The Next Banking Crisis Will Not Be in the Middle East

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The combination of conservative lending, strong capital buffers, near-guarantees of government support, and some distance from volatile financial instruments, the banking systems in the Middle East and North Africa look healthy enough to withstand another economic shock. The region's banking sectors might not prove the growth catalysts needed for economic development at present, but they will not cause the region's next crisis.

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A budding financial crisis perpetually loiters around the modern global economy. The increasing frequency of crises in banking sectors has shocked developing and advanced countries alike for decades, given that they are a subset – and often a harbinger – of broader financial crises. In their notable book, *This Time is Different: Eight Centuries of Financial Folly*, authors Carmen Reinhart and Kenneth Rogoff survey the causes and consequences of banking crises across the globe but overlook the Middle East and North Africa (MENA) region. This is not out of a lack of interest, but it is rather due to the scarcity of such crises in the region. In an otherwise comprehensive global list of banking crises – some of which date back to the early 1800s – MENA countries are largely absent, and when they do appear, the crises are almost never systemic.

Banks in the MENA region weathered the effects of the global financial crisis in 2008[i] and, on the whole, have strengthened in the intervening years. These particular banks played no role in the subprime crisis that began in 2007, having had almost no exposure to its root causes. In fact, the financial instruments that played a starring role in the global financial crisis, such as mortgage-backed securities and credit default swaps, are rare in MENA financial systems.

Bank profits suffered during the financial crisis because of a global decline in trade, investment, and economic growth, not because they were over-leveraged, lacked sufficient capital, or had balance sheets that were bloated with poorly regulated or understood securities. Although the member states of the Gulf Cooperation Council (GCC) were more affected by the 2008 global crisis than other MENA nations, given that they had open financial systems and more over-extended banks, they rebounded quickly in 2010, largely because of government support. The economic slowdown of the other MENA countries was moderated, -largely due to their less extensive overseas reach.

MENA banks, and in particular those in the Gulf Cooperation Council GCC), hold high levels of capital, generally comfortably above minimum capital requirements and standards set under the Basel II agreements, and virtually all of non-crisis MENA countries are already internalizing the capital requirements set forth in the Basel III Accord — regulations set by the Basel Committee on Bank Supervision, which provides recommendations on banking regulations in regards to capital risk, market risk and operational risk. [ii] According to a 2014 IMF study, this prudent approach enabled the banks in the GCC to weather the global financial crisis, with the banking system remaining "a bastion of financial stability amidst a global financial system that was in turmoil."[iii][iv] Bank capital acts as self-insurance, providing a buffer against insolvency, and MENA banks are generally well capitalized.

The Road to Banking Stability

The incentive structure in the U.S. and Europe that pushed some banks and financing companies into dodgy lending, overexposure, and dangerously high leverage ratios is mostly absent in MENA banks. With few exceptions, most banks in MENA – whether in the GCC or not – have historically engaged in conservative lending and maintained a stable base of depositors. These banks have generally focused on large, established clients as well as the public sector, and they have been reluctant to expand lending in riskier business lines, such as small and medium enterprise or mortgage finance.

This conservative trend also extends to investments, where banks rarely trade or invest in exotic derivatives. Of course, this hesitance to trade in instruments like mortgage-backed securities or interest-rate swaps is also because these instruments are not readily available in MENA countries. Could MENA banks in the coming years develop more sophisticated business lines and, in the process, expose themselves to greater risk? They could – especially in places like Dubai where the appetite for pushing the envelope is more developed. Before diving into these lines of business, however, banking executives would have to ask themselves the following questions: do we have the expertise and infrastructure in place, do we have a competitive advantage to justify entering into riskier business lines that are already sufficiently saturated by international banks, and would the local regulatory environment support such moves? The answer to all three of these questions is a qualified "no."

One short-hand – albeit imperfect – approximation of risky lending is the degree to borrowers repay their loans in a timely manner, which is calculated by examining the percentage of a bank's "non-performing loan (NPL)" as a percentage of its total loan portfolio. A bank loan is considered non-performing when more than 90 days pass without the borrower paying the agreed installments or interest — "bad debt" in other words. Assessing aggregate NPLs in a region with such divergent banking and economic systems is not optimal, but on the whole NPLs are strikingly low on average when seen against a backdrop of market and political turmoil.

In its 2018 regional economic report, the IMF notes that bank profitability has fallen in some countries because of tighter margins, but "NPLs do not appear to be a significant concern in many countries."[v] In a recent report on the financial soundness of its banks, the Central Bank of Egypt said that the NPL ratio amounted to 3.4 percent of the total loans in the top 10 banks operating in the Egyptian market at the end of 2017; the ratio was just 2.9 percent among the top five banks.[vi] Questions of reporting accuracy aside, these numbers show better than many ratios in advanced EU countries.[vii]

A note of caution is always appropriate, however, especially for countries like Egypt: The ratio of NPLs to total loans can be understated in an environment in which banks tend to roll over loans that otherwise would become nonperforming or disclosure is not up to snuff. That said, the overarching theme in most non-crisis MENA countries is that NPL ratios are healthy. The same goes for the region's more economically stable countries. According to Moody's Investors Service, the NPL ratio in Kuwait registers just some 2 percent,[viii] on par with German and Dutch banking sectors.

Of course, this paucity of relatively riskier financing to the private sector comes at a cost to long-term economic development and diversification. Conservative lending can protect a banking sector from exposure to risky assets, but a concentration on "safe" borrowers, like governments, large state-owned enterprises, and wealthy familial connections, retards the growth of private companies and of course comes at the expense of stronger profits.

Additionally, the story of modern MENA banking systems is often one of explicit government support and protection. Take banks in the GCC. The governments of most GCC states have significant – often controlling – interests in most of the major banks as well as established ties with the extended royal families. Dubai-based financial adviser Acreditus, as reported by *The Financial Times*, says that the arms of the GCC states — including sovereign wealth funds, state pensions, and social funds — have a shareholding in more than 80 per cent of the GCC's top 50 banks.[ix]

Through the Abu Dhabi Investment Council and Mubadala Development Company — two Emirati sovereign wealth funds — the UAE government owns 37 percent of First Abu Dhabi Bank, one of the region's largest banks following the merger of National Bank of Abu Dhabi and First Gulf Bank in 2017. To drive home the government and royal family's iron ties to the banking sector, FGB's Chairman is Sheikh Tahnoon bin Zayed Al Nahyan, the UAE's National Security Advisor and a member of the royal family. First Abu Dhabi Bank's shareholder information lists UAE entities and individuals as holding 52 percent of its shares, and although the publicly available information does not detail who these shareholders are, there is every reason to suggest that other members of the Emirati royal family hold interests in the bank as well.

The Investment Corporation of Dubai, a sovereign wealth fund owned by the government of Dubai, controls a 56-percent controlling stake in Emirates NBD, the UAE's second largest bank. Sheikh Ahmed bin Said Al Maktoum of Dubai's ruling family has been the bank's chairman since 2011.

The Crown Prince of Dubai, Sheikh Hamdan bin Mohammed bin Rashed Al Maktoum, owns 26 percent of Noor Bank (formerly Noor Islamic Bank), and the Investment Corporation of Dubai holds an additional 23 percent. The Abu Dhabi royal family owns 67 percent of First Gulf Bank, the country's fourth largest bank. The list goes on. According to Karen Young, the author of *The Political Economy of Energy, Finance, and*

Security in the United Arab Emirates: Between the Majlis and Market, family ownership appears to be a positive influence on credit ratings.

Emirati banks might seem to stand out in terms of the explicit symbiotic relationship between the government and its connected families, but they are not alone. The Qatar Investment Authority — Qatar's sovereign wealth fund — owns 50 percent of Qatar National Bank, and a large number of royal family members sit on the bank's board of directors. The Omani government, through state-owned pension funds, and the influential Royal Court Affairs control more than 40 percent of Bank Muscat, Oman's largest bank.

As for Saudi Arabian banks, despite years of liberalizing the sector, the government directly and indirectly owns significant shares in the kingdom's banks, often with substantial controlling interest. The Public Investment Fund (PIF, the kingdom's enormous sovereign wealth fund) holds 44 percent of the shares of National Commercial Bank, the kingdom's largest bank, with the General Organization for Social Insurance and the Public Pension Agency holding an additional combined 20 percent. The PIF owns more than 20 percent in Riyad Bank with the Public Pension Agency holding an additional 9 percent.

Unlike the governments in the Gulf, the region's other governments, such as Jordan, Lebanon, and Morocco, have much smaller footprints in their banking sectors. Government ownership of banks in Morocco has fallen to just 10 percent as the state gradually privatizes its economy.[x] Arab Bank, Jordan's largest bank and one of the largest banks in the Middle East, is majority privately owned, although the state-run Social Security Corporation still holds 16 percent of the bank's shares. Jordanian banks have continued to demonstrate healthy liquidity and adequate capital ratios.[xi]

Unlike in Europe and the U.S. where state ownership of banks is a thing of the past, if it was ever really a thing, banks in the GCC especially — whether state owned or influenced — have a more symbiotic relationship with their governments. This relationship has given the banks all but a guarantee of a state bailout should insolvency loom. The shortcomings of having too much government in finance are well known, but in the aftermath of the worst global financial crisis since the 1930s, the presence of a steady government hand with ample capital puts a stamp of stability on otherwise unsteady economic trends. In short, the reputation of these governments are on the line — not to mention the wallets of princes in places like the UAE — and, consequently, a bank failure would be countenanced.

Jordan has experienced only one important bank failure in its history — Petra Bank. Jordan's then third-largest bank collapsed during the kingdom's currency crisis of 1989, but its failure was almost certainly more prompted by malfeasance rather than regulatory failures or massive balance sheet mismatches. Ahmed Chalabi, the infamous Iraqi businessman, founded the bank in 1977 and was charged with embezzlement and hastily fled Jordan.[xii]

When to Worry?

As any good forecaster of economic or financial crises will tell you, the next crisis will seemingly come out of nowhere, and the origins of the new crisis will bear little resemblance to the previous one. The catalyst for the global financial crisis that began in 2007 was nothing like the catalysts for the Thai banking crisis in 1997, the savings and loan crisis in the U.S. of the 1980s,[xiii] or the Panic of 1907.[xiv] Rules of prudent lending and investments, limits on exposure and concentration, a stable macroeconomic environment, and solid transparency and disclosure rules all build foundations for a sound banking sector, but even in the best of circumstances when forecasters have ample data and can lean on seasoned analysis, crises can catch fire quickly.

The global financial crisis that began in 2007 laid bare the limitations of financial sector reporting and traditional analysis. Even with the most experienced regulators and seemingly sophisticated risk modeling, the capital markets in the United States and much of Western Europe sunk during the crisis. Large off-balance sheet liabilities or rapid declines in asset values can turn today's stable bank into tomorrow's multibillion-dollar bailout. A number of banking sectors in the MENA region are exposed to the notoriously volatile construction and real estate markets, such as Bahrain, Dubai, etc., while some are exposed to excessive government debt, like Lebanon, and others to economic insecurity, like Egypt and Iraq.

The health of any country's banking sector is nearly synonymous with economic stability, and the oversized role of the region's banks make their viability especially crucial. MENA banks might not deeply touch the lives of many citizens in the region's poorer countries because of the lack of financial inclusion, but the banks' role in financing government expenditures and lending to large companies and entities is enormous. Banks hold this position of economic influence in large part because alternative methods of financing — such as bond and equity finance or venture capitalists — are still developing.

The closest a banking sector in the region has come to a full-blown financial crisis in the last few decades has been that of Dubai in 2009. Excessive spending and leverage on the part of Dubai World, the state-run colossus that helped spearhead Dubai's real-estate development during the 2000s, had led that company to hold $59 billion in liabilities, more than two-thirds of Dubai's entire debt stock.[xv] It turns out that even without widespread use of mortgage-backed securities such as used in the U.S., big bad bets can turn sour. It took a $10 billion bailout from neighboring Abu Dhabi to prevent default and the promise of negative ripple effects. [xvi]

History is no forecast. The right mix of ingredients — whether fraud, currency mismatches on the balance sheet, overexposure to a declining market, regional economic shocks, over leverage or insufficient capital — can push any relatively healthy bank or banking sector to illiquidity or insolvency. The same is true for banks in the MENA region. Nonetheless, as this analysis aims to demonstrate, the current state of the region's banking sectors — notwithstanding of course those in crisis countries, i.e. Iraq, Libya, Syria, and Yemen — suggests little cause for alarm. This does not necessarily mean that banks in the region are consistently profitable or models of good corporate governance. But it does mean that, on the whole, MENA banks do not show signs of a looming crisis, which is perhaps one good bit of news in a region that needs it.

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