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The Financial Sector in the ESCWA Region: The Current Status and Prerequisites for Strengthening and Development

Note: This study has been prepared by Mr. Imad Shehab. The opinions expressed are those of the author and do not necessarily reflect the views of ESCWA.

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CONTENTS

Introduction

The existence of an efficient financial sector is central to the process of mobilizing domestic and foreign resources with regard to financing development and promoting sustained growth. The Economic and Social Commission for Western Asia (ESCWA) member countries have taken significant measures to strengthen and develop their financial sectors. Domestic reforms have been extremely thorough. In particular, there has been an intense focus on greater dependence on market forces, strengthening organizational and supervisory frameworks, enhancing domestic competition and mobilization of domestic savings.

Domestic financial institutions have responded positively to changes in financial policies. Furthermore, they have accommodated modern developments in the industry. They have enhanced capitalization, introduced new products and services, applied new technologies, developed their institutional frameworks and ventured into new financial businesses.

However, new challenges, both domestic and international, face domestic financial institutions. These include, greater liberalization of financial services worldwide globalization of international markets, cost and profit pressures on financial institutions, greater internal and external competition, accelerated developments in the banking and finance industry, the necessity of attracting national capital from abroad and international investment.

If the challenges of the present and of the future are to be met, the current status of the financial sector in ESCWA member countries must be further developed, on all levels.

This paper aims to shed light on the current status of the financial sector in ESCWA member countries with regard to commercial and Islamic banks, insurance companies, pension funds, investment funds and capital markets. Furthermore, the paper will analyse the weaknesses and strengths of the financial sector, and its role with regard to efficiently mobilizing domestic and foreign resources for financing development. In addition, the paper contains policy recommendations for strengthening the financial system in the region.

I. THE BANKING SECTOR*

A. CURRENT STATUS

The monetary and banking authorities in ESCWA member countries have attached great importance to the process of reform and liberalization of their banking sectors. This is because of the significant role that the banking sector plays with regard to the mobilization of domestic resources and foreign capital in addition to its enhancement of economic growth. Furthermore, it pertains to the importance of banking stability with regard to overall stability of the national economy.

The previously mentioned reform and liberalization of the banking sector in ESCWA member countries included the following:

(a) Seizure of administrative controls on interest rates and exchange rates;
(b) Transformation into indirect monetary control instruments;
(c) Development of legal and supervisory frameworks;
(d) Liberalization of banking activity.

In parallel to these reform measures, domestic banking institutions have consistently accommodated recognized developments in international banking and finance.

Significant changes with regard to banking in the Arab world include the following:

(a) Increased migration towards the "universal banking" concept. Many banks have incorporated financial leasing, capital market activities, insurance and many other non-traditional banking operations and services into their structures;

(b) The development of a service-product base. This has increased the scope of activities in retail banking, and has particularly focused on technology-driven lines of banking, such as home banking, phone banking, office banking, and Internet banking. E-banking is experiencing modest growth in the Arab region;

(c) The development of a financing base, whether from internal or external sources. This depends on subordinated debt instruments, fiduciary deposits, euro-bonds, global depository receipts, euro-CDs, in addition to credit lines and funds from regional and international financial institutions. This process has placed some Arab banks on the international financial map;

(d) A greater involvement in project financing of leading investment and economic projects in the Arab region. Several Arab banks have been active partners in syndicated lending schemes;

(e) Moves towards mergers and acquisitions (M&As) which were observed in some Arab banking markets. In these cases, whereby big or medium-sized banks targeted economics of scope, economics of scale and stronger expansion in activities and markets, largely by acquiring smaller banks;

(f) Increased compliance with international banking practices and supervision, disclosure and accounting standards, governance rules and Basle standards;

(g) Increased investment in human resources development and information technology.

In other words, Arab banking has undergone substantial changes in its efforts to accommodate the basics of modern banking. These changes have been effected to meet increased competition in domestic and global markets, and to improve competitive potential.

The banking sector in the ESCWA region comprises approximately 365 banking institutions. These provide mainly commercial, investment and Islamic banking operations.

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* Figures in this section are largely derived from annex table 1.

This sector has witnessed sustained growth in its overall activity since the beginning of the 1990s in line with the reform programmes adopted by ESCWA member countries. Over the past five years, the banking sector has achieved an average increase of 8.92 per cent over the past 5 years (1996-2000) in total assets to reach US$ 459 billion, and 9.04 per cent in customer deposits to reach US$ 277 billion in 2000. Therefore, the resources mobilized by the banking sector constituted 60 per cent of total assets over the past two years. The sector has extended credit to the economy of ESCWA member countries by nearly 96.7 per cent of customer deposits in 2000 (see table 1).

Banks in the ESCWA region managed some US$ 65 billion in foreign assets as of end 2000, or nearly 14.2 per cent of their total assets. These foreign assets experience ups and downs in their value as a result of periodic changes in domestic and international markets.

Furthermore, ESCWA banks in the region have consistently upgraded their capital bases to accompany expansion in their activities. The consolidated capital base of domestic banks grew by 4.4 per cent to reach US$ 51.6 billion in 2000.

Domestic banks have also enjoyed healthy financial ratios. Total shareholders' equity constituted 18.67 per cent of customer deposits, 11.24 per cent of assets and more than 15 per cent of risk-weighted assets in 2000. These figures reflect strong solvency ratios according to international standards. In addition, the return on assets reached 2 per cent, and the return on shareholders' equity 17.8 per cent in 2000. This therefore reflects solid profitability ratios. It is important to bear in mind that net profitability grew by 8 per cent to reach US$ 9.2 billion in 2000.

It is worth indicating at this point, that 58 banks in the ESCWA region, were included in *The Banker's* List of Top 1000 International Banks as of July 2001 in terms of tier-1 capital.[1] These included 8 Bahraini banks, 9 Egyptian banks, 12 Emirati banks, 2 Jordanian banks, 8 Kuwaiti banks, 5 Lebanese banks, 3 Omani banks, 10 Saudi Arabian banks, and 1 Syrian bank.

B. STRUCTURAL WEAKNESSES

While ESCWA member countries made steady progress with regard to restructuring the legislative and organizational frameworks of its banking sector, there are several weaknesses in the overall structure of this sector.

The major weaknesses include the following:

1. *Small-sized banks*

Despite observed increases in assets and capital, banks in the ESCWA region remain relatively small in size, compared to emerging or international banks.

The consolidated assets of the banking sector in the ESCWA region do not correspond to the assets of a single top international bank. Furthermore, only nine domestic banks have assets that exceed US$ 15 billion and only four domestic banks have shareholders equity that exceeds US$ 4 billion.

2. *Over-banking*

The banking markets in the ESCWA region are characterized by a relatively large number of banks. The number of banks is not in harmony with the size of the national economy, the size of the population or the size of the Arab banking sector as a whole. One example is Lebanon. It has 71 banks. Their assets amount to some US$ 45 billion distributed over 3.5 million people, and its overall national product is US$ 16 billion. Its banking sector's share is 10 per cent of total assets of the Arab banking sector.

[1] *The Banker*, "Middle East increases stake after profitable 2000", July 2001. Available at: www.thebanker.com.

3. *Bank concentration*

The banking activity in the ESCWA region is becoming increasingly concentrated in few banks. This definitely affects competition. Available data shows that the two biggest commercial banks in Yemen own 64 per cent of overall deposits. In Egypt, the four public commercial banks own 65 per cent of overall assets of the banking sector. In addition, the Qatar National Bank owns 45.2 per cent of the country's bank assets.

4. *Ownership structure*

The ownership structure of many banks in the ESCWA member countries is marked by hefty public sector participation. Therefore, the public sector dominates the managerial and operational levels in most banks. The two biggest banks in Yemen, the National Bank of Yemen and the Yemeni Bank for Construction and Development are public banks.

5. *Non-performing loans*

In many ESCWA member countries, previous loan practices have led to a noticeable deterioration in the quality of loan portfolios for many banks. The major source of this problem is the provision of bank loans to public institutions with inappropriate financial conditions. Owing to shortage in liquidity and high operating costs, this development has affected the ability of banks to play an efficient role in financial intermediation. For instance, non-performing loans in Yemen are estimated at 64 per cent of total loan portfolio.

6. *Weak disclosure and supervision*

Bank data and reports differ from one bank to another in their accuracy and inclusiveness in the ESCWA region. Furthermore, they lack the minimum required level for disclosure, which makes it hard to compare banks in the ESCWA region with international banks. It follows that there is an urgent need to improve transparency and the methods of publishing financial statements and data if foreign investors and depositors are to be encouraged.

7. *Segmentation of banking activity*

In many ESCWA countries, a number of specialized credit institutions and development banks have been established to encourage sectors that include agriculture, industry and tourism. This specialization has resulted in a certain degree of segmentation with regard to banking activity, which in turn, has diminished competition.

8. *Inefficiency of payment systems*

In the majority of ESCWA countries, the clearing system in use is the system of clearing record. This system is based on the actual transformation of debt and credit instruments and on manual checking procedures. However, this system leads to delays in clearing operations. Furthermore, in addition to the risks of losing documents, this system has increased the number of bounced checks.

C. DEVELOPMENT PREREQUISITES

More concern must be afforded to the issues outlined in brief, as follows:

1. *Transparency*

On a national level transparency and supervision systems must be improved and accounting standards must be developed. Furthermore, there is a need to establish unified organizational and accounting standards and rules in line with international standards. In addition, there must be better exchange of banking information with regard to banks with cross-border activities.

2. *Privatization*

ESCWA countries, as a whole, must move towards the privatization of public banks and financial institutions in addition to minimizing Government involvement in banks. This process is particularly important in countries where Governments still maintain a large degree of bank ownership and/or management. Diminishing Government involvement will enhance competition and capital efficiency and help to increase national savings.

3. *M&As*

M&As between small banks must be encouraged. This policy will strengthen the banking system as a whole. Moreover, M&As will facilitate the entry of banks into regional markets and increase their capability to compete internationally.

4. *Debt collection and non-performing loans*

Mechanisms for collecting debts and solving the problem of non-performing loans must be reinforced. There is also a need to strengthen the performance of the juridical and legislative systems to help them execute contracts and financial obligations and collect debts more efficiently.

5. *Deposit insurance system*

Several ESCWA countries do not have an official deposit insurance system, despite expectations that Governments will guarantee deposits. Therefore, a deposit insurance system must be established in these countries and they must be characterized by simplicity and clarity.

6. *Meeting the demands of globalization*

The banking industry in many developing and developed countries has undergone basic changes as a result of two important factors:

(a) Financial liberalization and deregulation;
(b) Outstanding technical changes manifested as a result of the Internet and electronic commerce.

Therefore, banking institutions in the ESCWA region must attempt to adjust to these rapid changes, to improve their services and be prepared to meet the challenges of globalization, deregulation and liberalization of financial services.

II. ISLAMIC BANKS**

A. GENERAL SITUATION

Islamic banking witnessed modest activity in the 1960s in many ESCWA member countries. During that time, it was largely dominated by individual initiatives. However, the growth in Islamic banking during the 1980s and 1990s in some countries was motivated by the Governments of these countries. Islamic banks were established either by private laws or by making modifications and changes to existing banking legislation.

Two primary methods have been observed with regard to Islamic banking practices. In countries where Governments were not forced to abolish interest rates, Islamic banks operated side by side with traditional banks. This happened in Egypt and in the Gulf region. Moreover, Islamic banking practices are gaining in popularity. For example, the Government has chosen to Islamize the banking system in Sudan. Moreover, in Lebanon, there are moves to develop a mixed system and the formation of Islamic windows is

** Figures in this section are largely derived from annex tables 2 and 3.

being encouraged in traditional banks. Furthermore several purely Islamic financial institutions exist within the country.

To date, there are 32 Islamic financial institutions in the ESCWA region. Of these, 19 institutions originate in the Gulf Cooperation Council (GCC) countries. This sector accounts for some 37.6 per cent of the total number of Islamic banks and financial institutions worldwide, 85 institutions altogether. The Islamic financial institutions in the ESCWA region have succeeded in mobilizing a large amount of funds. These are estimated at US$ 23.3 billion, US$ 17.8 billion of which derive from the Gulf region. The value of mobilized funds in Islamic banks in the ESCWA region is estimated at 84.4 per cent of the overall mobilized funds of Islamic banks in the world. The large number of Islamic institutions and the considerable funds managed by these institutions clearly illustrates the relative power of Islamic banks in the ESCWA region as compared to other regions in the world.

If the performances of the top ten banks in the ESCWA region are compared with counterparts in other regions of the world, it is possible to ascertain that the performance of the banks in the ESCWA region is superior. The average capital-to-assets ratio in the ESCWA region stands at 7.6 per cent compared to 4.2 per cent for the top 10 banks in Asia and 4.8 per cent for the top ten banks in the world. Furthermore, the average return-on-capital is 16.3 per cent compared to 17.3 per cent and 16.1 per cent respectively. In addition, the return-on-assets is 1.5 per cent compared to 1.1 per cent and 0.9 per cent respectively.

The financing structure in Islamic banks in ESCWA member countries reflects a dominant share for *Murabahah* at 82.3 per cent, *Musharakah* at 6.87 per cent, *Mudarabah* at 5.64 per cent, *Ijara* at 2.43 per cent and other services at 2.76 per cent. With regard to sectoral financing, Islamic banks provide 32 per cent of the financing for the commerce sector, 5 per cent for agriculture, 14 per cent for industry, 15 per cent for services, 6 per cent for real estate and 28 per cent for others.

B. CHALLENGES AND STRENGTHENING PREREQUISITES

The Islamic banking industry in the ESCWA region faces many challenges with regard to its desire for future development. These include, the need to increase and diversify their financial instruments and to enlarge their niche markets. Furthermore, there are challenges with regard to legislation, supervision, management techniques and risk management.

Many external factors in the ESCWA region with regard to Islamic banking practices have changed considerably. The number of clients has increased, operations have spread across the borders, and Islamic contracts have dramatically expanded. Despite these positive developments, Islamic banks still encounter the same challenges and risks faced by traditional banks. These include external shocks, mismanagement and the choice of suitable projects and their sound evaluation.

Another factor that hampers the growth of the Islamic banking sector is the issue of interest. Islamic banks, unlike traditional banks, do not benefit from the services of central banks as a lender of last resort. Furthermore, the non-existence of a core interbank market for Islamic banks means that most of their instruments are short term. Islamic banking has its own characteristics and features. Hence it is inappropriate to apply domestic and international standards to Islamic institutions without making changes to the institutional, supervisory and organizational frameworks which govern their activities.

Islamic banks and their special requirements suffer from a lack of institutional support. In many ESCWA countries, Islamic banks are subjected to the same conditions and rules that apply to traditional banks. For example, Islamic banks are required to leave a portion of their deposits with central banks. However, the attitude of Islamic banks with regard to interest rates means that they are unable to accept interest on their deposits.

Furthermore, it is impossible to ignore the international standards and measures that have been recommended by the Basle committee. In this context, therefore, the fundamental issue is to maintain the distinctive features of Islamic institutions without ignoring international standards. It follows that it is

essential to devise appropriate organizational frameworks and standards that will guarantee fruitful cooperation between Governments and central banks and Islamic institutions.

There is another basic element to consider. Islamic institutions must have sufficient liquidity to meet their financial obligations and services. Undoubtedly, the presence of a core interbank market to provide loans for banks is an important step in this regard. It would enable Islamic banks to retain sufficient liquidity without keeping short-term assets in large quantities.

Moreover, Islamic banks themselves must agree on specific issues related to capital treatment, risks, risk management mechanisms, liquidity-improvement tools and contractual obligations.

III. MUTUAL SAVING INSTITUTIONS AND INSTITUTIONAL INVESTORS***

A. PRESENT STATUS

Despite noticeable developments in mutual saving and institutional investor institutions in the ESCWA region over the past few years, the overall situation of the market is still below desired levels as compared to developing countries in general, and developed countries. Furthermore, the relative importance of mutual saving and institutional investor institutions varies among ESCWA countries. At the same time, the total assets of pension funds, insurance companies and mutual investment funds, constitute more than 100 per cent of gross national product (GNP) in developed countries that include the Netherlands, Switzerland, the United Kingdom of Great Britain and Northern Ireland and United States of America, 25 per cent in many developing countries and between 25 to 100 per cent in the majority of European member countries of the Organization for Economic Cooperation and Development (OECD). The average prevailing rate is only 10 per cent in the ESCWA region. Egypt, and to a lesser extent Jordan, are considered the most active countries with regard to mobilizing large amounts of mutual savings. The total assets of institutional investors constitute 40 per cent of gross domestic product (GDP) in Egypt and 20 per cent in Jordan.

In general, mutual savings institutions exist in ESCWA countries. These are considered developed in comparison with other developing countries. However, the insurance industry in these countries is considered relatively underdeveloped.

One of the major features of mutual saving and institutional investor institutions in the ESCWA region is the dominance of largely centralized public institutions. This has led to improper policies with regard to the allocation of assets and declining returns on investment.

B. THE INSURANCE SECTOR

1. *General situation*

Despite the large number of insurance companies and considerable industry growth in ESCWA countries, the role played by the insurance sector with regard to mobilizing savings and financing investments remains limited.

There are 18 insurance companies in Bahrain, 16 in Kuwait and Oman respectively, 82 in Lebanon, 8 in Qatar and 69 in Saudi Arabia.

The average value of subscribed insurance premiums over the past three years reached US$ 120 million in Bahrain, US$ 550 million in Egypt, US$ 100 million in Jordan, US$ 210 million in Kuwait, US$ 500 million in Lebanon, US$ 140 million in Oman, US$ 170 million in Qatar, US$ 770 million in Saudi Arabia, and US$ 690 million in United Arab Emirates. Insurance premiums achieved a fair growth of 23 per cent in Egypt, 10 per cent in Jordan, 3 per cent in Lebanon, 5 per cent in Saudi Arabia and 12 per cent in the United Arab Emirates. The contribution of the insurance sector to GDP in the ESCWA region is relatively low by international standards. Its contribution is estimated at only 1 per cent compared to 5 per cent in

*** Figures in this section are largely derived from annex tables 4 and 5.

developed countries. The total subscribed premiums is some US$ 5 billion in the ESCWA region compared to US$ 2,500 billion in the world. Furthermore, the average per-capita insurance premium in ESCWA member countries is only US$ 120 compared to US$ 500 in developed countries.

2. *General features of insurance markets*

The insurance markets in the ESCWA region are characterized by the following basic weaknesses:

(a) Disintegration of insurance portfolios as a result of an excess of insurance companies compared to the size of local markets. This is evident in Lebanon, Saudi Arabia and the United Arab Emirates;

(b) Imbalance in the portfolios of insurance companies, where medium-term risks are almost absent. Car insurance constitutes 33 per cent of overall insurance premiums, while high-risk projects, namely, oil and aviation, constitute 55 per cent, with low life-insurance levels;

(c) Weak capitalization on the part of national insurance companies. The capital level of many companies is less than US$ 15 million;

(d) Little focus on improving insurance products to accommodate international standards. Insurance companies largely concentrate on attracting customers through price competition;

(e) Diminutive role played by local insurance companies with regard to responding to individual needs that include life insurance, personal accidents, pensions and medical care. It is important to bear in mind that such insurances constitute about 60 per cent of the size of insurance premiums worldwide;

(f) Little concentration on developing insurance awareness among the public in addition to scant cultivation of their insurance needs and rights;

(g) Local insurance companies maintain poor information systems. This has negative repercussions for the decision-making process;

(h) Improper and inappropriate legislative, supervisory and accounting systems, that govern insurance companies;

(i) Overemployment in local insurance companies, especially in those managed by the public sector. This has led to considerable operating costs without real economic returns;

(j) Lack of sufficient capital and financial reserves. This prevents insurance companies from accepting big risk projects or retaining an acceptable level of subscribed premiums. At the same time, a large portion of these premiums, 60 per cent, find their way to international markets;

(k) High protection for insurance companies in Egypt, Iraq and the Syrian Arab Republic.

3. *Development prerequisites*

The insurance sector in the ESCWA region must be extensively reformed on many levels, namely structural, legislative and financial. This will help to accommodate domestic development needs and international changes. Basic reforms must include the following:

(a) Development of the existing legislative and supervisory frameworks that govern the insurance business. It will be necessary to partially privatize this sector and to encourage foreign competition in domestic markets as this will attract cutting-edge experience and technologies;

(b) Providing incentives to encourage mergers and strategic alliances between insurance companies. This will create large insurance units capable of operating with economies of scale and economies of scope;

(c) Raising the minimum level of capital for insurance companies to enhance capitalization ratios;

(d) Establishing strong balances with regard to insurance portfolios, mainly by increasing the share of intermediate and long term risks;

(e) Establishing strategic alliances between insurance companies and banks to develop the so-called bancassurance industry;

(f) Development of insurance products in line with national necessities and international standards;

(g) Enhancement of insurance awareness among the public, and development of life insurance. This is regarded as a good method of saving and could provide an alternative to existing social insurance programmes;

(h) Implementing strategic policies to meet the challenges of trade liberalization in financial services according to the principles of the General Agreement on Trade in Services (GATS) and the World Trade Organization (WTO) directives.

C. PENSION FUNDS

1. *General conditions*

Pension plans in the ESCWA region are characterized by the accumulation of long-term savings. These increase with further maturity of the system as long as the financing rate remains at high levels. However, these plans are transformed over time to non-financed plans because of three main factors. These are as follows:

(a) Increases in advantages without corresponding increases in contributions;

(b) Political opposition which usually delays increases in contribution rates that are essential to secure financial balance in the system;

(c) Social security institutions which are restricted as to the use of their resources because they assist in financing Government spending.

In Jordan, accumulated mutual savings represent the main financial source for social security institutions, and these in turn are financed through contributions with rates of 15 per cent. Egypt implemented higher contribution rates at 26 per cent with regard to social security systems. This explains the large amount of mutual savings in Egypt. Pension plans in Lebanon and some GCC countries have lower contribution rates, this amounts to 23 per cent in Lebanon, and their structures are more mature. However, they face extreme financial pressures as a result of limited financial resources.

Societies in the ESCWA region tend to be young. This is a scenario that causes anxiety with regard to long-term pension systems. Social security systems can benefit from extending and enlarging their range of coverage to include employees from the public and private sectors. However, these systems require fundamental reforms to achieve guaranteed benefits in the long run. Basic reforms in pension systems and greater integration with international capital markets, largely by opening national markets to strategic foreign investors, will increase efficiency with regard to mobilizing domestic and foreign resources and stimulating economic growth rates.

2. *Challenges and development needs*

Pension funds in the ESCWA region must take into consideration international diversification and increase returns on investment portfolios, particularly if the potential of institutions outweighs the capacity of national markets. Domestic funds usually prefer to invest in national markets, due to the nature of their obligations and to their inclination to invest in well-known markets and securities.

One of the biggest and most basic influences on the development of share markets in the ESCWA region is the trend towards globalization and the integration of national markets with international ones. However, local pension funds do not invest greatly in shares and do not play an effective role in trading shares and capital-market development.

It is essential to increase the confidence of the household sector with regard to pension institutions in the ESCWA region. Households tend to prefer to invest in mutual investment funds and in insurance companies. This is due to the rarity of pension funds and fears regarding the role of pension funds.

As stated previously, ESCWA societies are characterized by young populations. However, pension plans are under a great deal of pressure as a result of the current levels of contribution rates and returns on investment in general. Furthermore, since these contribution rates are considered high by international and local standards, the only two logical alternatives are either to enhance investment performance or to lower contributions.

ESCWA countries must re-examine their social security system and must find a way to establish firm ties between benefits and contributions. They must also adopt diversified means that will permit pension funds to increase their investment returns. One of these means is to hand over management to institutions specialized in asset management. Another method is the transformation of the social security system. This would involve moving from the principle of limited benefits to the principle of limited participations. The third option is a partial privatization of existing pension systems whereby a private entity is authorized to manage social security plans according to agreed rules and standards.

D. Mutual investment funds

1. *General conditions*

To a large extent, the mutual investment fund industry in the ESCWA region remains underdeveloped. It is non-existent in Iraq, Palestine and Yemen, and is in the early stages of development in Jordan and Lebanon. In Egypt and Saudi Arabia it is largely developed. Saudi Arabia is considered the most advanced country among all ESCWA countries in the field of mutual investment funds.

In all cases, the performance of industry remains below desired levels and international standards. The assets of this industry constitute less than 7 per cent of GNP in the ESCWA region. However, this ratio is 50 per cent in the United States and 39 per cent in France and ranges between 20 to 30 per cent in the majority of other OECD countries.

Investment funds in the ESCWA region were introduced in the late 1970s. They were considered to be a tool to attract and mobilize national savings and to direct them towards investment alternatives. In the early 1990s, legislative frameworks were developed to govern the activities of mutual investment funds. This was a development that fuelled further growth of the mutual investment fund industry as a basic tool for mobilizing domestic and international savings and investments.

2. *Development and evolution of investment funds*

The first investment fund in the ESCWA region was established in Saudi Arabia in 1979. The first fund was created by the National Commercial Bank. By 1990, there were 24 investment funds and by 1999, 117 funds. In 1985 two investment funds were launched in Kuwait. By 1999, the country had six funds. By 1999, Bahrain had 28 funds, Egypt had 22 funds, Jordan had 5, Lebanon 3 and Oman had 7. The investment fund industry in the ESCWA region includes capital growth, fixed or variable return funds, stocks or bonds funds and currencies or real-estate funds.

3. *Fund performance*

It is worth noting that the role played by investment funds in the ESCWA region with regard to mobilizing national savings, growth of securities markets and GDP is still relatively low by international

standards. The aggregate capital of these funds as a percentage of national savings does not exceed 1.6 per cent in Egypt and 8 per cent in Jordan. When deflated by market capitalization, the aggregate capital of these funds stands at less than 4 per cent in all countries except Saudi Arabia where it stands at 13.6 per cent. Furthermore, when deflated by GDP, the aggregate capital is less than 2 per cent in ESCWA member countries except in Saudi Arabia where it is 6.5 per cent.

4. *Difficulties and challenges*

Investment funds in the ESCWA region face numerous difficulties and challenges. Those hinder their development and affect their performance.

These difficulties and challenges include, inadequate financial analysis, inconsistent investment strategies vis-à-vis fund objectives, obscure financial investment goals, absence of strategic and financial planning, lack of clear and sound policies that are capable of dealing with financial crises, and lack of expertise.

Furthermore, domestic funds are hindered by the low supply of securities resulting from the dominance of family-owned and Government-owned corporations in the ESCWA region. These usually avoid listing on stock exchanges.

In addition, there is a moderate demand for securities. This is a result of low financial transparency, shortage in, and limited diversification of, the securities base and the absence, or weak existence of, market-support financial institutions, namely, market makers, brokerage firms, credit-rating institutions amongst others.

Finally, there is uncertainty as regards the ongoing economic reforms in the ESCWA region. This uncertainty is fuelled by the relative slowdown in privatization programmes and trade liberalization measures, in addition to the dominance of the Government over domestic resources and the ongoing restrictions on capital movement and exchange rates in some countries.

5. *Activation and development needs*

Certain reforms must be introduced to allow investment funds to play an important role in mobilizing foreign and national savings and directing them towards effective economic investment. These reforms should include the following incentives and actions:

(a) Encouraging further creation of investment funds to mobilize an increased amount of savings and to foster competition between funds. This will lead to better resource allocation and investment performance;

(b) Encouraging the formation of closed-end funds. By nature, those better suit the financial conditions of ESCWA countries because they reduce risks, secure capital and activate securities markets;

(c) Allowing investment funds to enter the domain of direct investment, namely, the electronic sector, in addition to the formation of securities portfolios;

(d) Encouraging small investors to depend on investment funds as an investment tool. This is more secure and less risky;

(e) Training fund employees and exposing them to international norms;

(f) Creating links between capital markets in the ESCWA region, largely through cross listings. This aims to encourage capital exchanges and the formation of new funds;

(g) Establishing specialized research centres to evaluate and predict current and future performance of investment funds;

(h) Implementing the appropriate legislation for investment fund activities in the ESCWA region. If confidence and support are to be ensured, this must be done by the book.

IV. CAPITAL MARKETS****

A. GENERAL CONDITIONS

Over the past few years, ESCWA countries have focused on the process of establishing and developing domestic capital markets. This is as a result of the significant contribution of these markets with regard to mobilizing savings and attracting foreign investments for the purpose of providing additional financial resources to meet national development needs.

The capital markets of the ESCWA region recorded noticeable growth between 1994 and 2000. The aggregate market capitalization of these markets rose by more than 2.3 times, from US$ 72.54 to US$ 165.8 billion. Several factors have supported this growth. In the first case, national economies recorded a relative improvement in their performance. Secondly, many countries have modernized their capital-market legislations and disclosure standards, in addition to opening them to foreign investment. Thirdly, the privatization programmes adopted by some countries have resulted in the further supply of securities in domestic markets. In addition, most listed companies in the capital markets of the ESCWA region achieved high rates of profitability. This increased demand on the shares of these companies. Moreover, many local banks increased their loan and credit facilities, directly or indirectly, for the purpose of trading in securities.

However, the relative deterioration (or drop) in performance which some ESCWA markets recorded over the past few years, has been attributed to a decline in economic growth rates and particularly in Gulf countries, declining oil prices.

When compared with other developing markets, and despite the substantial development which many domestic markets recorded over the past decade, the size of capital markets in the ESCWA region and in the neighbouring countries remains, relatively small. This is particularly evident when the market capitalization of these markets is compared to the GDP of these countries. The ratio in markets that include those in Egypt, Lebanon and Tunisia stood at 27.6, 20.3 and 12.2 per cent respectively in 2000. This clearly reveals the small size of these markets compared to the size of their economies.

These markets can be divided into two groups. The first group includes large markets, namely those of Bahrain, Jordan and Kuwait, where the ratio of market capitalization to GNP exceeds 50 per cent. The second group includes all other markets of the ESCWA region where the ratio is less than 50 per cent.

It is worth mentioning at this point that the market capitalization of the Saudi Stock Market has a substantial share of the overall regional market capitalization. In 1994, Saudi Arabia's ratio was 50 per cent. It dropped to 40 per cent in 2000.

The number of listed companies on domestic capital markets of the ESCWA region rose from 1,089 in 1994, to 1,619 in 2000. This is not high compared to levels prevailing in other developed and advanced countries. The average number of companies listed on the markets of emerging countries is 250. In developed countries this figure amounts to 900 companies. In comparison, the average number of listed companies on markets in the ESCWA region does not exceed 125.

With regard to trading in the capital markets of ESCWA countries, the amount of traded shares increased substantially during the period 1994-2000 by 332.4 per cent to reach US$ 34.9 billion in 2000. At the same time, the number of traded shares grew by 4.5 times to reach 9 million shares in 2000.

Concerning market liquidity in the ESCWA member country, which is considered an important indicator of market activity, the turnover rate (which is a measure of liquidity) decreased between 1994 and 2000 from an average of 4.65 per cent to 3.58 per cent. The market in Egypt is regarded as the most active

**** Figures in this section are largely derived from annex table 6.

market. Its turnover rate reached 6.15 per cent in 2000. It was followed by the market in Saudi Arabia which reached 5.9 per cent in 1999.

With regard to price movements of shares in markets in the ESCWA region, the composite price index of the Arab Monetary Fund increased by 8.4 per cent from 1999 to reach 94.6 points in 2000.

B. CURRENT PROBLEMS

The role played by capital markets in ESCWA member countries with regard to financing productive investment and new private projects in addition to economic development remains limited. The role of banking institutions however, is obviously dominant.

Several factors reflect the limited role of domestic capital markets. These are: (a) the relatively low level of primary issues that belong to newly-launched projects; (b) the relatively small size and number of productive corporates in secondary markets; (c) the fact that financial institutions dominate market activity and capitalization; and (d) the relatively small number of listed joint-stock companies.

These developments can be attributed to two major factors. The first is related to the domestic private sector and the second is related to the securities markets.

In ESCWA countries, the private sector is dominated by family-owned and closed-type companies, a feature which largely restrict the growth of domestic capital markets. Furthermore, listing incentives and advantages are not sufficient to convince businessmen to open their companies to public offerings.

With regard to capital markets themselves, they still suffer from numerous weaknesses. These limit their capabilities with regard to mobilizing savings and in providing medium and long-term funds to meet the demands of the private sector. Impediments are inherent in the following: (a) limited and small-sized markets; (b) inadequate information and disclosure standards; and (c) closed-type structure of companies and inadequate legislative and organizational frameworks. The limited role and small size of capital markets in ESCWA member countries can be attributed to the following three main factors: (a) the availability of few investment instruments, with regard to which trading is only restricted to shares, and there are no growing bond markets in private issues; (b) the small number of listed companies in these markets; and (c) the small number of securities available for trading. This is largely a result of the fact that a large portion of these securities are owned by public entities and important investors who prefer to withhold these securities for long intervals.

In addition, most capital markets in ESCWA member countries remain lacking with regard to international standards. Moreover, the quality of financial reports varies from one market to another, and many companies do not provide detailed data and accounts, even with minimum levels of transparency and disclosure, such as publishing final statements in a simplified manner.

While capital markets in the ESCWA region have witnessed many positive developments in their legislative frameworks over the past few years, some stock exchanges still lack administrative autonomy, because they are affiliated to the public sector.

Furthermore, domestic capital markets still lack necessary independent support. That include clearing, settlement, and depository institutions.

In addition, the majority of these markets lack underwriting and placement institutions. These play a leading role with regard to analysing the financial conditions of companies, underwriting and marketing their issues and providing valuable assistance with privatization activities. There is also the need for credit rating companies and market making companies. These would play a significant role in creating the necessary balance between the supply of, and demand for, securities.

C. DEVELOPMENT PREREQUISITES

To overcome the difficulties and weaknesses inherent in domestic capital markets, the authorities in ESCWA countries must continue efforts geared towards the following:

(a) Enhancement of primary-market activities to strengthen the supply of securities. Central to this is encouraging the creation of venture-capital companies and direct investment funds;

(b) Modernization of existing legislative and organizational frameworks, that govern the issue and subscription in securities and creation of financial intermediation institutions;

(c) Creation and development of new financial instruments. This pertains largely to bonds, but also includes shares;

(d) Adoption of further privatization activities that will enlarge the securities base in domestic markets;

(e) Improvement of accounting and disclosure standards in capital markets, with special focus on the transparency of financial accounts of listed companies;

(f) Rehabilitation and modernization of the infrastructure of domestic capital markets with the aim of introducing electronic systems;

(g) The need to separate the supervisory role from the management role in stock exchanges, and the need to create independent institutions with regard to the management of trading, clearing and settlement activities;

(h) The need to harmonize legislations and practices among domestic capital markets;

(i) Adoption of further measures to link domestic capital markets through cross-listing activities in addition to furthering openness to foreign investors;

(j) Encouragement of the creation of specialized research centres to improve the financial analysis culture and support the process of investment decision-making;

(k) The need to strengthen supervision measures and mechanisms in domestic capital markets, largely in the areas of solvency, trading, liquidity, insider trading, monopolistic activities, and overall market safety.

V. CONCLUSIONS AND POLICY RECOMMENDATIONS

The majority of ESCWA countries have undertaken significant measures to reform and strengthen their financial systems. However, there is still a need to continue these measures in the future.

With regard to conventional banking institutions, domestic monetary and banking authorities must encourage consolidations, mainly between small units, privatize several State-owned banks, enhance accounting and transparency standards in line with international standards. Furthermore, they must accommodate ongoing developments in international banking and finance.

With regard to Islamic banking institutions, domestic authorities must establish appropriate organizational, institutional, legislative and supervisory frameworks to meet the very specific nature of Islamic banking and finance.

Concerning domestic capital markets, domestic authorities must undertake serious measures to modernize market infrastructure. They must focus on creating an enabling environment for expanding the supply and demand bases for financial securities. Central to this is the development of new financial

intermediation institutions that will strengthen the demand side and the introduction of new financial instruments, particularly those linked to bonds, that will support the supply of securities. These must be supported by other significant measures, such as cross-listing of shares among domestic capital markets, adoption of international standards, modernization of organizational, legislative and supervisory frameworks, privatization of State-owned companies and greater openness to regional and international investors.

Furthermore, there is an urgent need to reform the pension fund systems and social security systems in the ESCWA region. Moreover, there is a need to embrace the development of the investment funds and insurance industries, on the basis that they play a significant role with regard to mobilizing domestic savings and attracting foreign investment. Domestic authorities must focus on directing a portion of these domestic and foreign resources to domestic capital markets.

The banking and financial authorities in the ESCWA region must foster coordination between their policies in the monetary, banking and capital-market fields. This is important for the growth and development of the financial sector in the region, particularly if liberalization measures are to continue in line with international directives.

ANNEX[*****]

[*****] Bibliographical and other references have, wherever possible, been verified.

ANNEX TABLE 1. THE BANKING SECTOR IN THE ESCWA REGION
(*US$ millions*)

	Assets		Loans and advances		Customer deposits		Shareholders' equity		Foreign assets		Average growth (for the previous 5 years)		No. of banks
ESCWA member	1999	2000	1999	2000	1999	2000	1999	2000	1999	2000	Assets (%)	Deposits (%)	2000
Bahrain	9 964.1	9 916.1	4 326.7	4 481.1	6 852.4	7 353.4	690.6	773.9	3 411.5	3 383.9	7.40	7.80	49
Egypt	103 541.2	102 130.1	60 109.5	58 803.4	69 889.0	66 394.7	13 394.9	12 863.1	4 742.6	4 619.5	8.00	7.60	42
Iraq	716.4	805.0	126.3	116.3	649.6	710.4	6.9	14.2	..	..	12.80	14.80	22
Jordan	16 292.2	18 188.0	7 082.1	7 506.9	8 296.1	9 139.2	1 857.0	1 940.7	4 101.4	5 227.7	8.84	8.76	24
Kuwait	42 619.9	44 536.1	31 825.1	30 640.3	28 541.9	29 980.3	5 012.2	5 694.2	5 875.4	6 350.0	2.60	1.80	12
Lebanon	40 444.9	44 869.9	28 414.7	30 082.3	29 191.0	31 925.4	2 666.2	2 892.5	5 910.7	8 129.7	20.00	16.30	71
Oman	9 994.0	10 430.5	7 539.4	7 843.9	6 110.5	6 598.4	1 181.3	1 140.3	768.5	849.7	15.10	12.60	20
Palestine	3 857.4	4 594.3	1 005.5	..	3 092.3	4 119.7	245.6	202.7	2 134.9	..	20.30	22.00	10
Qatar	13 090.5	13 803.4	4 674.2	5 119.0	5 454.1	6 611.9	1 480.6	1 739.0	2 119.0	2 785.5	8.00	6.80	15
Saudi Arabia	110 875.3	120 872.5	74 560.5	79 259.5	65 710.3	70 296.5	13 001.9	13 968.0	24 429.1	26 987.7	5.80	5.90	15
Syrian Arab Republic	14 159.7	13 063.7	6 666.6	5 897.4	6 719.7	5 774.9	1 040.0	939.1	6 080.0	6 182.3	5.30	5.70	6
United Arab Emirates	68 370.6	75 203.0	36 101.3	37 703.0	30 385.6	36 911.4	8 701.7	9 338.7	..	..	12.20	3.30	61
Yemen	1 459.9	1 526.0	634.3	596.0	1 354.5	1 249.6	112.0	125.4	544.1	463.8	-10.40	4.20	18
Total	435 386.1	459 938.6	263 066.2	268 049.1	262 247.0	277 065.8	49 390.9	51 631.8	60 117.2	64 979.8	8.92	9.04	365

Source: Data Bank and Union of Arab Banks, Lebanon.

Note: Two dots (..) indicate that data are not available or are not separately reported.

ANNEX TABLE 2. ISLAMIC FINANCIAL INSTITUTIONS IN THE ESCWA REGION AND WORLDWIDE

Region	Managed funds (US$ million)	Percentage	No. of institutions	Percentage
ESCWA	23 264.6	84.4	32	37.6
GCC countries	17 834.5	64.7	19	22.4
Others	5 430.1	19.7	13	15.3
South and East Asia	2 052.7	8.2	36	42.4
Africa	334.5	1.2	9	10.6
Europe and America	1 723.0	6.2	8	9.4
Total	27 374.8	100	85	100

Source: The Islamic Financial Institutions and Banks Directory, issued by the International Association of Islamic Banks, Saudi Arabia.

ANNEX TABLE 3. BASIC FINANCIAL INDICATORS FOR ISLAMIC BANKS VIS-À-VIS TRADITIONAL BANKS IN THE ESCWA REGION AND WORLDWIDE

Indicator	Top 10 in ESCWA	Top 10 in Asia	Top 10 in the world
Average capital to assets	7.6	4.2	4.8
Return on capital	16.3	17.2	16.1
Return on assets	1.5	1.1	0.9

Source: The Islamic Financial Institutions and Banks Directory, and *The Banker*, July 1997.

ANNEX TABLE 4. INSURANCE MARKETS IN SELECTED ESCWA COUNTRIES

Country	Insurance premiums (US$ million)[a/]	No. of insurance companies		
		Total	Foreign	National
Bahrain	120	18	10	8
Egypt	550	11	..	..
Jordan	100	27	..	..
Kuwait	210	16	11	5
Lebanon	500	82	11	71
Oman	140	16	10	6
Qatar	170	8	4	4
Saudi Arabia	770	69	..	69
United Arab Emirates	690	47	27	20

Source: General Arab Insurance Federation.

Note: Two dots (..) indicate that data are not available or are not separately reported.

a/ Average of the last three years.

ANNEX TABLE 5. MAIN FINANCIAL INDICATORS OF INVESTMENT FUNDS IN SOME ESCWA MEMBER COUNTRIES

Country	Ratio of capital to GDP (percentage)	Ratio of capital to market capitalization (percentage)	Ratio of capital to national savings (percentage)	Total fund capital (US$ million) (percentage)
Egypt	1.36	3.4	1.6	1 007.7
Jordan	0.02	0.03	8	14.8
Kuwait	0.8	1.02	-	198.4
Lebanon	0.3	2.9	-	0.04
Saudi Arabia	6.5	13.6	-	8 344

Source: Data Bank and Union of Arab Banks, Lebanon.

Note: A hyphen (-) indicates that the amount is not applicable.

ANNEX TABLE 6. MAIN INDICATORS OF CAPITAL MARKETS IN THE ESCWA MEMBERS

ESCWA member	Market capitalization (US$ million)		Amount of traded shares (US$ million)		No. of traded shares (million)		No. of listed companies (million)		Turnover rate (percentage)		AMF composite price index	
	2000	1999	2000	1999	2000	1999	2000	1999	2000	1999	2000	1999
Bahrain	6 624	7 161	245	444	442	534	41	41	1.19	3.84	108.5	122.39
Egypt	30 791	33 039	11 799	9 726	953	846	1 071	1 033	6.15	9.45	54.07	99.67
Iraq	..	..	..	..	..	..	..	..	..	..	..	..
Jordan	4 943	5 835	406	549	178	264	163	152	1.59	1.56	94.35	116.84
Kuwait	19 848	19.599	4 208	6 001	6 758	9 496	86	85	3.30	3.84	101.97	95.17
Lebanon	1 583	1 921	118	91	20	17	13	13	4.07	0.49	49.14	61.24
Oman	3 518	4 303	551	714	144	138	131	140	2.87	3.39	88.76	111.66
Palestine	593	529	63.6	25.1	15.6	10	20	20	..	..	..	..
Qatar	3 700	2 600	229.6	67.9	2.7	1.2	19	19	..	..	131.7	100
Saudi Arabia	67 166	60 953	17 313	15 087	552	528	75	72	5.91	9.96	125.44	119.48
Syrian Arab Republic	..	..	..	..	..	..	..	..	..	..	..	..
United Arab Emirates	27 000	21 000	..	..	..	..	..	..	..	..	..	..
Yemen	..	..	..	..	..	..	..	..	..	..	..	..
Total	165 766	156 940	34 933.2	32 705.1	9 065.3	11 834.2	1 619	1 575	..	..	..	..

Source: Arab Monetary Fund, United Arab Emirates and other sources.

Note: Two dots (..) indicate that data are not available or are not separately reported.