Box 1. Regulation and Supervision of Islamic Banks

The growing size of Islamic finance raises the important issue of how best to regulate and supervise Islamic banks.[1] In general, depositors in such banks share in the risk of the investment that their deposit is financing; neither the deposit's principal nor its return is guaranteed. This mode of operation suggests that Islamic banks need close supervision and regulation.

Islamic banks are subject to the same risks facing conventional banks (adverse shocks; mismanagement; etc.). These risks have effect on solvency and profitability and could have a systemic impact on the economy.

Since Islamic banks are under no legal requirement to safeguard the depositors' base, they have no incentive to hold collaterals. This suggests that such banks can be more risk-prone than conventional banks.

Islamic banking operations involve complex modes of financing, which are accentuated by shortages of relevant skills, and the absence of uniform accounting and tax standards.

Most "best practices" developed by the Basle Committee are broadly appropriate for regulating and supervising Islamic banks. In addition, such banks could conceivably be subject to lower liquidity requirements than conventional banks. However, there are three areas where stricter rules may be required.

Islamic banks' incentive to engage in risky activities and the absence of an incentive to use the "security buffer" of a collateral suggest the need for higher risk-weighted capital asset requirements.

Stricter information disclosure requirements and close monitoring are also important since deposits are not protected and depositors tend to allocate funds across banks according to their risk preferences.

Islamic banks face a strong "investment risk" since projects are the main source of return for depositors and given banks' reduced use of collateral. Regulators need to ensure that banks have adequate capabilities for project evaluation, appraisal, selection, auditing, and monitoring.

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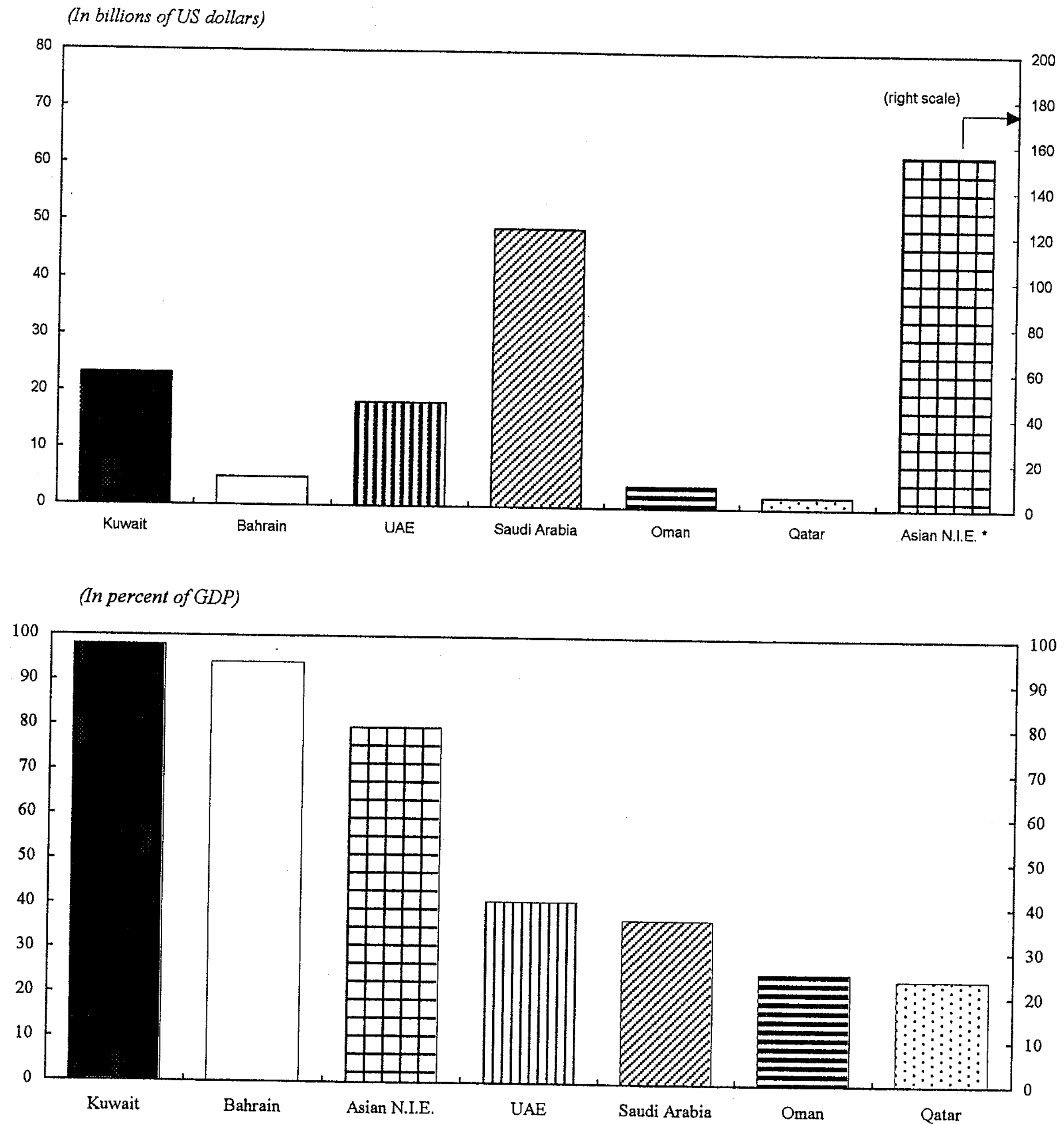
[1]This box draws on Errico (forthcoming).

Chart 5. GCC Countries: Equity Market Capitalization (1996)



Sources: Data provided by the authorities; International Finance Corporation, "Emerging Markets Factbook;" and *Middle East Economic Digest*.

* Newly industrialized economies of South East Asia.

Box 2. The Main GCC Equity Markets

Bahrain. Capitalization in the Bahraini Stock Exchange amounts to 100 percent of GDP; however, the number of traded companies stands at only 37. Limited trading in the market by non-Bahrainis is sanctioned (especially GCC residents and by non-Bahraini residents in Bahrain).

Kuwait. The Kuwait Stock Exchange (KSE) has existed since the early 1970s. Its capitalization amounts to slightly above 80 percent of GDP with 66 companies traded; bonds are also traded on the market, but in low volumes. The volume of trading at the KSE is twice as large as in other GCC countries taken together, but is second to Saudi Arabia in terms of capitalization. In 1996 and early 1997, activity on the KSE expanded, as large shares of government enterprises were sold to the private sector. About 60 percent of transactions are executed by institutional investors. The KSE is supervised by the Stock Exchange Commission consisting of 11 members appointed by the Ministry of Commerce, the Kuwait Investment Authority, the Central Bank of Kuwait, and the chamber of commerce. To facilitate transactions and encourage participation of foreigners, the KSE has established two international clearing schemes (Kuwait-Egypt-Lebanon and Kuwait-Bahrain-Oman).

Oman. The Muscat Securities Market (MSM) was established in 1989. Its capitalization in 1996 stood at 172 percent of GDP with nearly 100 companies traded. The removal of restrictions to GCC investment in 1992 contributed importantly to the increase in capitalization of the MSM. Recently, Omani companies were allowed to take in foreign investors without jeopardizing their tax status.

Saudi Arabia. Saudi Arabia's equity market is over the counter (OTC) where commercial banks have been granted the exclusive right to trade for their clients. At end-1996, total capitalization was about US$40 billion—a level larger than all of the Arab stock markets put together—although only 70 companies are traded. There is a large concentration of holding of shares and of market capitalization, with the 10 largest companies accounting for 60 percent of total capitalization in 1993 compared to 15–20 percent in developed economies and 30 percent in emerging markets. While GCC nationals can trade in the Saudi equity market, restrictions apply to foreign (non-GCC) participation. However, non-GCC residents can invest in the stock market through mutual funds. In March 1997, the Saudi American Bank launched the Saudi Arabian Investment Fund (SAIF), a closed-end fund that is listed on the London Stock Exchange and is open to institutional investors.

Arab world in terms of volume of trading. Stock exchanges in Oman, Qatar, and the United Arab Emirates are relatively new. In general, the GCC stock markets are well capitalized with ratios to GDP (1996) ranging between a high of 98 percent in Kuwait and a low of about 24 percent in Qatar. However, both the number of traded companies and the turnover ratios are considered low compared with stock markets in industrial countries and in rapid growing emerging markets. The number of listed companies is also relatively low.

The region's equity markets face a number of important constraints: there is a lack of brokers and market makers; foreign access to the markets is generally restricted to GCC nationals; a number of large corporations remain under government control; and there is a general weakness in transparency requirements and the provision of information. Also, private shareholders have been reluctant to move away from traditional bank financing and open their companies' capital to new investors. These issues are discussed in Section IV.

III. Main Challenges Facing the GCC Financial Markets

A key challenge facing the financial sector in the GCC countries is to respond to the new demands arising from the strengthening of the role of the private sector and the governments' gradual disengagement from economic activity. Fiscal retrenchment is likely to continue for the foreseeable future, and the private sector is expected to be the main engine of growth. Under this scenario, large investment projects in the petrochemical industry, in ports, power generation, airline transportation, utilities, and health care will have to be carried out with private sector participation and financing. External borrowing may be an option, as is currently the case for a number of large gas-related projects in Qatar, but there are obvious limitations to this policy, including mainly the reluctance of governments in the region to accumulate external liabilities. Therefore, there will be strong incentives to mobilize resources from the domestic market (including through the issuance of long-term financial and corporate paper) and to encourage foreign direct investment. In any case, domestic financial intermediaries will be under pressure to compete for this large and lucrative business, or run the risk of being marginalized.

It is clear that for GCC financial institutions to play an important role in this changing environment, they would have to strengthen further their deposit base and increase their capital to absorb the risk emanating from financing megaprojects. This, in turn, may lead to mergers among banks or associations with regional or international banks. More important, financial markets would have to gain depth and sophistication both at the national and regional levels to allow for the mobilization of large financing packages at competitive conditions. This can be achieved through concerted efforts to increase the volume and attractiveness of corporate bonds and government paper, encourage equity investment by pension funds and by small savers through mutual funds, and make further headway in reforming stock markets. In all these areas, efforts should focus on establishing a regional financial market in which saving and investment flows can be pulled together under homogenous and market-determined conditions.

Another challenge facing the GCC financial systems is to further open up to foreign participation and competition. While the recent good performance of the region's banks was largely due to improved overall economic conditions and enhanced efficiency in the provision of financial services, it is clear that the prevalence of quasi-monopolistic situations and insufficient competition from foreign banks had also been an important factor. Opening up the financial sector to foreign investment, be it in banks, in mutual funds, or in investment advisory services, would add depth to the GCC markets, help strengthen management practices and the provision of financial services, foster the transfer of technology and know-how, and through increased competition, help raise productivity and lower the cost of financial services.

A related issue is the need for GCC financial institutions to respond to the demand for new financial services by domestic clients. GCC nationals are increasingly taking a more active interest in innovative financial instruments that can help them manage their savings or provide them with appropriate investment tools. Wealthy individuals and corporations have had access to these services either locally or through international banks; however, in the next few years, strong demand for these services is likely to emanate from a wider segment of the population as evidenced by the public's enthusiastic response to initial public offerings of shares at GCC stock markets. To a certain degree, the GCC financial intermediaries have been already developing fee-based services, including mutual fund investments, but they would need to strengthen their ability to meet the demands of a larger segment of the population at competitive conditions.

Increased diversification of instruments, of market participants, and intensified competition among financial intermediaries will be beneficial to the region's economies by enhancing efficiency and lowering the cost of financial services. Diversification, however, will also involve added risks that should be minimized through adequate prudential regulation and bank supervision, supported by more stringent international standards of dissemination of information and transparency.

Finally, financial sector reform can play a key role in meeting the challenge of maintaining macroeconomic stability in a changing economic environment. Reforms aimed at deepening domestic capital markets could provide the authorities with added instruments of monetary management and more room for maneuver in enhancing the effectiveness of monetary policy. Obviously, fiscal policy will continue to be key in maintaining financial stability and preserving the credibility of the exchange rate arrangements. In recent years, fiscal deficits in all GCC countries have been reduced and government spending has been brought under control (Chart 5). Inflation rates have been maintained below those in industrial countries, and exchange rate variability has been virtually nonexistent. While the region's economies are likely to remain dependent on volatile oil revenue for many years to come, government spending will need to be brought under control, and ongoing privatization and deregulation efforts must be enhanced to help decouple non-oil activity from government stimulus and accelerate economic growth. In this respect, privatization and the development of domestic capital markets are closely interrelated and must be carried out in a coordinated manner.

IV. Remaining Reform Issues

As highlighted above, the GCC countries have already completed most of the crucial stages in their gradual process of liberalization and reform of their financial sectors. Nevertheless, there are some outstanding issues in the reform process and further measures are needed to reinforce stability and efficiency within the region's changing economic and social environment. Key reforms should aim at strengthening market forces, reducing government participation in financial intermediaries, opening up the financial sector to foreign competition, strengthening bank soundness by enhancing the regulatory and supervisory framework, and developing the capital markets.

A. Strengthening Market Forces

Efficiency could be raised through lifting the few remaining obstacles that exist in some countries to the free market determination of interest rates and the allocation of financial resources; taking measures to promote further market competition and integration; and diversifying financial instruments. Remaining regulations on maximum lending rates and spreads (Kuwait and Oman) and deposit rates (Qatar) would need to be eliminated as soon as possible. Although apparently nonbinding at the present time, the elimination of such regulations would have an important signaling affect and would ensure the free working of the markets, should conditions change.

To enhance competition among financial institutions, the authorities in all GCC countries must ensure that transparent rules govern the entry and exit of new banks and other financial institutions, including the possibility of establishing new private banks and transforming other financial institutions, such as finance companies, into banks with a full array of financial services. Mergers and takeovers of banks and other financial institutions could be encouraged to strengthen the financial system without hindering competition; and, as needed, the closing of banks that become insolvent should be permitted. In the long run, this would allow the structure of domestic financial systems to be determined mainly by the markets and not by the regulators. At the same time, the authorities would need to strengthen and enforce antitrust regulations designed to maintain the contestability of the financial markets, and remove remaining regulations that require financial institutions to specialize in certain activities. Any degree of specialization by institutions should develop as a result of the choices made by the individual institutions.

In a market-determined financial system such as that emerging in the GCC countries, the panoply of financial instruments available to market participants can be expected to evolve in line with the needs of the customers for greater diversification of savings and borrowing instruments, and as a result of competition among financial institutions. However, the diversification of instruments can also be affected by the behavior of central banks and regulatory agencies. For instance, a tightening of central bank refinancing facilities and an expansion of market-based instruments to supply and withdraw reserves may be useful not only to control monetary expansion but also to

encourage banks to trade among themselves in the interbank market. The activation of the interbank and other money markets can be promoted by establishing prudential norms, improving the payment systems, and developing efficient mechanisms to distribute and trade government securities. In turn, the activation of interbank and other money markets can enhance the mechanisms for the efficient market determination of interest rates and the conduct of monetary policy through indirect instruments.

The GCC countries, particularly Oman and Qatar, need to complete the unfinished business of conducting monetary policy solely through the use of indirect instruments. The authorities can help this process by strengthening the efficient functioning of money and capital market mechanisms, including developing a primary dealers system for the trading of government paper in the secondary market, which can facilitate the use of open-market operations by the central bank as the principal instrument of monetary policy. This could also help improve public debt management.

B. Reducing Government Ownership and Increasing Foreign Participation

Integration of the GCC financial systems with the rest of the world has advanced rapidly in recent years as a result of the deregulation of domestic interest rates and the removal of remaining capital controls, which has facilitated free private capital movements. This has resulted in a progressive equalization of domestic interest rates with U.S. dollar interest rates. At the same time, it is often argued that rising profits do not reflect an absence of banking competition or the effects of the moratoria on new bank entry. Given the costs of setting up a bank, there is a natural tendency toward consolidation; consequently, according to this view, the GCC is not "under banked" and the markets do not require additional banks. However, more than the number of banks or concentration ratios, dynamic competition can be gauged by the effective possibility of entry and exit of financial institutions, without which bank profits and the cost of financial services would be determined under quasi-monopolistic conditions.

The process of integration of the GCC financial systems could be further promoted by allowing greater foreign participation in the ownership and management of financial institutions. For this to be achieved in an orderly manner, the authorities of the GCC countries could contemplate implementing this policy in two stages. The first stage would commence by publicly announcing the intention of the authorities to permit greater foreign competition starting at some future date several years into the future. During the intervening period, existing institutions would be encouraged to prepare themselves through restructuring, takeovers, and mergers to face the competition of foreign entities. As part of this preparation, the authorities would have to be ready to "commercialize" publicly owned banks and reduce government participation in others through a strong program of divestiture of their financial intermediaries. This policy would ensure a more level playing field among financial institutions; assist in encouraging new private entrants, both domestic and foreign; further enhance competition; and promote financial innovation and help mobilize domestic financial savings. During the second stage, the authorities would

allow freer entry of foreign banks either de novo or through purchasing stakes in domestic banks. Foreign investors should be allowed to participate in financial institutions on equal terms as domestic investors.

Allowing for greater participation by foreign institutions in the domestic financial system would encourage acquisition of technology and know-how and create competition through new entry and exit of financial institutions. Restrictions on some types of foreign participation in domestic financial institutions, as well as in portfolio investment through the stock exchange, have been somewhat reduced in some GCC countries in recent years, particularly for investments coming from other GCC countries. Also, restrictions on investment have been eased for expatriate residents in some GCC countries; for instance, in Kuwait, the United Arab Emirates, and other countries, expatriate workers can invest in equities through mutual funds. However, further progress is needed, especially in opening up the financial sector to competition outside the GCC area, and in developing the equity markets. The commitments made by a few GCC countries with respect to financial services under the WTO General Agreement in Trade and Services (Bahrain, Kuwait, the United Arab Emirates) need to be embraced by all other GCC countries and carried out to a higher level of open access. A first step toward an eventual universal opening of the GCC financial services sector could be a single GCC banking license. This would complement the recent agreement to allow GCC banks to open branches in all the member countries.

C. Strengthening Bank Soundness

In recent years, the GCC countries have strengthened the soundness of their financial systems through stepped-up enforcement of prudential regulations and accounting systems in line with international standards; provisioning for bad loans; and recapitalization of weak institutions. All the GCC countries now require banks to comply with the Basle Committee's minimum capital standards. Substantial progress has been made in overcoming the difficulties related to the nonperforming loans inherited from past shocks to the system, including the property market collapse of the 1980s, the 1990–91 regional crisis and, in the case of Kuwait, the failure in 1982 of the parallel Souk Al-Manakh stock exchange. Nonetheless, in some cases, the public sector has borne the cost of recapitalization, resulting in moral hazard concerns, given the laxity in the application of the ultimate market sanction, that is, the exit of insolvent financial institutions.

A number of important regulatory issues remain to be addressed fully in most GCC countries.

- Providing prompt and useful information to market participants has become an important matter in international discussions to ensure the efficient working of financial institutions, particularly in the emerging markets. Progress has been made in this area in the GCC countries; for instance, banks in Saudi Arabia and Kuwait already publish regularly audited accounts, although sometimes with a certain delay. All banks and other financial institutions in the GCC countries should be

required to release at least interim and audited annual statements within a prescribed reasonable time period and in accordance with international standards.

- The introduction of a simple, transparent, and limited deposit insurance system in those countries lacking such a system can help resolve the trade-off that normally exists between the need to protect small depositors and avoid bank runs, on the one hand, and the need to minimize the costs to the government of bank failures and avoid the moral hazard problem caused by unlimited bailout of depositors, on the other hand.
- Ensuring that the legal and judiciary systems can effectively help enforce contracts and allow banks to collect debts should be a major undertaking in the GCC countries. By and large, the judiciary system in most of these countries has hindered collection of bad debts and liquidation of collateral, because of delays, cumbersome procedures, and bias in favor of debtors. Moreover, in some countries, the courts have been ambiguous regarding the application of Sharia law to the payment of interest for bank claims. These problems need to be resolved promptly to ensure that the expected expansion of bank credit to the private sector does not lead to an increase in nonperforming loans, which would create inefficiencies in credit distribution and risk eventual bank failures. The law and the courts can help prevent a permissive credit culture.
- The harmonization of the financial sector regulatory system in the GCC countries, while maintaining consistency with internationally accepted standards, is a major objective of the authorities in the GCC countries. Much has been accomplished in terms of standardizing prudential regulation and supervision, where explicit international standards are available. Nevertheless, more attention needs to be paid to ensure that the regulatory and supervisory framework covers all financial institutions, including, in particular, Islamic banks, insurance companies, and securities markets. Wherever there is more than one regulatory authority, adequate coordination among agencies should be ensured.
- Although the supervisory systems in the GCC countries have improved notably in recent years, there is still need for further enhancements, particularly in the case of emerging institutions (for instance, capital markets) and special institutions (for instance, Islamic banks). With regard to Islamic institutions, the authorities must ensure that they maintain adequate liquidity matched to servicing obligations. This can be a particularly tricky issue in light of the often expressed view that the interbank market is to be avoided by Islamic banks; however, other countries' experience (e.g., Malaysia) demonstrates that innovative instruments could be designed to facilitate Islamic banks' access to interbank markets. The principles of consolidated supervision of financial institutions enunciated by the Basle Committee on Banking Supervision remain to be fully implemented in some of the GCC countries. Also, there is a need to improve financial surveillance and early warning systems and inspection procedures, as well as to establish a credit risk bureau or evaluation unit in GCC countries that have not already done so. Further

work will be needed in all countries to update the existing supervisory methods and procedures to conform with the Basle Committee's "Core Principles for Effective Banking Supervision," and with other suggestions for financial stability.[5]

D. Developing the Capital Markets

There is substantial scope in most GCC countries for further development of capital markets, including securities and money markets and stock exchanges. In this way, the range of instruments available to borrowers and savers could be expanded further as they switch from traditional banking instruments to equity and marketable securities.

The region would benefit from the introduction of more fixed-term securities of various maturities (for instance, government bonds and corporate paper). Such instruments would widen the choice of assets available to savers, help deepen secondary markets, facilitate the conduct of monetary policy, and more generally support the development of capital markets.

Country and, especially, regional stock markets could be expanded through standardization and improvement of stock market regulation and supervision, and reform of pension funds. On the supervisory side, the authorities in all countries should remain vigilant to ensure that the private sector borrowing from banks to invest in the stock exchange is in conformity with prudential norms and does not pose risks to the financial system. Capital markets could be further spurred by more ambitious programs of privatization, which are already at various stages of development in Kuwait, Qatar, Saudi Arabia, and the United Arab Emirates, but need further impetus. The expansion of investment banks and investment advisory institutions could provide support to private corporations by offering a range of services that can help them become familiar with securities and exchange markets. In addition, further development of mutual funds in the GCC countries could help attract small savers to equity investment, as well as foreign direct and portfolio investment if the markets were opened to nationals of non-GCC countries.

To increase the supply of equity and improve liquidity, it would be helpful to provide appropriate incentives to share trading in stock markets. First, bringing prudential regulation and supervision in these markets fully up to international standards would be the most promising route to enhance confidence and accelerate growth of these markets. Second, the integration of the national markets into a larger regional market through opening them up to regional trading (as it is already the case in the Bahrain and Kuwait Stock Exchanges) would greatly enhance their growth; this may include cross-listing of shares, coordination of primary issues, common secondary trading arrangements, and coordination of regulatory and supervisory functions. Ultimately, the GCC countries should aim to open up their market to all foreign investors. In some countries, there is need for reform to make it easier for existing private companies to go public. Such measures could

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[5]See International Monetary Fund (forthcoming), which also includes the Basle Committee's "Core Principles for Effective Banking Supervision" as Annex I.

help to reduce the existing reluctance of private owners to relinquish individual or family control by selling equity to the public, and also discourage share transactions outside the official stock market on a bilateral basis between investors.

V. Concluding Remarks

The GCC countries face important challenges of improving economic efficiency; diversifying their economic base, given their excessive reliance on depletable natural resources; and more important, providing increased employment opportunities to a growing indigenous labor force. To help achieve their objectives, the GCC countries have reduced financial imbalances and are gearing their medium-term economic policies toward achieving high economic growth through liberalization, deregulation, and promotion of private sector activity. These challenges and the required policy reforms to deal with them have important implications for the GCC financial systems, which will need to adapt to the changing demands of the private sector, support the structural changes in the period ahead, and position themselves to compete in the global economy.

The GCC bank intermediaries are at an advanced stage of development, having already undergone important changes in their size, structure, managerial capabilities, and adoption of modern technology. Nonetheless, domestic money markets remain underdeveloped, stock exchanges face various constraints, and corporate bonds and secondary markets for government paper have not emerged in any significant manner. Moreover, competition remains limited, government equity participation in and control of financial institutions is relatively significant, and there are moratoria on new domestic and foreign banks.

This paper has identified a number of steps toward completing the reform of the GCC financial systems, with a particular focus on the need to strengthen market forces; promote competition and efficiency; open up the financial sector to increased foreign participation; deepen and develop capital and equity markets; enhance prudential regulations and supervision; and upgrade the standards of transparency and the provision of financial information. These reforms will need to go hand in hand with structural reforms, including privatization and deregulation, as well as sustained efforts to maintain financial stability through prudent fiscal and monetary policies. The GCC policymakers are fully aware of these challenges and of the required structural changes, some of which are at various degrees of preparation or implementation. The reform measures outlined in this paper are signposts rather than a detailed road map; the latter will have to integrate other elements of the reform agenda and take into account the political and social dimensions of economic change.

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