Gulf Research Center

Knowledge for All

GCC Bond Markets

GRC Report

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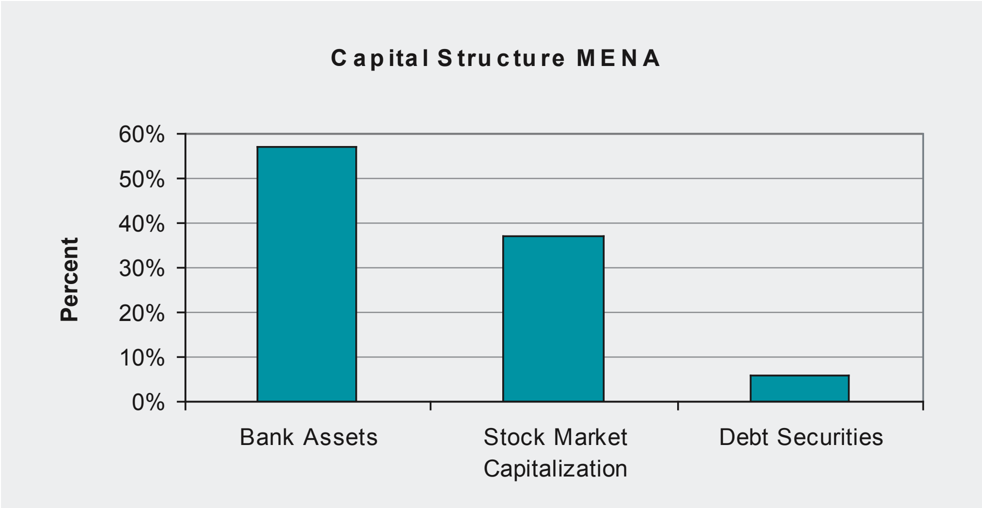
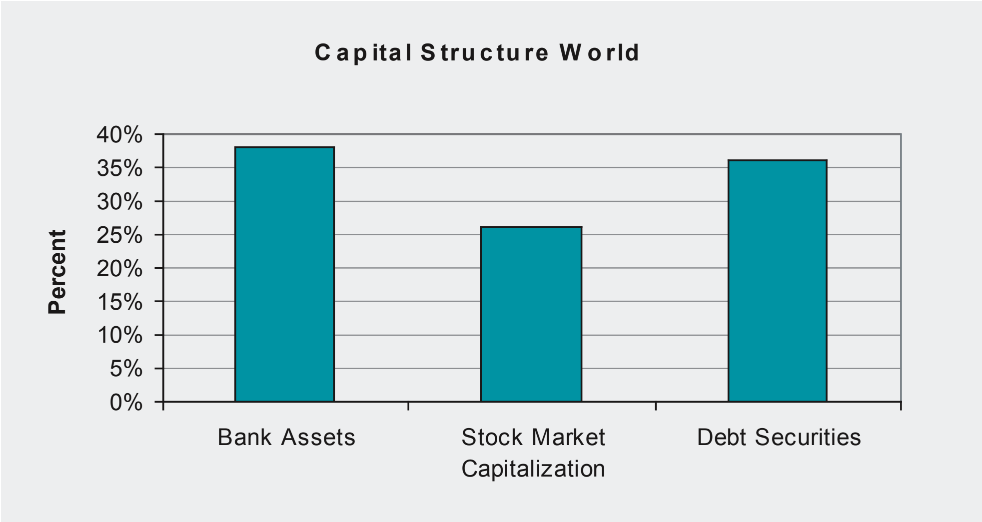
Introduction

Despite impressive economic development, the GCC countries have not yet developed a sophisticated bond market. Though primary issuance has increased, the bond and sukuk markets of the GCC countries still lack important ingredients of a functioning debt capital market like variety of issues, rating culture, transparency, market making and a broad spectrum of institutional market participants. The current high oil revenues put the region's governments in a comfortable position and they do not need to issue debt in order to finance fiscal deficits. Corporations, on the other hand, still rely mainly on bank financing and have had easy access to equity financing particularly during the stock market boom. Because the local debt market is not yet up to the task of mobilizing internal investment potential, to the extent that debt instruments are issued, the majority has been in external markets. So while the Gulf is sitting atop huge liquidity, its project, corporate and sovereign issuers still depend largely on the international capital and intermediation. Thus, the market is characterized by a lack of benchmarks, limited variety of issues and sometimes, limited liquidity. Longer maturities are absent and, on the government side, only Qatar, Bahrain and Abu Dhabi have issued Eurobonds in recent years, but not enough to form a benchmark all across the yield curve. The Saudi market is the largest, but has shrunk as the government has repaid debts in the wake of the current oil boom. Dubai pioneered the Asset Backed Securities (ABS) market by securitizing mortgages from the Palm Jumeirah project in 2005 followed by another deal with Tamweel in 2007. But overall this market is in a very early stage and some legal issues surrounding ABS (e.g. property laws, true sale) are still in the process of being sorted out. Furthermore, a derivative market for interest rates and credit risk is still largely absent. A developed GCC bond market could play a vital role in long term project financing and portfolio diversification of a nascent GCC institutional investor class. It could also serve as a conduit for small and medium enterprises to access the capital market as the banking system is not very open towards this market segment.

1. Bond markets Underdeveloped as an Asset Class in the GCC

- While world capital markets show on average a balanced capital structure of 36 percent debt securities, 26 percent stock market capitalization and 38 percent bank assets, the MENA's balance is heavily skewed towards bank assets (57 percent) with a strong stock market component (37 percent). Debt securities still play a minor role with only 6 percent:





Source: IMF Global Financial Stability Report 2008

- In the GCC, the percentage of corporate bonds issued in comparison to GDP equaled 3.2 percent in 2007. In the US, the ratio was 112 per cent and in China, it was 10 percent.

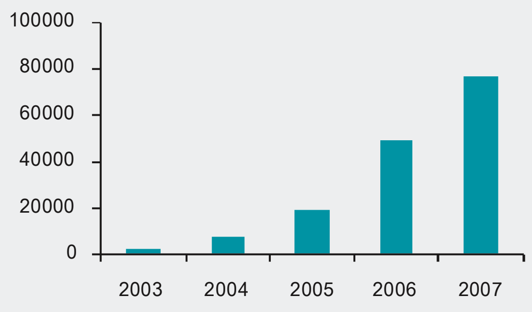
- An increase of the relative importance of bond markets in the overall capital structure of the GCC and other MENA countries is certainly warranted. It could lead to better capital access, efficiency gains and improved price discovery and risk assessment.

2. GCC Bond Markets: Issuance, Market Capitalization and Structures

- Like in other emerging market countries, there has been a considerable rise in issuance over recent years, particularly in the Sharia compliant sector. In the case of Eurobonds in international currencies (conventional and sukuk, mainly USD) accumulated bond issuance has risen ten-fold from 2003 to 2006 to about $80 billion. The annual bond issuance rose more than ten-fold as well to about $30 billion before there was a slight decline in 2007 due to worsening credit conditions in the wake of the US sub-prime crisis.
- Still, the market is underpinned by a good macroeconomic environment, strong demand for large-scale project finance and fundamental credit quality. Its depth and sophistication is growing and it shows an increased variance of offered structures and maturities. Over 2008 and the first half of 2009, Moody's expects a rise in corporate bond issuance to up to $50 billion.
- The market also saw increasingly sophisticated structures. Convertible sukuks and bonds like the issues of Al Dar and Danagas predominately attracted stock market oriented investors and their popularity could be largely attributed to their equity component.
- Issues are predominantly floating rate notes with shorter maturities in the range of 3 to 5 years. Fixed coupons and longer tenors are still relatively rare.
- ABS issues and the markets for credit default swaps and interest rate derivatives are still in their infancy.

GCC Bond Markets: Annual Issuance (Conventional and Sukuk)

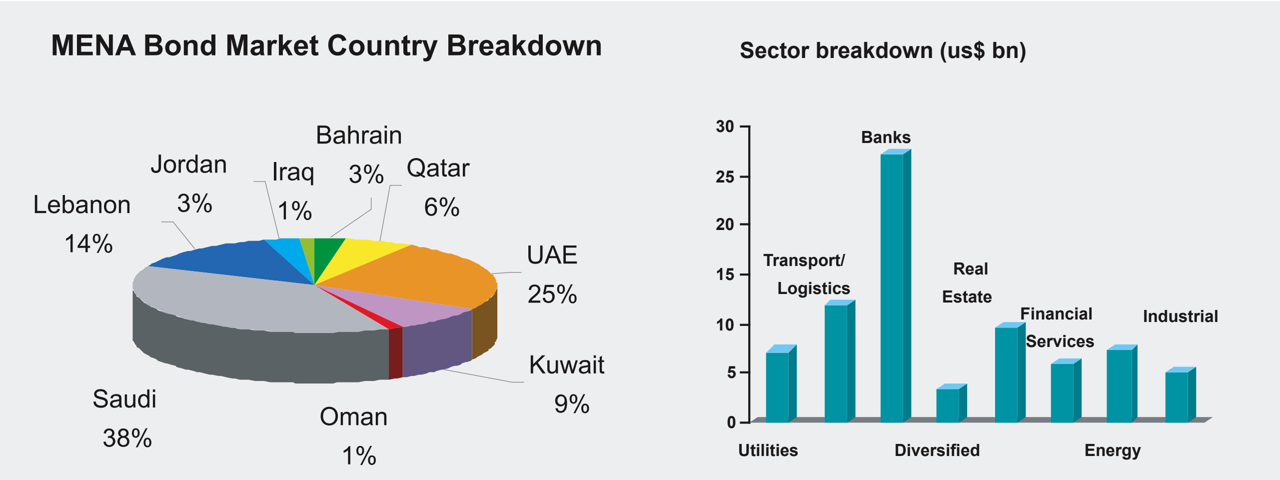
GCC Bond Markets: Cumulative Issuance (Conventional and Sukuk)



Source: HSBC

3. Issuers and their Ratings: Corporates, Quasi Sovereigns and the Lack of Government Benchmarks

- Issuance of corporate debt in the Middle East has a strong bank component (35 percent) and has been dominated by the UAE, which accounted for $52.5 billion of a total of $78.5 billion at the beginning of 2008. The largest issuer of sovereign debt is Saudi Arabia with $70 billion.



Source: HSBC

- Backed by high oil prices and sound macroeconomic fundamentals, ratings of GCC bonds improved from an average A- in 2002 to A+ in 2008. As many companies are owned by the state in full or via majority stakes the raising of country ceilings proved to be particularly beneficial.

GCC Country Ratings

Country	Rating (S&P/ Moody's)
Saudi Arabia	AA-/ Aa3
UAE	---/ Aa2
Abu Dhabi	AA/ Aa2
Kuwait	AA-/ Aa2
Qatar	AA-/ Aa2
Bahrain	A/ Aa3
Oman	A/ Aa3

Source: Bloomberg

- Apart from the sovereign debt in domestic currency in Saudi Arabia, government issuance has been rare, especially in foreign currency. Bahrain, Qatar and Abu Dhabi have issued some government Eurobonds, but not enough to constitute a government benchmark all across the yield curve.
- The Saudi government has retired much of its external debt, and this is also true for its riyal denominated government bonds, which it had issued during the nineties when the country had a budget deficit and was in need of financing. This reduction comes at a time when demand for domestic currency issues is high because of expected revaluations.
- A benchmark of government bonds all across the yield curve functions in all developed capital markets as a beacon for the corporate bond sector as well as for securitized

mortgage and loan portfolios. Without such a benchmark it is difficult to measure the risk that is attached to a certain bond and quote a price for it in terms of its spread to a comparable bond of the benchmark yield curve.

- The UAE federal government has announced its intention to issue government bonds in order to form a benchmark across the yield curve, perhaps out to 30 years. But the plan will need 2-3 years to come to fruition, according to many estimates. Singapore and Hong Kong could function as examples as they issue benchmark bonds, in the absence of a funding need, in order to supply guidance to the corporate sector.
- Write downs at GCC banks in the wake of the sub-prime crisis have been limited, and GCC equity markets showed the least correlation with global turbulences, but relative financing costs for GCC corporates on international markets increased alongside their peers in other markets – spreads rose from about 60 bps above Libor to a peak around 240 bps above Libor in March, before receding in April 2008. In absolute terms the increase in international financing costs was less pronounced because of falling interest rates, but still sizeable as the increase in bond yields since early 2007 shows.

GCC Conventional Bond Spread: April 2007-April 2008

Source: HSBC/ DIFX GCC Conventional US Dollar Bond Index (GCBI)

GCC Conventional Bond Yield: April 2007-April 2008

Source: HSBC/ DIFX GCC Conventional US Dollar Bond Index (GCBI)

- On the other hand, the GCC banking sector is still the major source of funding for the region's corporations, and lending in domestic currencies has increased strongly while its costs have decreased. With their currencies pegged to the dollar, GCC central banks have followed the monetary easing of the Fed in Washington. As inflation in the GCC is higher than in the US this has led to an environment of massively negative real interest rates. Thus, savings are effectively discouraged and there has been a steep rise in demand for domestic credit, which was further fueled by speculations on a revaluation of the Gulf currencies. In the UAE, for example, growth in money supply and credit were well beyond 30 percent in 2007.

4. Market Infrastructure: Regulatory Framework, Trading Platforms, Investor Relations on the Part of Issuers

- Corporate governance codes and market transparency need further improvement. Apart from awareness campaigns, this includes the establishment and enforcement of corporate governance codes and laws.
- Investor relations activities within GCC governments and corporates are often not seen as a priority. Some companies are reluctant to share information about numbers and strategies with banks, analysts and investors. Often it is difficult to reach persons in charge who could give investors authoritative information about a particular company on an ongoing basis. This is particularly true for bondholders who are sometimes treated as "second class citizens" in comparison to their equity brethren. This may also be because financing via bond issuance has not reached enough recognition yet in the finance departments of GCC companies.
- Liquidity has improved considerably; still market makers could improve it further in the sometimes illiquid secondary market.
- Settlement and clearing procedures have become largely compatible with international standards (e.g. Euroclear) and have increased the tradability of issues.
- The development of a rating culture and rating institutions which make the involved credit risk transparent and accessible is important.

5. Sukuks and Specific Regulatory Requirements

- The sukuk market in the Middle East is dominated by the UAE with 69 percent of all issuance and is focused on logistics and real estate. The estimated size at the beginning of 2008 was $33 billion, of which $9.5 billion have been convertible bonds.

- Recent discussions about an alleged non-Sharia compliance of existing structures by the Accounting and Auditing Organization of Islamic Financial Institutions' (AAOIFI) have damaged market sentiment for Islamic securities like sukuks. A centralized and standardized approach to handle questions of Sharia compliance would be advisable in order to avoid contradictory statements by competing scholars and Sharia boards.

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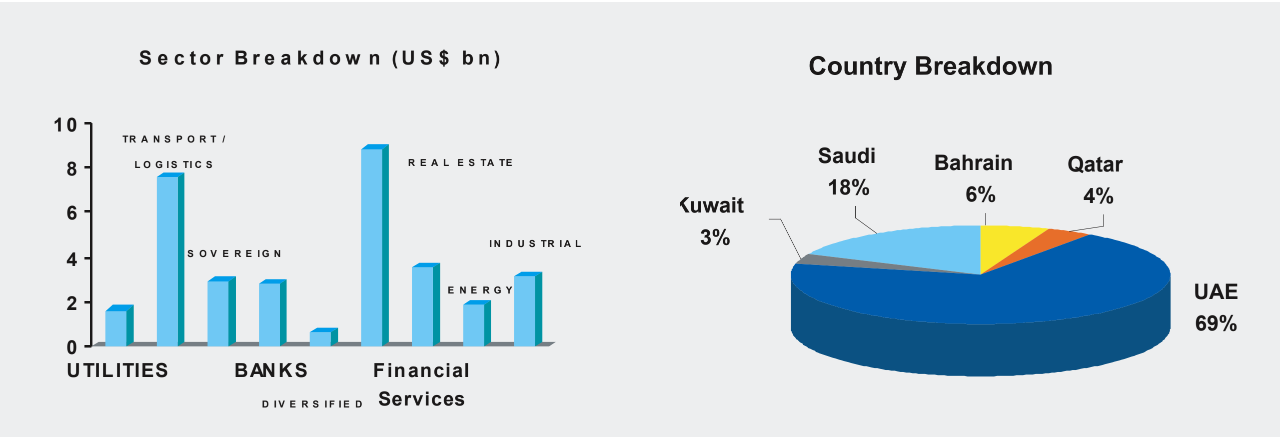

Source: HSBC

6. The Investor Base: Influx of Foreign Institutions and the Lack of Large Domestic Institutional Investors

- There are still only a few domestic institutional investors. Experiences in other countries have shown that the development of pension funds and insurance companies and the encouragement of saving schemes by the state would be crucial.
- There are signs of a nascent fund industry though. Mutual funds in the GCC have increased, but mainly they are still GCC equity funds or international equity and fixed income funds. Proper GCC fixed income funds remain the exception.
- The insurance and pension fund industry in the GCC is in its infancy and not a large scale investor, with the exception of the public pension fund in Saudi Arabia. The market is dominated by banks, high net worth individuals and foreign institutional investors.
- Foreign institutional investors have taken notice of the GCC capital markets – equity and fixed income alike. The healthy macroeconomic environment of the region and the small correlation with other international emerging markets have made GCC credit risk an interesting portfolio diversification.

7. Securitization and Derivative Markets

- A derivative market for GCC securities is in its infancy. There is a nascent OTC derivatives market but it is not very sophisticated and seems to cater mainly to equity investors who want to gain exposure to local markets. Interest rate derivatives, a liquid forward FX market and credit default swaps, however, are largely absent. For hedging purposes this would, however, be essential. It would also enable the issuance of synthetic bonds, which play a major role in developed markets besides cash bonds.

- The securitization market in the GCC is still in an early stage and basically confined to Dubai and the Emirates National Securitization Corporation (ENSEC). With growing mortgage, credit card and consumer financing markets, there would be room for more securitizations, but with the current lack of confidence in the wake of the sub-prime crisis, the investors’ appetite for such structures is limited. ENSEC has placed two deals thus far to a predominately foreign investor base. They had a size of $350 million and $210 million, whereby the securitization of mortgages of the Palm Jumeirah additionally relied on an overcollateralization with securities in a London trustee account.

8. Towards a Gulf Bond Market Association?

- Bond market associations can play a major role in developing and administering a market by raising awareness among the public, articulating the needs of the market before regulators, issuers and the treasury, and also by agreeing on conventions and implementing best practices among participants, as the examples in many countries have shown. Similarly, the Asian Bond Market Initiative has brought together all relevant parties to promote a coordinated approach in the Asian region, resulting in deeper and more liquid markets. With these examples in mind, the possibility of forming a bond market association at the national or GCC level has been raised by various market participants in the UAE and in the rest of the Gulf.