

Lessons for the Gulf from the credit crunch

The credit crunch resulting from the global financial crisis has a few hard lessons for the GCC's financial markets. **Matein Khalid** emphasises the need to learn from the mistakes made.

The sheer scale of the 2008 - 2009 financial crash has exposed the deep flaws in the business models and operating templates of the Gulf's banks, money managers, sovereign wealth funds, Islamic finance houses, investment banks, insurers and stock brokers. The entire constellation of GCC finance will be transformed by the trauma of the crash and the social, regulatory and even cultural forces that it has unleashed. There will be some winners and many losers in the Gulf money game as even the rules of the game change. Fortunes will be lost, as I anticipate at least another US\$300 billion in bank capital write offs, bankrupt brokers, capital deficient insurers, a default wave in property developers (who, sadly, includes commercial banks in the Gulf), restructured sukuk issues, credit downgrades and stock exchange losses. Gulf finance faces a leaner, harsher financial zeitgeist.

Take banking, for instance. Banking systems with loan to deposit ratios above 100, such as the UAE and Qatar, will be forced to contract. GCC banks will no longer be able to compensate for sluggish deposit growth by borrowing in the wholesale Eurobond market to finance local asset books. Consumer lending, the cash cow of Gulf banking, faces a secular shock as expat populations decline, borrowers "skip" from their debt to escape debtor's prison (in the absence of credible bankruptcy and foreclosure laws) and usurious credit card rates choke retail sales.

The role of the Gulf's sovereign debt agencies in domestic economic development and global markets will clearly be transformed beyond recognition as the region heals from the wounds of 2008 - 2009.

There are critical lessons to be learnt from the behaviour of Gulf SWF's during

the crash. One is that highly leveraged, aggressive funds that invested wildly in Europe and America with no competitive advantage lost billions of dollars. Was there any real point in the bidding war for the London Stock Exchange between Qatar and Dubai funds when the price of the LSE eventually lost two thirds of its value? Did it make any sense to take passive stakes in international banks with borrowed money at the peak of history's greatest credit bubble, let alone issue press releases boasting about the fact? Was it sensible for Gulf sovereign funds to contribute to local inflation by investing in domestic, overheated real estate markets at the peak of the property bubble? Is not the whole idea of sovereign funds investing an attempt to diversify risk, not amplify it?

We have learnt the hard way that intelligent, successful Gulf sovereign wealth funds do not just focus on

generating the highest possible returns, regardless of risk or political consequences. They recognise that they have multiple roles and an impact that goes beyond financial markets. Mubadala, for instance, has realised that transparency is the new name of the game in international finance. In fact, the era of secretive black boxes is truly over, and that's the reason Mubadala published that its US\$3 billion loss in 2008, its write offs on Pearl Energy, the size of its funding from the Abu Dhabi government and details about its balance sheet.

Debt market to change

The Gulf's funds can no longer borrow unlimited cash from international banking syndicates, as in the past. It is now necessary to access the public debt markets to engage in active deal making and capital structure management, as Mubadala and Temasek have done. It is



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also never a good idea to beseech Gulf sovereign wealth funds to buy shares in local stock exchanges in free fall, as happened in Qatar and Kuwait. After all, the Kuwaitis lost more than US\$100 billion in the past in Souk-Al Manakh, the London KIO's property speculation in Spain and the bailout of the banking system after the Iraqi invasion. Will Kuwait's KIO now be used to revive dozens of local, bankrupt investment companies, the new zombies of Gulf finance? Hopefully not, though it often seems to me that the enduring lesson of Gulf finance is that, since we do not learn the lessons of the past, we continue to relive it again and again.

Hopefully, the West will learn to have a more nuanced view of Gulf sovereign fund deal making, after the hysteria over DP World's American ports and Qatar's accumulation of a stake in Sainsbury, a deal which caused outrage in the City of London when the QIA aborted it due to a spike in borrowing costs. The scramble for equity by international banks led Wall Street's Masters of the Universe to coax investments from the Gulf, even though ADIA- Citigroup, Kuwait- Merrill and Saudi-UBS all proved financial debacles. I envisage Gulf sovereign issuers to be more active in the Eurobond market, as the US\$1.5 billion Mubadala issue

demonstrates. Moreover, it is inevitable that the cash rich UAE will take advantage of depressed valuations to buy trophy stakes in western companies, as recent Gulf investments in Porsche, Daimler Benz, General Electric and Credit Suisse demonstrate.

Cash is king

Gulf funds will eschew leverage and refocus on liquidity. Real estate and private equity investments made in 2006 or 2007 may well cost the Gulf sovereign funds more than US\$50 billion in additional write offs. In a world where leverage is the kiss of death, Gulf funds will need to scale down their return expectations to single digits and grasp that cash is king, queen and emperor amid global recession. Norway's sovereign fund, a model of transparency, governance and ethical consciousness, is an ideal template for the Gulf's sovereign funds.

Islamic financiers have pointed to the credit crunch to vindicate their own model of allegedly prudent, low leverage finance. Yet the Islamic finance model has not escaped unscathed from the crash. In fact, its structural flows and financial architecture deficiencies have been all too exposed in the harsh spotlight of the bear markets. Why did the sukuk new issue market disappear just as the Eurobond market froze if Islamic finance was an alternative and not a complement to conventional banking? How come Islamic banks got hit by the same spike in funding costs as conventional banks? Moreover, Islamic banks still have no real lender of the last resort. What will be the endgame of the property crash in the Gulf, where Islamic banks are extraordinarily overexposed? There are no deep, liquid Islamic debt markets to act as shock absorbers when equity capital markets shut down. This is a lesson that will prove painful, if not fatal, to dozens of Islamic banks in the decade ahead.

The Gulf's money managers have been exposed as classic beta chasers by the crash. Not one major Gulf-based hedge fund made a fortune shorting the market before the crash. Diversification proved an illusion as coefficients of correlation among GCC markets soared to one

when the stock exchanges were in free fall. Disclosure, transparency, exchange regulation, insider trading laws, market making, IPO issuance in the Gulf is still archaic, nowhere near international norms. Several Gulf investment banks that rushed headlong into proprietary trading because it was so much more profitable than agency stock broking, during the bull market, now face Armageddon on mark to market losses. With Stone Age risk controls, many independent Gulf investment banks and money managers will not survive the protracted bear market. The Gulf's insurance companies never learnt the lessons of the successive 1990's stock market crashes, when so much of their capital was wiped out. Investment banking, fund management and stock broking firms in the Gulf face a Darwinian shakeout in the regional financial ecosystem.

Banking balance sheets will shrink. The cost of corporate credit will soar as banks learn the bitter lesson that name lending in the GCC is as toxic to their bottom line as the most risky CDO or lethal derivative. Money markets in the GCC will see banks hoard cash and obsessively monitor counterparty risks, even if it means acting on bazaar rumours. The home mortgage finance market in the Gulf, embryonic and fragile, has been hit by a financial neutron bomb by the property crash and the loss of any access to the international mortgage securitisation funding markets. Confidence in home mortgage financiers will not be easily restored, even if bankrupt lenders are merged or granted access to banking licenses.

The financial markets and banking systems of the Gulf are not at all "decoupled" from the global financial markets. Correlations with Wall Street indices, crude oil prices, the vagaries of hot money, credit spreads in the Eurobond market, volatility in the dollar- Euro foreign exchange rate are only some of the myriad indicators that regional investors simply cannot ignore. This is perhaps the ultimate lesson of 2008.

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