The ADB's ability to negotiate the fixed rate is assisted by the growing appetite of investors for long term local currency risk. To an increasing degree international investors are willing to take a risk on local interest rates rather than buy debt issued by a developing economy in US dollars. This makes them a natural counterparty to the ADB either directly or acting through the local government. Could this swap mechanism be adapted to the GCC context? If so it could certainly play an important role in financing infrastructure investment where project revenues are denominated in local currency. IMF research shows that the knowledge that finance can be raised locally as a long term basis is a key spur for foreign direct involvement.

I would like to conclude by making the case for a regional capital market for the GCC countries. I indicated previously how the real interest rate environment has been less conducive to local market development in the GCC than in Asia. This interest rate derives directly from the region's linkage with the US dollar. And it is precisely this currency linkage that provides the GCC with an opportunity for the type of regional market development that is unlikely to occur in the Asian region for a very long time. Unlike in Asia closer economic integration has been a leading goal of the GCC since it was formed in 1981. The next planned step is the introduction of a common currency in 2010. The region's central bank governments have announced five convergence criteria, including interest rate levels, which are loosely based around those set at Maastricht for the convergence of European economies prior to the introduction of the Euro.

In the run-up to a single GCC currency there are practical steps that can be taken today to boost the prospects for a genuine regional capital market. These practical steps could include initiatives to achieve convergence towards a uniform regulatory framework. Over time a convergence of rules, regulations, terms and conditions should emerge throughout the different facets of the regional capital markets. An important aim should be to identify where obstacles exist and how best standards and practices can be harmonised to facilitate cross-border financial transactions within the region. Possibilities could include a regional rating agency and a regional settlement and payments system. The objective would be to leverage off the existing infrastructure within each GCC country and create a network of bilateral links between jurisdictions.

In each GCC country the capital market needs to be brought under the umbrella of a single centralised regulatory body. In the case of Kuwait, this single entity could absorb the regulatory activities of the Kuwait Stock Exchange together with the regulatory oversight of the Central Bank and the Ministry of Commerce and Industry. An obvious example of this is the recently established Saudi Capital Markets Authority. A single regulatory body would encourage the streamlining of rules for filing, securities registration, disclosure and transparency in each GCC country.

There is little doubt that a unified GCC capital market would boost cross border capital flows. This in turn will broaden product and investment options for the region's liquidity while ensuring more efficient allocation of the region's capital. Work might start today on identifying impediments to product development within Asia, a specific regional initiative is underway in the sphere of securitisation with the aim of addressing structural impediments in that market; and removing those impediments through specific action plans in each country. In the absence of benchmark government bonds the case is even stronger for GCC policy makers to encourage the issuance of relatively risk free securities such as mortgage backed bonds. The broadening of the range of local currency products will promote regional savings and investment. Equally important it will reduce the probability of potentially dangerous asset price inflation in individual GCC member countries.

The private sector also has a role to play by encouraging the harmonisation of market practice. A common characteristic of mature capital markets is how private trade association initiatives grow up alongside and compliment formal government regulatory structures. I served as Chairman for five years of the International Primary Market Association, which was set up in 1984 to bring some consistency to the new issue process in the multicurrency Eurobond market. The harmonisation and standardisation of market practices under IPMA's leadership contributed greatly to the success of the Eurobond market. We recently merged with the International Securities Market Association to form the International Capital Market Association which has a number of member firms from this region. I believe that there is an excellent case for the major banks and securities firms within the GCC to combine forces in a new trade association either on a "*de novo*" basis or under the wings of the International Capital Market Association.