The Basel Reforms and Banking in the MENA Region

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Introduction

In the wake of the global financial crisis of 2007-2008, consumers, bankers, government officials, and regulators attempted to pinpoint the causes that led to a severe downturn in the global economy. The aftermath was clear. Investors took huge losses, millions of jobs were lost, homeowners defaulted on their loans, some financial institutions failed and completely dissolved, and government bailouts were engineered to infuse money into the system and keep institutions that were deemed "too big to fail" afloat. Financial shocks have traditionally caused many observers to look at causes and solutions through a national framework. This approach fails to understand the interconnectivity of the modern global financial system and the relatively unknown international bodies that seek to institute stricter banking standards to ward off major economic crises.

This research paper seeks to review the overall macroeconomic picture in the Middle East-North Africa (MENA) region after the financial crisis and delve into the features of the successive Basel Accords from the Basel Committee on Banking Supervision (BCBS) since 1988. Further, it will be important to analyze the actual implementation of the current Basel standards in the MENA region through a data analysis by country. The paper will then study specific cases in Saudi Arabia and Kuwait to see how central banks and financial institutions are adjusting to the most recent reforms and adherence schedule. Finally, the paper will attempt to provide an monetary outlook of the region as the global economy recovers and banks across the world adjust to an era of enhanced global financial regulation.

I. Macroeconomic Picture of the MENA Region

The varying economic structures in the MENA region responded to the financial crisis of 2007-2008 in different ways. Broadly, the region can be divided into three or four groupings, according to the World Bank and Organization for Economic Co-Operation and Development (OECD). The first group includes resource-rich, labor-poor countries or the Gulf Cooperation Council (GCC) counties: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates (U.A.E.). With the exception of Dubai's housing collapse and credit default, oil prices have generally kept these economies moving forward since the recession. The second group includes resource rich, labor-rich countries or oil exporters with large populations: Algeria, Iraq, Iran, Libya, and Syria. The economic conditions of these countries have been less stable because of socio-political uncertainties and regional security issues. The third group includes resource-poor countries: Egypt, Jordan, Lebanon, Morocco, Tunisia, and Yemen. However, World Bank economist Auguste Kouame splits this group into two sections. First, Jordan, Lebanon, and Yemen have "linkages with GCC through remittances, FDI and tourism, or with strong dependency on foreign aid, or both."[1] These countries are hindered somewhat due to their reliance on outside factors. Second, Egypt, Morocco, and Tunisia are more diversified countries with trade and tourism with Europe and the West. While this often creates a profitable economic environment, the financial crisis showed that risk is difficult to contain in integrated financial systems.[2]

The monetary frameworks and central banking systems vary between MENA countries, but some overall trends can be observed. The International Monetary Fund (IMF) analyzes the countries in the region between oil exporters and oil importers. As the crisis was developing in the United States and in other advanced economies, MENA central bankers generally took the standard approach to monetary policy through price stability by controlling interest rates. As these pressures grew, central banks began to adopt broader responsibilities to protect prices, banks, and financial systems. In a policy handbook through the IMF (2013), two general pathways are articulated for oil exporters and oil importers. First, it recommends that oil-exporters should move beyond price stability and work more toward financial stability, using macro-prudential tools and chart

[1] Kouame, Auguste. World Bank. Q&A on the Global Financial Crisis and MENA. 23 April, 2009. Accessed: web.worldbank.org.
[2] Ibid; O'Sullivan et al. "Opportunities and Challenges in the MENA Region." OECD. Accessed: http://www.oecd.org/mena/investment/49036903.pdf

a more long-term growth strategy (See Figure 1 in Appendix).[3] This meshes well with the objectives and requirements of the Basel Committee. Second, it recommends that oil-importers take a more medium-term growth strategy and focus on social programs to create more access to labor markets, government services, and financial services (See Figure 2 in Appendix). [4] This response is more attuned to reacting to the political unrest in the region since the Arab Spring protests erupted in late 2010.

To sum, as the advanced economies of the G-20 pushed to reduce the risk of another major crisis through increased global regulation, the central banks of the MENA region were also shifting from price stability and currency concerns to a financial stability footing in an attempt to protect MENA economies from global shocks. This movement also allowed for MENA financial institutions to sync better with the revamped international regulatory standards, the topic of the next section.

II. The Basel Accords

The failure of a German bank and U.S. bank in the mid-1970s due to foreign exchange problems increased the need for more focused international financial observation. A precursor to the BCBS was formed and after the Latin American debt crisis of the 1980s, the Basel Committee moved to establish international standards that could be followed by countries and financial institutions around the world. It should be noted that a group of central bank governors in the world's largest economies craft these standards, which has enlarged over time (now the G-20), and participation and implementation is completely voluntary. No charters or treaties exist to place the regulatory standards in force. However, in the wake of the financial crisis, there is a stronger public sentiment for more market confidence and the embrace of risk-adverse policy to protect investments and assets.

The Basel Accord (1988) addressed capital adequacy and credit risk. It offered that banks should have a minimum capital ratio of 8% for held capital to risk-weighted assets (RWAs). These standards were mildly altered in subsequent years, but the Basel II agreement (2004) greatly enhanced requirements to try and keep pace with rapidly

[3] Gray, Simon et al. "Monetary Issues in the Middle East and North Africa Region: A Policy Implementation Handbook for Central Bankers." IMF (2013), p. 41-44.
[4] Ibid.

transforming and developing financial instruments, markets, technologies and structures. Basel II created a three-pillar system to create more stability. In the first pillar, banks were urged to have minimum capital requirements in case of market shocks or a crisis. In the second pillar, the Committee suggested a supervisory review of a financial institution's capital adequacy and internal planning. In the third pillar, the Committee sought to increase disclosures from the financial institutions to inform the rest of the market and regulators that sufficient financial planning was being conducted.[5]

In less than five years, regulators and economic officials realized that the Basel II standards did not do enough to limit the damage of the financial crisis. As a result, the Committee beefed up the previous agreement into reforms known as Basel 2.5, which revised many elements. The United States currently operates within this framework and many MENA economies are still working toward full implementation of these standards, which will be studied in further detail in the next section. The most comprehensive and strict global regulatory standards to date were issued in late 2010 and endorsed by a meeting of the G-20 nations in Seoul in November 2010. These regulations include a capital conservation buffer, a countercyclical capital buffer, leverage ratios (such as the Net Stable Funding Ratio or NSFR), liquidity requirements (such as the Liquidity Coverage Ratio or LCR), and recommendations for Systemically Important Financial Institutions (or SIFIs).[6]

The banking industry's reaction to these stiff regulatory norms has been mixed. On the one hand, financial institutions want to boost market confidence and discipline, reinvigorate participation in the sector, and establish policies to limit the type of catastrophic risk that was evident during the financial crisis. On the other hand, complete observance of all of the Basel agreements will be costly for banks. The institutions will need to hire additional compliance officers, update technology systems, and most importantly, hold much more capital on their balance sheets. By retaining more capital and liquidity, many observers think the standards will decrease bank lending and curb economic growth as the global economy slowly moves out of the fog of recession. The next few years will be a crucial time for global financial regulation. As of January 2012,

[5] "History of the Basel Committee." Bank for International Settlements. Accessed: http://www.bis.org/bcbs/history.htm
[6] Ibid.

an implementation schedule has been in place for national governments to follow. The leverage ratios, including the NSFR, are scheduled for implementation by January 2018 and the LCR is set for full implementation by January 2019.[7] Of the MENA countries, only Saudi Arabia is a member of the G-20 and had a direct hand in the creation of the policies and standards. How the Kingdom and the other MENA economies are keeping pace is the next topic.

III. Implementation of Basel Standards in the MENA Region

Implementation of the Basel standards from national draft legislation to actual regulatory policy has been realized more quickly in the G-20 countries, particularly up to Basel 2.5. Due to their direct membership on the Committee and the size of their economies, this is to be expected. For the MENA region, the results are more varied, but some general trends can be found. In an analysis for this research paper, a survey from the Financial Stability Institute (FSI) from July 2013 was studied and the data was broken down. The FSI survey asked countries around the world how far developed their regulatory practices have become in various measurement categories of the Basel II, Basel 2.5, and Basel III guidelines. For each field, complete adherence (or instituted national policy) registers a 4 on a 4-point scale. For an example of a brief response, see Figure 3 in the Appendix for Jordan's response to Basel II compliance. This research paper's analysis averaged all of the field responses to find an average for each country that replied on each agreement. If a field was marked "N/A" it was not included in the averaging. Of the 17 countries considered part of the MENA region, 11 responded to the survey. Thus, the analysis does not include data from Libya, Iran, Iraq, Syria, or Yemen.[8]

The complete results can be seen in Table 1 (Basel Compliance in the MENA Region) of the Appendix. Overall, the responding MENA countries rate 2.95 / 4.00 for Basel II, 2.17 / 4.00 for Basel 2.5, and 1.37 / 4.00 for Basel III implementation. When divided between GCC and non-GCC countries, the results are more interesting, especially with the implementation of the basic Basel II framework. GCC countries registered 3.36, 1.79, and 1.43, and non-GCC countries registered 2.45, 1.75, and 1.29 for each Basel

[7] Gray et al, p. 92-100.
[8] FSI Survey: Basel II, 2.5 and III Implementation. Financial Stability Institute. Bank for International Settlements (July 2013).

successive agreement, respectively. The highest-level rating was found, understandably, in Saudi Arabia, where the country has reached full compliance with Basel II and 2.5 and is working toward full compliance of Basel III.[9] Interestingly, Tunisia is the lowest-rated country that produced a survey. The birthplace of the Arab Spring, which is seen as the one country that could potentially come out of the protests with improved socio-economic and governmental reforms is still struggling with Basel II reforms, namely instituting better board governance rules and risk assessment approaches. The survey also mentions the country is getting more strategic guidance through the IMF.[10]

IV. Two Cases in Saudi Arabia and Kuwait

Global political and economic bodies have a "top-down" approach when it comes to new policies and this can explain why the Saudi Arabian Monetary Agency (SAMA) has been able to move at a crisp pace toward full Basel implementation. But perhaps the most important link is not urging political figures and central bankers to agree to ward off financial risk in more countries around the globe. The true test is whether financial institutions and banks are willing to coordinate oversight with the national regulatory body and establish in-house policies and reporting systems that mesh with the Basel directives, increase capital and liquidity on-hand, disclose fiscal health regularly, and ensure trust and balance with governments, corporations, and retail customers. This section will look at two banks in the MENA region—Al Rajhi Bank in Saudi Arabia and the National Bank of Kuwait (NBK)—to see how the firms are adjusting to new global standards.

SAMA issued a guidebook for banks in December 2012 that serves as a roadmap for Saudi banks to follow while implementing the Basel norms. Al Rajhi Bank, one of the largest in MENA, has been issuing Basel II qualitative disclosures bi-annually since June 2008. Since June 2013, Al Rajhi has been issuing Basel III disclosures.[11] A report from Aljazira Capital in December 2013 shows that due to consistent regulatory practices, Saudi banks are ahead of many Western developed economies. In general, Saudi banks

[9] Progress Report on the Implementation of the Basel Regulatory Framework. Basel Committee on Banking Supervision. Bank for International Settlements (April 2014).
[10] FSI Survey, p. 18.
[11] Al Rajhi Bank. Investor Relations. Basel II and III Disclosures. Accessed: http://www.alrajhibank.com.sa/en/investor-relations/pages/financial-results.aspx

are well capitalized to meet the Basel requirements. Figure 4 in the Appendix shows that Al Rajhi and many other banks are well above the capital adequacy ratios expected through Basel II and Basel III (8% and 10.5%, respectively).[12] Figure 5 in the Appendix shows how banks like Al Rajhi will need to phase-in the requirements of Basel III and retain more capital and liquidity. Moreover, since Al Rajhi is the world's largest Islamic bank, the practices associated with these conservative banking methods will allow the bank to hold more capital in comparison to other commercial banks. Two key indicators need to be analyzed in the future as Al Rajhi and other Saudi banks implement the Basel standards. First, long-term lending practices could be altered as Al Rajhi is forced to keep more capital on its balance sheet. With less lending, certain projects or financing arrangements could be stalled. Second, Al Rajhi is a leading retail and consumer bank. As MENA countries work on the challenges of bringing more people into the banking economy, interest rates, loans and deposits need to be measured as these operations grow.

In 2005, Kuwait was one of the first countries to implement Basel II measures in the world. However, their advancement since that time has lagged behind Saudi Arabia. The Central Bank of Kuwait announced on February 1, 2014 its intention to implement the standards in the regulation of Kuwaiti banks.[13] Research has shown that NBK has been steady in its disclosures of Basel capital ratios since December 2008.[14] Still, due to the long "on-ramp" toward full regulation, it remains too early to tell how banks like NBK will develop internally for better reporting and disclosure externally. Some hints can be gleaned from an interview with Mondher Bellalah, the head of market risk for NBK. In 2011, he explained the uncertainty banks would face in the coming years as it relates to credit, liquidity, and capital. Since the financial industry is constantly changing, he thinks that regulation will always be one step behind and Basel III could become outdated, just as Basel II became when the financial crisis erupted. Bellalah also explained that the technological costs are high for banks and that larger banks would have a faster time adhering to the standards than smaller, local banks. Finally, while perfect

[12] "Saudi Banking Sector Report." Aljazira Capital. December 2013. Accessed: http://www.aljaziracapital.com.sa/report_file/ess/SEC-117.pdf
[13] Press Release: "CBK Approves Implementation of Basel III Capital Adequacy Standards for Kuwaiti Banks." 1 February 2014. Accessed: http://new.cbk.gov.kw/en/
[14] National Bank of Kuwait. Investor Relations. Financial Results. Accessed: http://www.nbk.com/investorrelations/financialresults_en_gb.aspx

harmonization is preferable with more advanced economies, he believes this will always be difficult due to the specifications of each country's regulatory practices and banking sector.[15] The next three years leading up to the implementation of leverage ratios by January 2018 will be critical to measure the pace of implementation and disclosure for a number of MENA banks like NBK.

V. Economic Implications for MENA Region

Financial regulation does not grab the headlines like foreign policy, political protests, or regional violence, but the management and supervision of financial institutions is increasingly relevant in the MENA region. The Arab Spring protests showed that the people of the Middle East and North Africa want to participate more fully in the political and economic actions of their states. For many economies around the world, banking is a critical ingredient to that prosperity. While MENA countries have often operated through more familial and cultural avenues, formal financial arrangements are becoming more common and more necessary. From getting a loan to start a business to buying a car or home to managing income, banks will need to have a deeper relationship with the public and tailor to their needs, both conventionally and through Islamic finance. In turn, MENA banks and regulators will need to adhere to global regulatory standards to become more fully integrated into the world economy to bring stability to the regional economy and weather any future financial disruptions.

The IMF identifies three major channels of influence the Basel standards will have on MENA banking in the years ahead. First, in the long run, MENA banks will be better off due to the regulations and less business risk will exist. However, the IMF warns that MENA banks could feel the effects of transitioning from the status quo to the most stringent, global regulations to date. In other words, while the overall goal of the Basel standards may be security and reassurance, MENA countries are "potentially strongly exposed to any contraction in global (or G20) liquidity, cross-border credit availability and demand for exports."[16] Second, supervisory responsibilities are shifting globally and inside the MENA economies. Since the financial crisis and Eurozone crisis, more

[15] "Towards a Better Understanding of Basel III Requirements." *FTSE Global Markets*. Issue 48 (February 2011). Accessed: http://www.ftseglobalmarkets.com/

[16] Gray et al, p. 95.

attention has been given to entities like BCBS and the bigger role they are playing on the global stage. Domestically, MENA countries are realizing that their central banks need to reach new levels of sophistication and supervision. At the bank level, an emphasis is being placed on diversified corporate governance and responsible, transparent reporting, just a couple of the basic expectations in modern regulation. Third, the IMF realizes that implementation is expensive, but relays that the adoption of these standards will attract smarter foreign investment and lower overall risk premiums in the MENA regions. If outside investors feel more comfortable with the financial health of a MENA institution, the economic results can be lucrative and profitable.[17]

In addition to more regulation, there are many other trends to watch in the MENA region as banks adjust to a new normal through the rest of the decade. The non-GCC countries must contend with huge populations and strong protestations for more opportunity and economic advancement. Large, state-run development projects that have been launched will need long-term financing and the financial institutions in MENA will play a critical role in sustaining those efforts under new constraints. While MENA financial groups, especially in the GCC, are well capitalized, the growing importance of Islamic finance will be a trend to watch. With relatively low participation rates and meager lending to small and medium-size enterprises, any growth in these areas could be significant in the coming years. For the GCC counties, exports-imports are an enormous part of economic activity and a few organizations have sounded alarms as it relates to trade finance. BAFT-IFSA has calculated that the latest Basel standards could increase trade-pricing costs between 18-40%.[18] Therefore, trade finance will need to be monitored as banks continue to keep pace with capital and liquidity requirements. A statement from Gerard Rizk of Blom Bank in Lebanon sums up the big picture rather well: "Until now many MENA banks have managed risks in their individual frameworks. The market has now matured to a point where a number of banks are thinking about ERM (enterprise risk

[17] Ibid, p. 96.

[18] "Trade Finance – Key Concerns and Recommendations for the Basel Framework." BAFT-IFSA (25 October 2011). Accessed: http://www.esf.be/new/wp-content/uploads/2011/12/BAFT-IFSA-Basel-Talking-Points-2011-12-01-Final.pdf

management) and how they can implement ERM. Basel III requirements will help act as a spur to develop an implementation strategy..."[19]

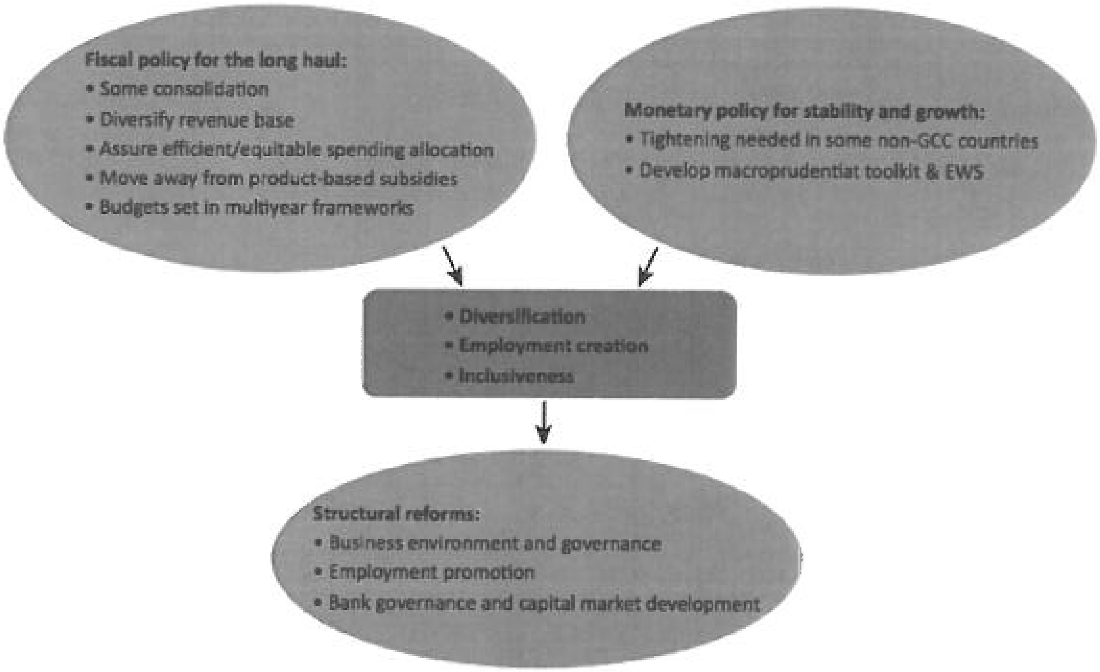
Conclusion

In this era of globalization, countries and economies are becoming more integrated and connected through the movement of goods and services and in the development of complex financial instruments and systems. Financial services and banks work across borders and national and global regulators—previously in place to monitor exchange rates and focus on price stability—are now trying to institute new norms to supervise and measure risk through more targeted ratios. In the aftermath of the financial crisis, the burden of risk has shifted away from the central banks and directly onto the balance sheets of banks. The MENA region, already an area of the world with a heavy banking sector, is following the lead of the G-20 nations and this paper has shown how the MENA countries, and two banks in particular, are adjusting to the Basel standards. At this time, a majority of MENA countries are on track toward implementation, but many countries are also struggling with social upheaval, political problems, and security challenges. How banks balance these domestic concerns with the desired dates for international compliance will have real impacts on the economy of the entire MENA region and the people who live there.

[19] "Risk Leaders Report." Progress and Trends in Risk Management in MENA Financial Institutions. IIR Middle East (2014).

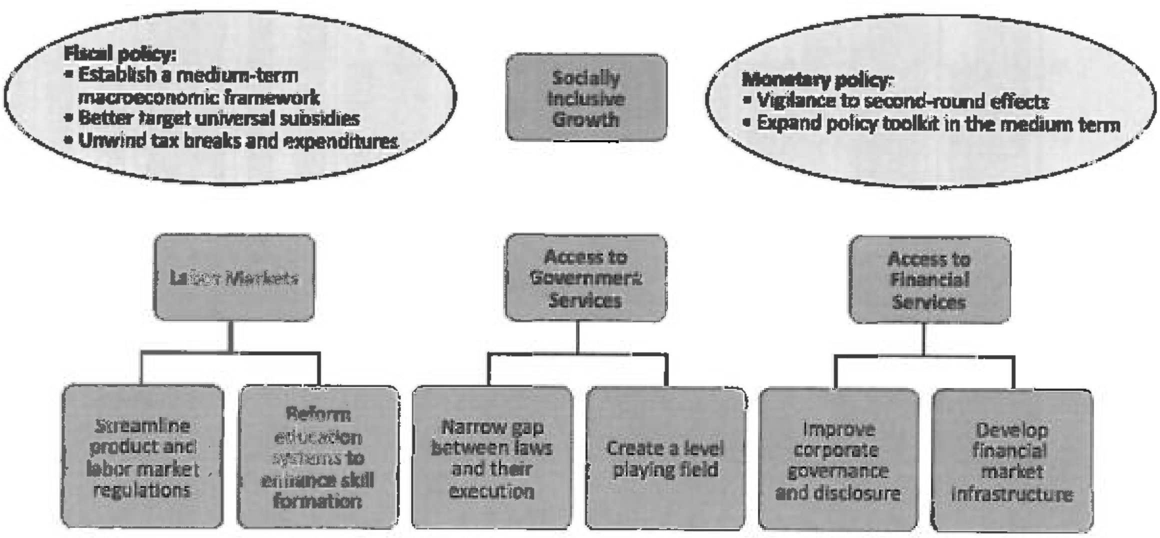
Appendix

Figure 1. MENA-OX: Promoting Stability and Long-Run Growth



Source: REO, MCD, Fall 2011.

Figure 2. MENA-OM: Promoting Stability and a Medium-Term Inclusive Growth Strategy



Source: REO, MCD, Fall 2011.

Figure 3. Jordan's Survey Response to Basel II Compliance

Jordan	SA	4	2008
	FIRB	1	NA
	AIRB	1	NA
	BIA	4	2008
	TSA	3	2008
	AMA	1	NA
	P2	4	2010
	P3	4	2007

The Central Bank of Jordan (CBJ) considered the adoption of IFRS(7) as being equivalent to compliance with Pillar 3 of Basel II, noting that all banks in Jordan are compliant with IFRS(7).

Source: Bank for International Settlements / Financial Stability Institute

Table 1. Basel Compliance in the MENA Region

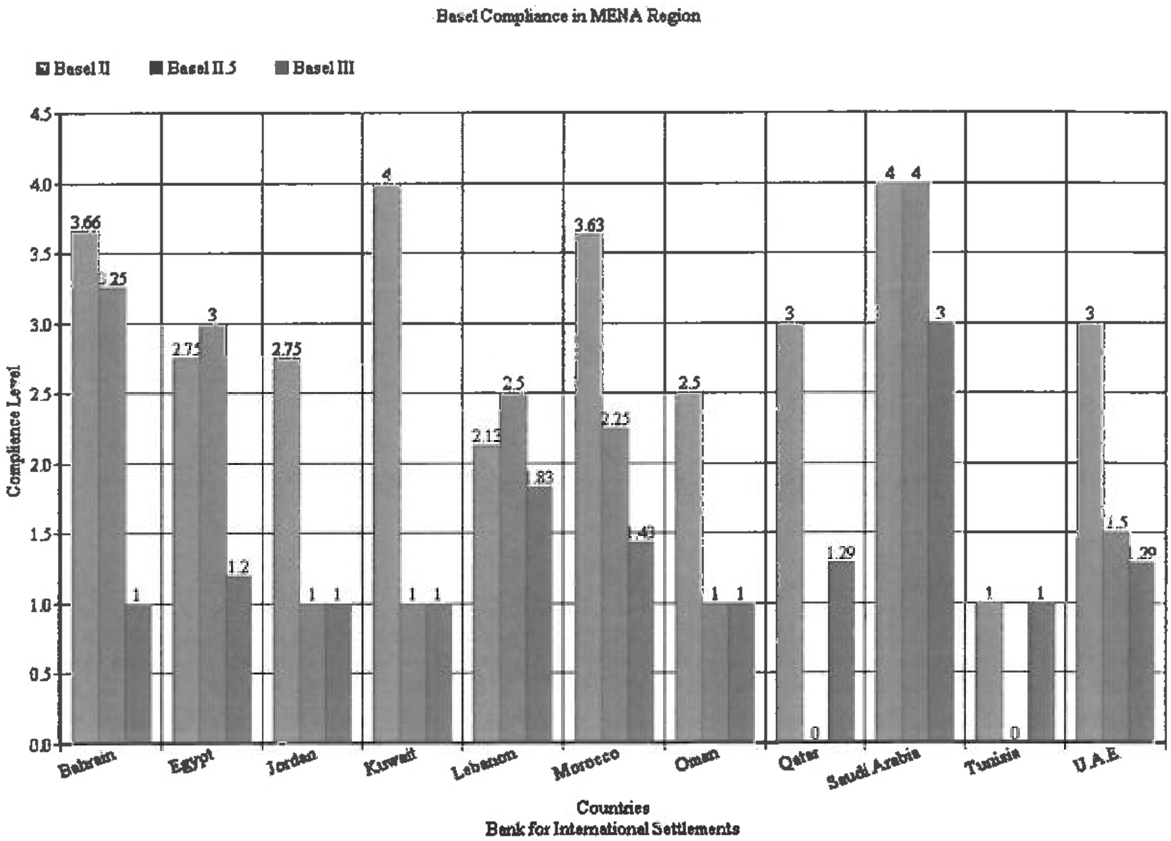
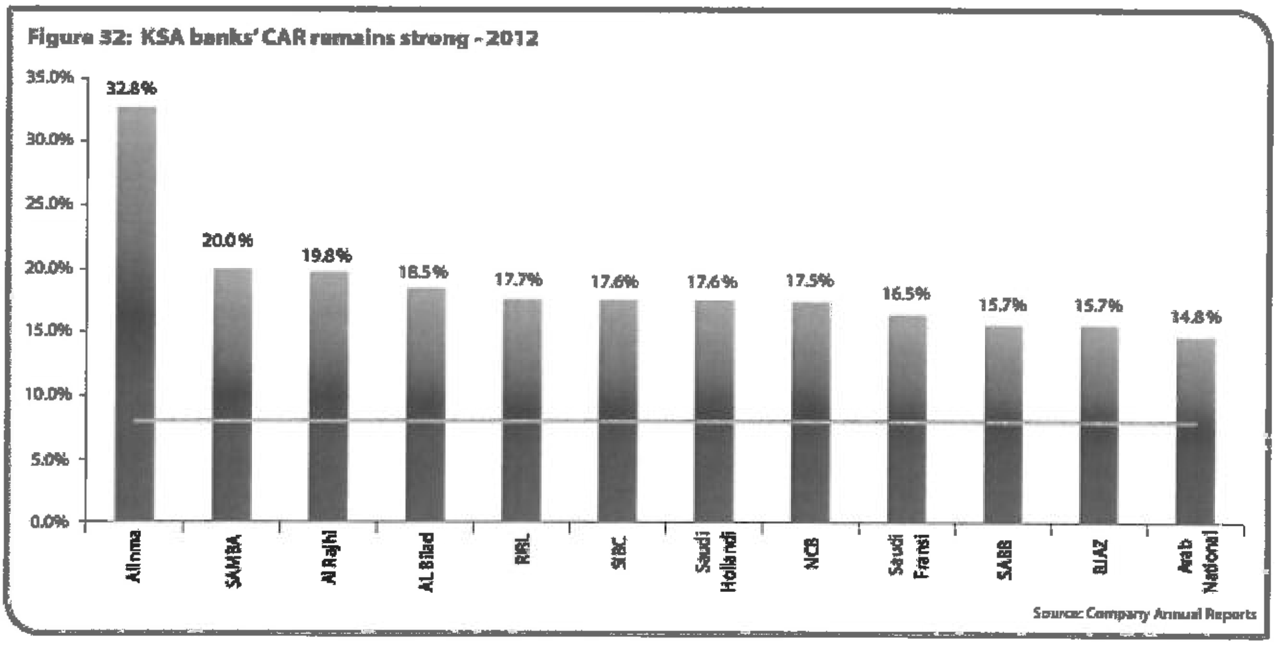


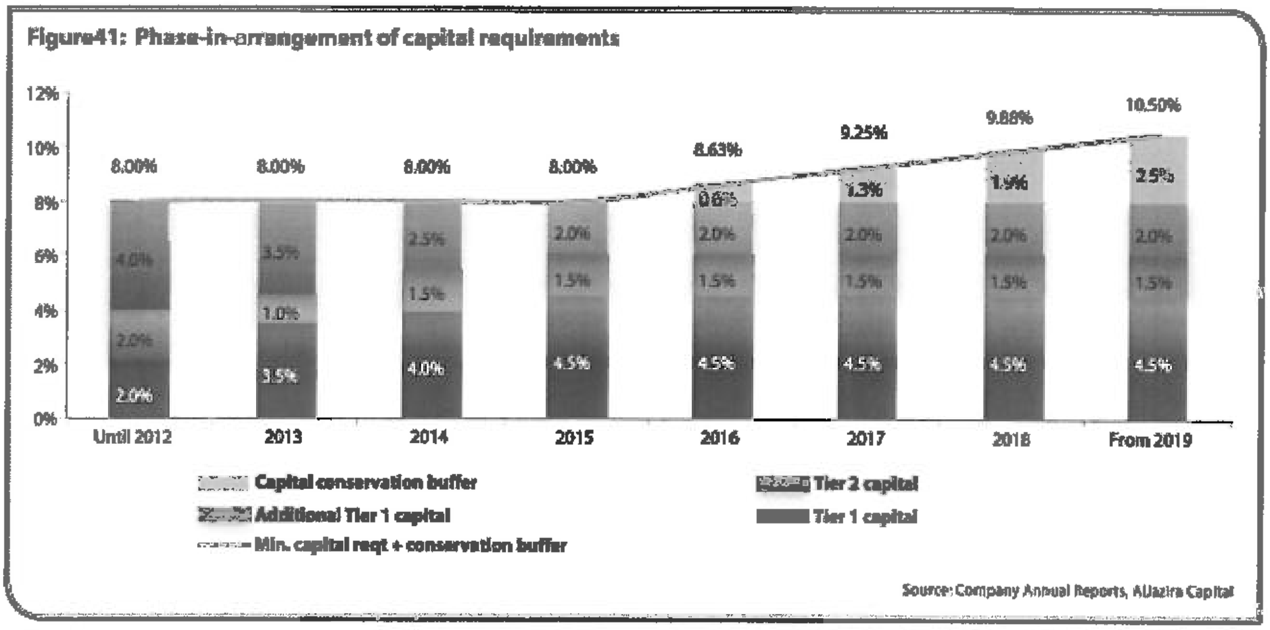
Chart created by Michael Schmuhl. Data source: Bank for International Settlements.

Figure 4 (32): KSA Banks' Capital Adequacy Ratio Remains Strong - 2012



Source: Aljazira Capital (Dec. 2013)

Figure 5 (41): Phase-in Arrangement of Basel Capital Requirements



Source: Aljazira Capital (Dec. 2013)

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