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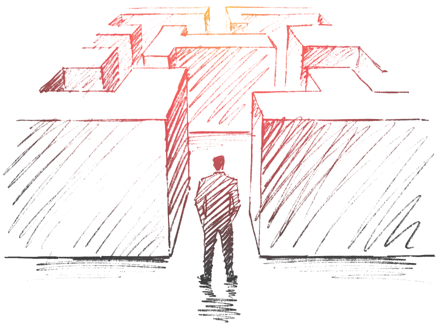
Global Financial Crisis, 2008



The year 2008 created a divide in global finance, classifying it into two periods: 'pre-2008' and 'post-2008', just as world Economics is classified into pre-1929 and post-1929. The crisis was a culmination of a series of events that started in the US housing market, spread to the banking sector, and finally made its way to the unknown world of derivatives. It came to be called the sub-prime crisis.

In 2005, many people invested in the US market. Unfortunately, the market went through a prolonged period of low-interest rates. To earn reasonable returns, the US banks began reckless lending to borrowers with poor credit scores, aka sub-prime customers, thereby increasing their default risk.

To build protection, the banks went for financial engineering. They asked investment companies to pool the sub-prime mortgages to create investment products and sold them to retail investors looking for alternative assets. Under the omnibus name of Collateralized Debt Obligations (CDOs), these were ticking time bombs in the hands of those who bought them.

Credit default swaps

One of the front-running derivative instruments, under the umbrella- term CDO, was Credit Default Swaps (CDS). Introduced by JP Morgan Chase in the 1990s, it helped banks insure against loan defaults. These instruments were outside the balance sheet and, as subsequent events showed, in many cases, they were riskier than the liabilities disclosed in the balance sheet!

This is how it worked.

The risky loans were pooled, securitized, and sold to various investors, including banks and retail customers, at a good discount. Thus, a loan portfolio of $10,000 maturing in one year was sold at $9000 to multiple investors by breaking it into instruments of $100. In fact, so attractive were the rates that some investors borrowed from banks to invest in these CDOs, thus increasing their risk manifold!

Worse still, rating agencies rated these instruments as 'investment grade!' The results would have been different had these CDOs been honoured on due dates. Ironically, most of the AAA-rated CDOs defaulted, leading to a collapse of the investment banking powerhouse, Lehmann Brothers, and the near bankruptcy of JP Morgan and Citi Group.

For once, USA ducked its moniker of being the land of the market economy, when its government intervened and bailed out significant players in the banking industry, to save the country from marching into a 1930s-like depression. But it was too late. By then, people had lost a bulk of their savings. The bailout helped institutions, not individuals.

America's regulatory failure

Lehman Brothers had the reputation of being an institution that was massive enough to withstand failure.

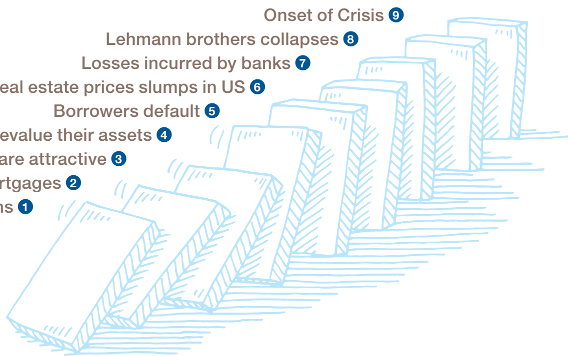
Yet, Lehman Brothers had collapsed. Letting it happen was a regulatory catastrophe as it unleashed waves of negative sentiment. This led investors to back out and banks choose not to lend, leading to a halt in economic activity leading to a halt in economic activity. The Fed not only allowed Lehmann to fall, but it was also guilty of two other things: one, retaining a low-interest rate regime for extended periods of time and, two, not controlling the housing bubble.

The crisis slowed down global growth. For two years, the USA and Europe stared at stagflation. Surprisingly, emerging markets, such as China and India, were more resilient, their prudent central banks having built safety nets. The long-standing Governor of the People's Bank of China, Zhou Xiaochuan, and the two successive heads of the Reserve Bank of India, Y V Reddy, and D Subbarao had ensured that their respective countries came unscathed.

Some investors had invested in the market indices of US (Dow Jones), UK (FTSE), Germany (DAX), Japan (Nikkei), and MSCI-EM and saw their portfolio fall like ninepins. It was an object lesson that would be impossible to forget. In 2008, such a collection lost 45% on average. Emerging Markets, which fell by 53% that year, was particularly disappointing. Lack of investments, reversal of capital flows and a slowdown in global growth were touted as the causes of the fall.

And to top it all off, the CDOs they had bought crashed.

Complex chain of debt crisis



Impact on GCC economy

Players had been sucked into the vortex of the financial crisis that had created shock waves across the world affecting trade balances, financial channels and stock markets in many countries, including the GCC. In GCC, capital inflows reversed that year leading to a liquidity crunch. Investments in CDO had crumbled, and the Middle East markets had gone bankrupt.

The good news was that the sub-prime crisis didn't affect the GCC directly because the banks had limited exposure to sub-prime assets, and this insulated the region from the developments in the global financial markets. However, the crisis was felt indirectly through contraction of the world economy, the decline in oil prices, and fall in real estate prices.

Investor confidence deteriorated. As GCC countries peg their currency to the dollar, interest rates move in tandem with the Fed's policy. Before the crisis, the real annual average credit grew by 23%, mostly in Qatar and the UAE. Such expansion fuelled real estate lending and created a real estate boom.

Those who had bought properties had been positive about the outcome.

But, once the financial crisis took centre-stage, the capital received in 2007 and early 2008 started to reverse, tightening liquidity and affecting investor confidence.

The next shock came in 2009 when oil price made a sharp downturn. Export revenues crashed. The crisis was accentuated by the fact that GCC countries depend heavily on imports. The combined effect of 'declining export earnings' and 'higher dependence on imports' increased the magnitude of the disaster.

Gulf nations saw their GDP tumble with Kuwait and UAE experiencing negative real GDP growth. Other economies too had their GDP growth slashed. Kuwait, Qatar, and Saudi Arabia had the mortification of watching their current account balance decline, as well.

Impact on stock market

These had their reverberations in the stock market.

The equity markets, for the most part, followed the global trend. Kuwait, UAE, and Bahrain, which allow Foreign Institutional Investments (FIIs), experienced greater shocks than Saudi Arabia, which does not permit FII participation. Asset prices tumbled. CDS spreads widened, indicating that investors had lost confidence in sovereign debts.

The markets collapsed. Though the indices recovered in 2009, it took five years to get past their pre-crisis levels. It was far too long a time for many who had put vast sums of money into it, to wait.

Many thought that, by investing across countries, their portfolio would be well diversified. In the end, it ended up being naive. Same factors prevailed across GCC leading to identical falls in other countries as well.

In Saudi Arabia, the bears had a field day. The Tadawul Index lost 57% in 2008, and every sector in the index declined. Insurance tumbled 74%, followed by petrochemicals, which fell 67%. Retail and Agriculture segments were the least hit, despite registering 32% and 33% losses respectively.

Among stocks, Saudi Basic Industries (SABIC), the largest petrochemical producer in the Middle East, crashed 69%. Worse still, there was prolonged negative outlook on Saudi telecom stocks.

There was wide-scale investment in all these. Suddenly, stocks and shares now read shocks and stares.

In UAE the story was the same. The Dubai General Index toppled by 72%, and real estate stocks bore the brunt of the fall. It dropped off the cliff in 2008, by 83%. Other shares too fell like a pack of cards. Services, Telecom, and Financial services rolled down the hill by 70%. Insurance declined 28%. Energy stocks registered a 70% collapse.

Emaar Properties and DP World, UAE's two blue-chip real estate stocks, lost 85% and 68%, respectively. First Gulf Bank and National Bank of Abu Dhabi went down by 55% and 53% respectively. They all recovered the following year, but by then the damage was done.

Qatar was the least affected. Its general index declined by 28%, while telecom and insurance indices dropped 43% and 32%, respectively.

Government's measures, such as bank asset purchase and capital injections helped Qatari banks recover at a faster pace, in-turn assisting the stock markets to improve.

Annual returns of blue chip stocks (UAE, 2007-2010)

	2007	2008	2009	2010
Etisalat	49.6%	-48.3%	32.9%	8.0%
First Gulf Bank	83.5%	-54.7%	75.4%	13.7%
DP World	N/A	-68.0%	10.3%	46.5%
National Bank of Abu Dhabi	42.2%	-53.2%	54.0%	4.2%
Emaar	22.1%	-84.8%	70.8%	-8.0%

Source: Reuters

Annual returns of blue chip stocks (Saudi Arabia, 2007-2010)

	2007	2008	2009	2010
SABIC	88.6%	-68.9%	60.2%	27.0%
Saudi Telecom	0.9%	-41.4%	-10.2%	-3.4%
Al-Rajhi Bank	35.0%	-52.2%	27.2%	16.5%
Saudi Electric	13.2%	-38.3%	21.6%	24.4%

Source: Reuters

Annual returns of blue chip stocks (Qatar, 2007-2010)

	2007	2008	2009	2010
Qatar National Bank	18.2%	-2.1%	9.0%	62.2%
Industries Qatar	82.2%	-28.1%	13.5%	20.7%
Ooredoo	NA	-43.2%	31.6%	23.4%
Masraf	23.0%	-52.2%	21.8%	42.5%

Source: Reuters

Impact on corporates

Among corporates, the crisis affected the earnings growth.

Non-performing loans in GCC banks increased significantly. There were loans to Saudi Arabian conglomerates, which led to higher NPLs. The Dubai World debt restructuring added to the crisis.

Earnings in GCC declined by 41% in 2008, due to declining sales in real estate. This decrease led to lower growth in the banking industry that constituted 80% of the regional earnings. Financial service industry's revenues dipped by 204% Y-o-Y in 2008. Higher provisioning made by GCC corporates in 2009, led to lower earnings despite stronger revenue growth.

Bahrain and Kuwait were the worst affected, as income from commodities dwindled. Compared to 2007, Kuwait's revenues declined by 94% in 2008. Five investment companies in Kuwait defaulted between 2008 and 2010.

Saudi Arabia's financial services sector's earnings declined 44% YoY in 2008, due to losses incurred on their investments in global equities and commodities.

UAE suffered lower earnings in 2009 and 2010, with the fallout of Dubai World crisis and poor performance of real estate sector. In 2010, revenues of real estate industry in UAE declined unimaginably from USD 282 MN profit in 2009 to a loss of USD 3,773 MN in 2010). Projects were left halfway, and promoters fled. Overnight, construction sites were left deserted.

Earnings in GCC, 2006-2010

	2006	2007	2008	2009	2010
KSA	21,251.9	22,834.7	12,791.0	16,221.0	22,185.9
UAE	9,756.1	13,237.4	12,683.7	8,626.0	4,880.5
Kuwait	7,907.8	13,737.1	860.7	1,503.5	5,507.8
Qatar	3,840.0	5,528.9	7,459.8	9,094.1	8,132.8
Oman	1,032.1	1,509.1	1,400.0	1,457.4	1,649.5
Bahrain	1,897.7	2,630.7	(36.7)	(222.0)	677.8

Source: Reuters

Impact on real estate

In 2002, Dubai allowed non-GCC nationals to own property on a freehold basis. This caused massive interest from abroad. Several projects were launched, but the implementation of these was slower than anticipated. There was shortage of finance and the famed project management skill of Dubai failed. It caused severe shortages in the market and increased the rentals as well as sale prices of the apartments. During 2003-08, Dubai was a 'Punter's Heaven.' Many bought when prices were skyrocketing. They invested in haste and repented in leisure.

When the financial crisis swept through Dubai, the impact on the real estate market was huge: job losses, defaults, and distress sales. It also temporarily stopped the speculation-driven increase in sale prices and rentals. And then slowly rents started falling, at least until 2011. Apartment prices continued crashing post the crisis. The Business Bay area's sale prices dropped, by as much as 65%, between 2008 and 2009. It fell from AED 2700 to AED 950 per square feet. Similar trends were witnessed in Dubai Marina and Downtown Dubai.

Average values (AED/sq)

District	2007	2008	2009	08/09 Change
DIFC	3,200	4,600	2,200	-52%
Business Bay	1,500	2,700	950	-65%
Burj Dubai Downtown	3,500	5,000	2,150	-57%
Jumeirah Lake Towers	1,200	1,800	720	-60%

Source: JLL

Abu Dhabi had an increase in prices of real estate during 2003-08 that peaked in 2008. Increased demand from expats prompted the launch of numerous projects. Again failure to deliver projects on time caused an unprecedented increase in rents and selling prices. Many projects, sold at rapidly increasing prices, came to a standstill.

The global financial crisis led to a correction in prices, which dropped 50% from its market peak in Q4 2008 to a market low by the end of 2011. Rental rates fell by nearly 60% since the peak in 2008.

Rentals in Abu Dhabi dropped by 44%, and the decline continued till 2011. Apartment sale prices also saw a huge decrease in sale price, post the crisis. Marina Square area's sale prices fell by 48%. Similar trends were witnessed in Al Muneera and Sun & Sky Towers. The average price for residential units in Abu Dhabi stood at USD 545 per sq. ft., at the end of Q2 2008. However, it declined to reach USD 340 per sq. ft., at the end of Q2 2010.

Government-related entities, such as Dubai World, engaged in real estate activities with other people's money. In no time, Dubai World accumulated USD 59bn in debt, as it had borrowed heavily to build showcase projects, such as a giant island shaped like a palm tree that attracted investments from many global celebrities. When the boom burst in 2009, Dubai was stuck with houses that did not have any investors.

When the government requested that Dubai World be allowed to skip six months of interest payments, it spooked markets globally and sparked fears of a crisis in real estate. Those fears were put to rest, as foreign banks' exposure to

UAE was a mere $130 billion. This amount was negligible, as its only 0.4% of the foreign banks' total cross-border exposure. It made investors wary of Dubai's status as a global financial hub and rattled the confidence of those in highly leveraged economies, like Greece, Britain, Spain, and Ireland.

Investors feared a sovereign default by Dubai World, which could lead to subsequent crashes in Dubai and Abu Dhabi equity markets. In a bid to rescue its neighbour, Abu Dhabi stepped in with a $20Bn loan. The debt deal finalized by Dubai World in 2010 with its lenders, helped improve the prevailing market situation.

Other GCC real estate markets were no better. Kuwait and Saudi Arabia's markets slowed down after 2008. Kuwait witnessed huge volatility. Prices in Riyadh markets declined in 2008 and remained stagnant until 2010. Apartment prices, rentals, both office and residential, started slowing down.

How the GCC fought back

The economy started showing signs of resilience.

The government adopted various measures, such as fiscal stimulus, deposit guarantees, liquidity support, capital injections, bank asset purchases, stock market purchases and monetary easing to fight back.

Different countries responded differently, although mostly the measures were the same.

Saudi Arabia provided fiscal stimulus to increase credit to non-oil sectors through state-owned credit institutions. This stimulus helped mitigate the risk of slow down, due to lower credit from banking institutions.

To encourage people to save their money in banks, Kuwait, Saudi Arabia, and UAE introduced deposit guarantees. Investors were insured of their deposits in case of default. The governments increased their short-term deposits with the banks and provided long-term support and liquidity adjustments through their respective central banks. All this helped banks overcome a tight money squeeze of the kind faced by US and European banks.

Capital adequacy ratios in GCC banks

	2007	2008	2009
Kuwait	19.3	15.6	16.7
Qatar	N/A	N/A	15
KSA	20.7	16	16.5
UAE	16.6	13.3	19.5

Source: IMF

In 2008, in the wake of the crisis, the GCC banks' capital adequacy ratios suffered. The government injected capital to provide stimulus to weak banks and to improve the availability of capital.

The Qatar government purchased 20% of all banks and real estate companies' assets, investing more than USD 30bn in the bargain. This purchase helped the banking sector stay resilient during 2008-10.

That was very much like Kuwait, which adopted a somewhat similar strategy. The Kuwait Investment Authority (KIA) launched a fund worth KD 1.5Bn (USD 4.95Bn) for investments in the domestic stock market. However, its impact on the market was minimal, as only 1/3rd (500Mn) of the planned investments were implemented.

All GCC central banks, except Qatar, lowered interest rates and reduced capital requirements to move from the tight credit approach they had followed before the crisis. It was a much-required move to tackle the effects of a credit crunch in GCC economies, as banks suddenly became risk-averse after defaults in Kuwait and Saudi Arabia.

These were a few of the strategies to recover from the global financial meltdown.

Lessons learnt from the crisis

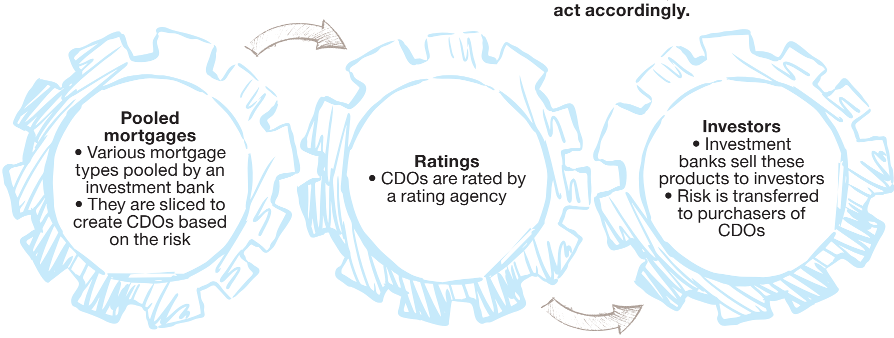
1 Supervision and maintenance of standards in banking and financial systems by the central banks would be a requisite, to prevent a similar crisis in future.

2 Very few analysts foresaw the crisis before its onset. Even international agencies did not predict the occurrences of such crisis in 2006 and 2007 when the markets and economies were thriving.

3 Investors are more risk averse than expected. Institutional, as well as individual investors, withdrew their investments even from fixed income assets.

4 Compliance and regulatory mechanisms must be strengthened. Regulators could be consulted before new products enter the market. They must look deep into the implications of changes in the market, and act accordingly.

5 Lenders must be incentivized to lend to high-quality borrowers after proper due diligence. The crisis led to increase in non-performing loans in GCC banks.



Source: Economists, Marmore Analysis