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Souk Al-Manakh Crisis

A slice of history

The Kuwait stock market has surprised many; first in the early 1970s and later in the mid-1980s.

In the early 1950s, Kuwait started emerging as a destination of choice. Those were golden years, when the oil business boomed, major public works programs began, and the surrounding atmosphere was liberal. By 1952, when His Highness Sheikh Abdullah III Al-Salim Al-Sabah ruled Kuwait, the country had become the largest exporter of oil. In the same year, the first Kuwaiti Shareholding Company (KSC) was incorporated and so was the iconic National Bank of Kuwait.

At that time, 40 public companies were listed on the Kuwait Stock Exchange (KSE), popularly known as the Official Exchange. There was a second exchange, an unofficial one, known as Souk Al-Manakh. Up to 46 unlisted Kuwaiti Shareholding Companies (KSCCs), and 38 non-Kuwaiti companies incorporated in other Gulf countries traded on the more famous Souk Al-Manakh.

The companies listed on the Official Exchange were established under the Commercial Law of Kuwait and regulated by the Committee on Securities, appointed by the Ministry of Commerce. The trading of securities on the Souk Al-Manakh, which accounted for 80% of the volume traded, was out of the regulatory reach of the committee.

The Gulf's tragic story is that of a crisis that engulfed the Souk Al-Manakh that had serious ramifications for Kuwait.

It began in the year 1973 when Arab oil embargo was announced, leading to a sharp rise in crude oil price. In the six months ending March 1974, oil price escalated by 400%, from USD 3 to USD 12 a barrel. This surge brought unprecedented cash income to Kuwait, mainly because the country was one of the world's top oil producers. With a production capacity of about 2 million barrels per day, it was generating anywhere between USD 6 million to USD 24 million per day in oil revenue (USD 2.2 billion to USD 8.7 billion annually).

To the Kuwaitis, this was windfall gain. The government used the money productively by investing it in infrastructure. This move changed the landscape of the economy and helped create enormous wealth. Therein began the first signs of trouble. World-over, history records that when people have excessive disposable income, such income somehow finds a way to the equity market. That's what happened in Kuwait as well.

The KSE witnessed a spurt of speculative financing opportunities, which led to a massive rise in Kuwaiti stock prices and, in turn, resulted in a jump in demand for equities. The rally injected an overdose of optimism, and investors began to pay a premium for newly issued shares. The rally was not surprising given that world history is replete with documented examples of how crowds had been swayed the wrong way by sentiments and emotions. History records the South Sea Company bubble of 1711-20, the Mississippi Company bubble of 1719-20 and the much-fancied Dutch tulip mania of the 17th century. One would have thought that people would have learned from those examples. In late 1976, the Kuwait stock market witnessed a significant drop, as the annual index declined 18.7%, from 235.2 to 191.8, and trading volume fell by a whopping 66%.

Government intervention and Souk Al-Manakh

The Kuwaiti Government intervened to take control of the situation. It began by suspending the incorporation of new companies and restraining the existing companies from raising further equity. There was a feeling that excessive Initial Public Offerings (IPOs) were affecting domestic liquidity, leading to a market crash. The government also bailed out the investors by purchasing the shares at a floor price, which resulted in massive losses.

While the Kuwaiti Government bought shares worth approximately KD 150million between Jan 1977 and April 1978, the banks were badly hit after lending to the stock dealers. After that, the Central Bank of Kuwait set up a facility to purchase the bad debts incurred by banks. The market recovered by the end of 1978, with both the official and unofficial markets remaining stable until the beginning of 1981.

During this time, the government banned incorporation of Kuwaiti Shareholding Companies between 1977 and 1979. This made it difficult for the investors to indulge in speculative trading on the Official Exchange. In Sep 1980, Saddam Hussein's Iraq invaded Ayatollah Khomeini's Iran and the war unsurprisingly led to a rally in crude oil price. By 1981, the price had touched USD 40 a barrel.

The tide changed.

Kuwaiti investors who had a huge stock of petrodollars, were seeking investment opportunities that could generate substantial returns.

The US and European markets were facing downturns at that time, and the official Kuwait Stock Exchange was stringently regulated which made investors look for an attractive alternative forum.

Motivated by the Kuwait Government's bailout of investors during the 1977 crisis, investors began ignoring the risks associated with speculative investments and started investing in the securities listed in this unofficial market. So much was the positive sentiment that Souk Al-Manakh, was ranked third by market capitalization, behind the New York Stock Exchange (NYSE) and the Japanese Stock Exchange (JSE)!

The ban imposed in mid-1977 on the incorporation of KSCs was removed in mid-1979, and this led to a rapid rise in the formation of KSCCs and Gulf companies. According to the Central Bank of Kuwait (CBK), 45 new Gulf businesses and 120 KSCCs were incorporated between 1979 and 1982. These incorporated Gulf companies were Kuwaiti-owned but established in the other Gulf States. Several of them were offshore companies created for a speculative purpose, which meant they were outside the purview of Kuwait's regulations.

During the years of boom, the government reduced the maximum subscription amount, which led to small investors taking up the opportunity to incorporate firms and benefit from the boom. In 1982, traded shares of Al-Manakh's Gulf companies amounted to 3.5 billion, compared with only 837 million on the KSE. Approximately 2 billion shares got traded during the three months between June and August 1982. The market value of the Gulf companies reached KD 2 billion in 1982, as against a face value of only KD 648 million. Around that time, there were about 6,000 individuals and institutional investors trading on the Al-Manakh market, and it was widespread for a new issue to double in value, within a few weeks of its IPO.

The markets were destined to collapse, and it is exactly what happened.

Futures trading triggers the crisis

'Futures trading' was at the heart of the Al-Manakh crisis. Before 1977, 'futures' trading was informal. The traders who were accustomed to dealing in commodities and real estate, found new opportunities in shares.

Here's how it worked.

The seller sells at market price if the buyer pays for the share immediately in cash. This amount is called the spot price.

If the buyer makes the payment using a post-dated cheque (PDC), the seller adds a premium to the spot price. On an average, the premium charged was 60% of the spot price. Sometimes, the premium was as high as 300%, and investors were ready to pay!

Once the PDC was given, the contract was considered closed. Such closure technically locked the price of the stock and protected the buyer from a loss if share prices moved upward, and the seller from a loss if the price moved downward. During the boom, the holders of PDC availed finance from banks against these instruments, and the proceeds were used to purchase further shares.

A Stock Market Committee was established in 1976 to regulate the futures market after the 1977 crisis struck. The Committee laid down specific regulatory requirements for carrying out futures trade. One, all futures traded were to be registered with the Securities Administration. Two, the maximum maturity period allowed would be 12 months. Three, a seller deposit equivalent to 10% of the purchase value or the difference between the spot and futures prices whichever is greater had to be made. And four, the seller retained the title of the shares during the contract period unless the buyer made the total payment.

The new rules turned out to be ineffective without a clearing intermediary, as it meant that the trade was not guaranteed for performance. If either of the two parties to the contract defaulted, the other would be held accountable.

Also, under the Kuwait Commercial Law, a cheque was considered a cash instrument payable upon presentation, and so the investors continued treating the sale as a cash transaction with deferred payments. The future date of the cheque was not a significant concern, as it was overdue beyond a month. For example, the payment for the shares could be deferred for a maximum of 12 months, and the PDCs were valid for encashment up to one month, after the deferred period of 12 months. Otherwise, the cheque was accepted as cash, enforceable by law within the stipulated time.

After the law got amended in 1981, the contract had to be signed by a broker and had to be registered with the Exchange. The agents ensured that the buyer delivered the cheque, and the seller gave the share. The process of registering the contract gave the buyers and sellers the leverage of being protected by the law and led to a significant increase in futures trading in the bullish stock market. However, this also resulted in the dealer's exposure to large, open and unbalanced positions.

There was no intermediary to monitor the 10% deposit requirement during the contract period and to ensure transfer of the title at the end of the duration of the contract. Consequently, the title was transferred at the time of sale itself.

The stock exchange's role continued to be limited to registering the contract, and it had no role in regulating the clearing mechanism. The minimal regulation implemented at that time applied to the trades related to official stock exchange. The business in the rampant parallel stock market continued to be completely unregulated. And thus, the bubble formed.

Bubble burst

The Al-Manakh market index plunged from 240 in March 1982 to 110 in August; a greater than 50% crash in six months flat, leading to an annualized loss of 100%. By August, one of the largest of the 18 major trading companies defaulted on its debts and the Al-Manakh bubble finally burst. Selling shares became difficult as the volume of trade collapsed from 602 million shares in the previous month to 72 million. Yes, there were large sellers, but very few buyers. Though the KSE was initially resilient to the collapse of the Al-Manakh market and declined only by 6.5% between March 1982 and August 1982, the all-share index fell 53% from 509.4 at the end of 1982 to 238.6 in 1984.

Clearly, the contagion effect was at work.

The initial resilience of the KSE was due to the share purchase program of the Government. The securities that traded on Al-Manakh market lost 60 to 90 percent of their peak values. In September 1982, the estimate of the outstanding post-dated cheques amounted to USD 94billion, out of which USD 78billion (83%) were related to transactions in Gulf and KSCC shares. Almost 95% of the total outstanding debts involved only 18 traders, and the bankruptcies during the initial days reached 350.

The collapse of the Al-Manakh market affected a large segment of the Kuwaiti population and triggered a nationwide crisis with regional and international effects. The banking sector had expanded domestic credit issuance in 1982, at almost twice the rate compared to the previous year. And the dealers in the Al-Manakh market issued cheques against the Kuwaiti banks. Since there was no clearing intermediary, these cheques kept accumulating. The challenges with an intermediary offering this service were: one, the cheques originated from transactions that were illegal; two, these were against companies incorporated outside the jurisdiction of Kuwait; and three, the cheques were not issued under the supervision of a regulatory body.

Government response

To limit the fallout of the Al-Manakh calamity and avoid a liquidity crisis, the Kuwaiti Government took a few measures:

The International Finance Advisors (IFA) took over as a clearing agent, with the objective of collecting, matching, verifying, and systematizing the financial accounts of individuals and brokers in 1981. A trust fund of USD 1.7 billion was set up to compensate investors for losses less than USD 1.7million.

An Arbitration Panel finalized the settlements voluntarily reached between traders and effect settlements.

The Government established the Corporation for the Settlement of Company Forward Share Transactions in April 1983, to design and implement policies, and bring an end to the crisis.

A task force headed by the Minister of Finance was set up by the Government to resolve the Al-Manakh crisis. Initially, the government tried to sort out the mess by legally mandating the traders to fulfil their promises and pay their debt in full to all creditors. However, several traders were insolvent and couldn't meet their debt obligations. Furthermore, it was ineffective, as it failed to restore the confidence in the economy and business sentiment. Also, it was impossible to trace the right positions of the traders, due to heavy inter-linkages.

An example of six entangled traders:

Payables from traders

Payables from traders	Trader 1	Trader 2	Trader 3	Trader 4	Trader 5	Trader 6	Total payables
Trader 1	0	62	98	28	8	22	218
Trader 2	84	0	36	85	19	10	234
Trader 3	43	50	0	49	24	28	194
Trader 4	97	50	10	0	52	3	212
Trader 5	37	93	66	53	0	64	313
Trader 6	57	57	41	80	80	0	315
Total Receivables	**318**	**312**	**251**	**295**	**183**	**127**	**1,486**

Source: The Institute for Operations Research and the Management Sciences

On April 20, 1983, the Ministry of Finance established the Settlement Organization for Futures Transactions to handle settlements, liquidation, and bankruptcy procedures. The organization was also given the authority to settle claims amicably and authorized to issue negotiable and transferable bonds against assets, which assisted the payments process for other debtors.

The three kinds of assets held by the debtors were cash and other liquid assets, real estate and KSC shares, and the Gulf and KSCC shares. The organization issued three kinds of bonds depending on the type of assets held by debtors. As and when the assets were liquidated under the government purchase or restructuring program, payments were made to the creditors.

In August 1983 a new law was passed incorporating a number of significant changes. This included a mandate that all debt related to forward shares would mature on the date of effectiveness of the law. The maximum interest rate or premium would be 25 percent. Dealers could insist on clearing claims against other traders.

The first two changes affected the financial position of traders, depending on the maturity and premium profiles of their assets and liabilities. After implementation of the new law, some dealers with surplus accounts changed to a deficit. Moreover, the debtors who made settlements to their creditors under the old law were left with receivables with reduced value.

Response through stock market reform

The Kuwait Stock Exchange was set up as an independent authority chaired by the Minister of Commerce in August 1984. It was bestowed with the responsibility of setting up and supervising trading procedures, registering brokers and developing the market. The Exchange was the foundation for market regulations and legal structure of clearing and settlement.

Two committees were established with full authority to rule on disputes and take disciplinary actions, such as warnings, calling in guarantees, terminating trading in stocks, and withdrawing membership. Both Kuwaiti and foreign shares and bonds and other financial instruments, licensed by the exchange committee, could be traded. All companies were required to provide regular financial data to the exchange.

In 1986, the KSE authorities appointed the Kuwait Clearing Company (KCC) to act as the clearing and settlement agent for all security transactions at the KSE. In the same year, in consultation with the KSE, KCC formulated and implemented the necessary mechanisms and procedures for clearing and settlement processes.

By 1986, the worst had subsided to an extent.

However, the crisis had strong repercussions in the market. Many had lost their shirt. It marked the failure of well-known players in the market, while others took the bailout as a personal stigma.